FEDERAL RESERVE BANK OF PHILADELPHIA

SRC INSIGHTS

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SVP Observations on…

The Acceleration of Merger and Acquisition Activity

by Michael E. Collins

The pace of mergers and acquisitions in the financial services industry in 1997 and into 1998 continues unabated. In 1997, over $95 billion in bank and thrift acquisition deals were announced, up from $45.5 billion in 1996, and mergers absorbed 599 banks. On average, banks paid more than twice book value and 18 times earnings on acquisitions.

In studying these mergers, it is clear that two main themes have emerged—consolidation within the industry and the convergence of financial services. These activities create new alliances and risk management challenges, raising questions on the proper balance between market discipline and government regulation.

Within the industry, mega-mergers have become more evident. In 1997, we saw the announced merger of First Union and CoreStates, which, at the time, was the largest banking merger in industry history. In 1998, we have seen more large bank consolidation with the announced mergers of Bank of America and NationsBank, and Banc One and First Chicago. Banks were active in nonbank mergers in 1997, as many acquired brokerage or insurance firms. Nonbanks also aggressively entered the banking business, often through a denovo thrift charter.

It is obvious from the scale of these deals that one clear factor driving merger activity is size. However, the changing demographics of the industry are also spurring merger activity. The industry is now moving from markets bounded by legislation and regulation to looser boundaries within which business sectors can converge. Organizations themselves have evolved from looking inward for solutions to an expanded use of alliances and partnerships to grow markets and deliver products. We are also seeing a shift from using regulation to serve competitive ends to relying on change management, market forces, and innovation to optimize efficiencies. In this environment, companies are seeking to create new wealth either by better execution or by changing the rules of the game.

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The Year 2000 — Time Marches On

by John V. Mendell, Team Manager

Much has transpired since the initial FFIEC statement on the subject of Year 2000 was issued in June 1996. Seven additional interagency statements have been issued during the past 12 months, providing guidance on such topics as testing, customer awareness, and contingency planning. In addition, on March 4, 1998 the Federal Reserve System issued SR 98-3 *The Federal Reserve's Intensified Year 2000 Efforts.*

By now, the message to the industry should be loud and clear. Banking regulators consider Y2K to represent a serious potential threat to the banking industry, and organizations must take appropriate action to mitigate the risks.

A Two-Phase Process

In order to assess the industry's and individual organization's Y2K preparedness, the federal regulatory agencies established a two-phase supervisory process. All FFIEC-regulated banking organizations and data processing service providers were subject to a "Phase I" Y2K supervisory review over the past year. These reviews were to be completed by June 30, 1998.

A second round of reviews —Phase II—will commence on July 1, 1998, with completion scheduled for March 31, 1999. During Phase II, bank supervisors will concentrate on reviewing the adequacy of testing and contingency plans. Because of the more technical nature of Phase II, throughout this phase this Reserve Bank will use examiners who are information systems specialists. As outlined in FFIEC's *Guidance Concerning Testing for Year 2000 Readiness,* the degree and nature of testing required at each institution will depend upon the complexity of the operations involved, the organization's level of Y2K risk, and the degree of reliance on third-party processors.

In addition to implementing Phase II, our Reserve Bank has established a policy of conducting quarterly Y2K updates for all state member banks and selected holding companies. We anticipate that these updates will require a brief 1 or 2 day on-site presence. However, we plan to continue to rely upon or work together with other regulators, where appropriate, to reduce regulatory burden. This approach proved very effective during Phase I.

Third District Status

The Federal Reserve Bank of Philadelphia has completed the required Phase I reviews in our District. The early results of these reviews indicated that a significant percentage of Third District state member banks had not been aggressive enough in their approach to the Y2K problem. However, the nature of the problems identified was such that remediation was possible over a short period of time. The peak period for organizations rated less than satisfactory in our District was reached late in the first quarter of 1998. Fortunately, remediation efforts have been successful, and the trend has reversed.

However, now is not the time for bank managers to rest on their laurels. As shown in the box, the FFIEC has announced several important target dates associated with the testing phase of the Y2K effort. As our reviews continue through Phase II, organizations that are not on course to meet the established targets may well be rated less than satisfactory.

06/30/98	testing plan in place
09/01/98	begin testing of mission critical systems
12/31/98	internal testing of mission critical systems substantially complete
03/31/99	testing by service providers substantially complete
06/30/99	testing complete and implementation substantially complete

Review of Service Providers and Software Vendors

A major area of concern to many Third District institutions is their service provider's readiness for the Year 2000. Relief is now at hand. Additional information will be available to institutions that use service providers for all or part of their information processing needs. Initial targeted Y2K reviews of data processing service providers, including assigned ratings, will be distributed to their existing clients by the appropriate FFIEC agency.

Eleven of the twelve software vendors currently in the Shared Application Software Review program have granted permission to the FFIEC to distribute the results of their Y2K regulatory reviews to their clients. Discussions are continuing with the remaining vendor. Subsequent quarterly updates of the data processors and software vendors will only be distributed if there is a change from the rating previously assigned. The Federal Reserve System has also adopted a policy of distributing the information system examination report of data processing servicers to all serviced organizations regulated by the Federal Reserve.

Time Marches On

The absolute deadline for banks and service providers to become Y2K compliant is fixed—January 1, 2000. No one has the power to extend this deadline. Consequently, adherence to the established testing and implementation target dates is critical. An organization that is unable to meet FFIEC's timetable for testing will face several consequences. Obviously, the inability to adhere to testing guidelines will have an adverse impact on the examiner's assessment of the organization's overall Y2K readiness. However, Y2K readiness will also be taken into account when applications for expansion or acquisition are initiated, and a Y2K rating that falls into a less than satisfactory category could adversely impact applications.

If you have any questions on the Federal Reserve Bank of Philadelphia's supervisory program, please call Olaf Schweidler at (215) 574-3434 or John V. Mendell at (215) 574-4139. Alternatively, you can visit the Federal Reserve System's web site on the Year 2000 at 'www.bog.frb.fed.us/y2k/'. ■

The Acceleration of Merger and Acquisition Activity

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When considering mergers, banking organizations must be able to choose the right franchise and maintain managerial and cultural flexibility. Merger and acquisition experts suggest that only 35 percent of mergers and acquisitions will achieve their stated goals. Common problems center around realistically determining a deal's value, synergies, and prospects; minimizing employee stress, distractions, and turnover; overcoming cultural differences; retaining customers; and performing adequate due diligence.

Some of the recent bank consolidations have resulted in a higher number of very large banks controlling a greater share of uninsured deposits. Additionally, the risks that major banks are undertaking as they pursue new lines of business are far different and more complicated than the risks assumed in the past. This has raised questions about Community Reinvestment Act obligations and the optimum structure for ensuring the safety and soundness of the industry, and has rekindled discussion of the too-big-to-fail concept.

Bank supervisors are responding to these mega-deals and convergence trends with efforts to develop a more coherent and coordinated framework to oversee these organizations. Efforts have included the shift toward risk-based supervision, performing on-going risk assessments, placing increased emphasis on market discipline and self-policing, and increasing the number of bilateral information exchange agreements with foreign supervisors.

While banking organizations are responding to these transformation factors, they must stay grounded in the present realities to ensure a strong operating environment focused on people, processes, and technology. This is also true for bank supervisors. Ultimately, the true measure of the success of all of these initiatives will rest in the ongoing stability, resiliency, and soundness of the banking system over a full economic cycle. ■

Accounting for the Maintenance and Disposal of ORE

by Eddy Hsiao, Assistant Examiner

In the last edition of SRC Insights, we discussed accounting treatments for the acquisition of other real estate (ORE) properties. In this article, the second and final in this series on ORE, we will discuss accounting practices for the maintenance and disposition of ORE.

Maintenance Period

Once a property is acquired as ORE, the unfortunate reality is that the bank must adequately maintain the property pending its final disposition. Accounting issues during this period arise in both the balance sheet and income statement.

Ongoing Valuation. As stated in the previous article, ORE should be recorded on the bank's books at the lesser of the fair value of the real estate acquired, less disposal costs, or its cost, often the recorded amount of the loan. A question frequently arises concerning the accounting treatment when the fair value of ORE declines during the holding period. The answer to this question depends on whether the decline is temporary or permanent.

If a decline in fair value is considered temporary, a valuation reserve should be established to account for the deficiency. Future changes in value will increase or decrease the reserve, but not below zero. If, however, the decline is deemed permanent, the ORE balance should be reduced by the deficient amount to reflect the property's fair value.

Whether temporary or permanent, the decline should be reported on the income statement as "other noninterest expense." As a reminder, the determination of changes in fair value must be made on a property by property basis, and ORE should be reported on the balance sheet net of the reserve.

Income, Operating Expenses, and Capital Expenses. According to the Call Report instructions, revenue generated from ORE such as rental income should be reported as "other noninterest income." In our experience, many bankers may have accounted for these revenues as reductions to the ORE balance. While this treatment is conservative, it does not comply with the matching principal of accounting.

Generally, expenditures incurred while holding an ORE property are reported as operating expenses. These expenses include, but are not limited to, insurance, taxes, utilities, management fees, and normal maintenance and repairs. However, expenditures incurred in relation to the completion of a partially finished ORE property can be capitalized. Capitalization of expenditures is also allowed for material improvements that are deemed necessary to enable the bank to sell the property. In short, the determination of whether an expenditure is capitalized or expensed should be consistent with GAAP.

Sales Efforts. In general, federal banking regulations state that a bank may not hold an ORE property for longer than ten years, including extension periods. However, regulations of individual states may be more restrictive. Regardless of allowable holding periods, bank management should make diligent efforts to dispose of the ORE properties, converting these nonearning assets into productive sources of income. Management should also maintain documentation to reflect their efforts.

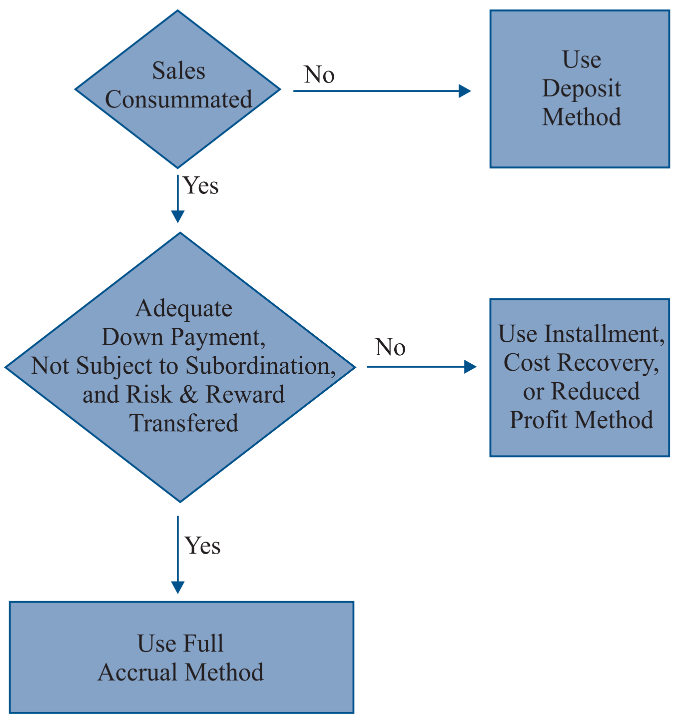
Recordkeeping. A well-organized ORE program should have procedures requiring a file to be maintained for each ORE property. This file should contain information regarding the acquisition of the ORE, the determination of the fair value, and the recording of expenses and/or revenues, as well as details on marketing activities.

Disposition

Banks may sell ORE and provide financing for the purchaser to facilitate the disposition of the property. An Interagency Statement, *Accounting for Dispositions of ORE*, which became effective with the June 30, 1993 Call Report, addresses this issue (SR 93-42). This Policy Statement revised the Call Report instruction for ORE by eliminating certain minimum down payment requirements and instructing banks to conform with Statement of Financial Accounting Standards No. 66 *Accounting for Sales of Real Estate* (FAS 66) when accounting for ORE dispositions.

FAS 66 outlines five methods of accounting for ORE dispositions—the full accrual method, the deposit method, the installment method, the cost recovery method, and the reduced-profit method. The full accrual method and the deposit method are the two most commonly used by banks. However, it is important to remember that regardless of the method used, any losses on the disposition of ORE should be recognized immediately.

The following flowchart briefly describes which method to apply under different circumstances.



Full Accrual Method. The full accrual method allows the transaction to be reported as a sale. Under the full accrual method, the ORE is removed from the balance sheet and a loan is recorded with the entire gain, if any, reported on the income statement. Several criteria must be met to qualify for the use of the full accrual method:

1. The sale must be consummated. A sale is deemed consummated when *all* of the following criteria have been met.
   - the parties are legally bound by the contract
   - all consideration has been exchanged
   - financing provided by the bank has been arranged
   - all conditions precedent to closing have been performed

   Normally, these conditions are met at the time of closing or after closing, not when an agreement to sell is signed.

2. The purchaser's down payment and continuing investment are adequate.

   The adequacy of the down payment as a percentage of the sales price varies by the type of property. For example, a 5 percent down payment is considered adequate for single-family primary residence. However, a 25 percent down payment is required for land to be developed after two years. To meet the continuing investment criteria, the contractual loan payments must be sufficient to pay the loan off over the customary loan term for the type of property involved.

3. The loan must not be subject to future subordination.

4. The usual risks and rewards of ownership have been transferred and the bank does not have a substantial continuing involvement with the property. Following are some examples of extenuating circumstances listed in FAS 66 that do not meet these criteria:
   - an option or an obligation exists for the seller to repurchase the property,
   - the buyer can force the seller to repurchase the property, or
   - the seller retains an equity interest in the property sold.

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Bank Holding Company Risk Assessments: An Efficient Use of Resources with Added Value to the Industry

By Frank A. Germano, Senior Examiner

Bank examination and holding company inspection procedures have undergone considerable change over the last two years. The direction has been toward risk-focused supervision, through which we hope to gain efficiencies in the use of supervisory data and human resources by focusing on those areas that represent the most risk to the institution and, ultimately, to the financial system.

In keeping with this philosophy, the Board of Governors of the Federal Reserve System has instituted a framework for inspecting small shell bank holding companies (SSBHCs). SSBHCs are defined as institutions with consolidated assets of less than $1 billion, with no public debt, and with no significant nonbank activities. SSBHCs present the least risk to the financial system, and primarily reflect the operations of their bank subsidiary. As such, the Board, in its efforts to increase staff effectiveness, enhance interagency coordination, and reduce regulatory burden, felt that limited resources should be devoted toward their supervision.

The risk assessment program for SSBHCs, sometimes referred to as "desk reviews," tailors supervisory strategies for these companies based on an assessment of their reported condition and activities, as well as the condition of their subsidiaries. Reserve Banks are required to develop a strategy for addressing issues related to each organization based on the results of the assessments, with the ultimate objective of determining a final BOPEC rating (Bank subsidiary, Other subsidiaries, Parent only, Earnings-consolidated, and Capital-consolidated). The purpose of the risk assessment is to determine whether the risk profile of the SSBHC has weakened, whether the company is having an adverse effect on the subsidiary bank(s), or if there are violations of law or regulation warranting further review. Where significant risk factors are present, a full range of supervisory responses will be considered, including requests for information, management interviews, visitations, and targeted or full-scope on-site inspections.

Risk assessments, or desk reviews, will be performed in-house at the Federal Reserve, and will be completed within 45 days of the receipt of the full-scope commercial examination report of the lead subsidiary bank as completed by the other regulatory agency. In most cases, risk assessments are driven by the conclusions expressed in those examination reports. However, they may also incorporate information from other sources, such as corporate annual reports, regulatory financial reports, previous inspection reports, and surveillance reports. Requesting additional information from the bank holding company will not be a routine procedure.

Reviews of the following six areas will be included in the assessment.

- Financial condition of the parent, including an evaluation of debt levels and cash flow

- Financial condition of bank subsidiaries and the consolidated organization (if applicable)

- Management, including any changes in senior management or ownership

- Compliance with laws and regulations by the parent company and bank subsidiaries, as well as compliance with regulatory orders and other requirements imposed in connection with the granting of any application or other request

- Intercompany and insider transactions as addressed by examinations and financial reports

- New and proposed activities

If no unusual supervisory issues or concerns are identified by the assessment, no special follow-up with the company is necessary. The assessment alone will serve as the basis for assigning a final BOPEC rating for the company. However, financial or organizational changes that have occurred during the time between receiving the commercial examination report and the date of the risk assessment will also be considered. Furthermore, all companies will continue to be monitored under existing surveillance and banking studies programs aimed at identifying significant changes in the company's condition, performance, or risk profile that may prompt further review. These changes may include:

- A material decline in the earnings performance or capital position of a bank subsidiary

- Significant changes in management or ownership

- A large increase in outstanding debt

- New or expanded activities that may pose additional risk

- Rapid growth

- Questionable insider or intercompany transactions

- Less than satisfactory SEER or other performance factors for the subsidiary bank(s)

- Information suggesting less than satisfactory compliance with regulatory orders and other requirements imposed in connection with the granting of any application or other request

The findings of the risk assessment will be communicated to the organization in a brief letter detailing the overall conclusions of the assessment and the BOPEC rating. Management activities at SSBHCs are generally conducted in the subsidiary banks and the risk management process of the company is essentially the same as that of the bank(s). Consequently, the primary regulator will assign a risk management rating at the subsidiary bank level, eliminating the need for a risk management rating at the holding company level.

With the implementation of this program, the Board rescinded the bank holding company inspection scope and frequency requirements of SR 85-28 *Examination Frequency and Communicating with Directors* for SSBHCs. Going forward, each company's supervisory cycle will be determined by the examination frequency mandated for the lead bank subsidiary.

The SSBHC program was mandated to be operational throughout the Federal Reserve System on November 30, 1997. However, various Districts had programs in place for one year or more at that time. We began developing our program in the Third District in May 1997, and began performing risk assessments within two months, completing the first on July 24, 1997.

As stated earlier, this program was designed to focus supervisory energies and resources on the more complex and riskier financial institutions within each Federal Reserve District. The program has accomplished that and, as a side benefit, has saved examiner hours and expense dollars, and has been praised by senior management of most of the institutions involved for reducing regulatory burden. With no on-site disruptions and no need to assemble volumes of data for examiners, management can focus on its primary function—running the company. Furthermore, the Federal Reserve has realized the benefits it had envisioned—using time and resources more efficiently while adding value to the regulatory process. Going forward, you can also expect to see a more efficient use of automation reducing risk assessment processing time, thus improving an already improved program. ■

Accounting for the Maintenance and Disposal of ORE

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Deposit Method. The deposit method is used when a sale has not been consummated. Under this method, the bank does not record the loan nor does it recognize any profit. The property continues to be carried on the bank's books as ORE despite the transfer of legal title. Payments received from the buyer/ borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

Other Methods. The installment method, the cost recovery method, and the reduced-profit method are similar to the full accrual method where the sale and the corresponding loan are recorded. The major differences among these methods are the timing and the amount of profit recognition. Since banks seldom apply these methods, we will not discuss them further. However, you can refer to either FAS 66 or the Call Report glossary for "Foreclosed Assets" for additional guidance.

Summary

Just as each institution is unique, each ORE transaction is unique. While the guidelines and standards enumerated in this and the prior article will assist you in properly accounting for most ORE transactions, questions will arise. We strongly encourage bank management to consult with their independent public accountant or with their institution's Team Manager at the Federal Reserve whenever they have unusual questions concerning ORE. ■

NEXT ISSUE

More on Derivatives

Consumer Compliance and the Internet

Emerging Technologies in Financial Services

Editor.................Cynthia L. Course

SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current issue and immediately prior issue of SRC Insights are available at the Federal Reserve Bank of Philadelphia's web site at www.phil.frb.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone ((215) 574-3760), or by e-mail (Cynthia.Course@phil.frb.org). Please address all correspondence to: Cynthia L. Course, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

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