FEDERAL RESERVE BANK of ST. LOUIS

Banking Insights

Topics of Interest to Community Bankers

Is High Tide Approaching for Bank Mergers and Acquisitions?

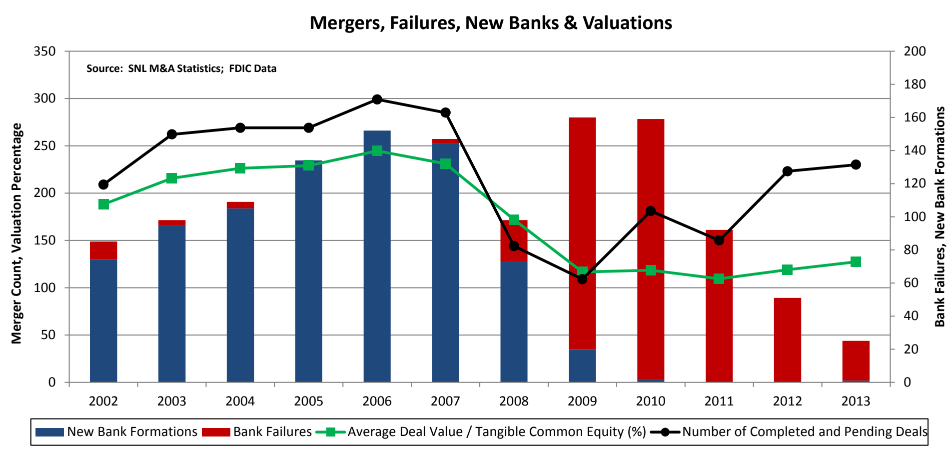
Summary

Bank merger and acquisition (M&A) activities are once again in the headlines, as many bankers have expressed renewed interest in strategic partnerships after weathering the financial crisis. While many investment bankers had predicted a wave of consolidation once the financial crisis subsided, the volume of transactions is only now returning to precrisis levels. Moreover, valuations remain comparatively weak. This issue of *Banking Insights* looks at the trend in the number of bank and thrift charters over the past 12 years and uses historical consolidation activity as a predictor of what the future may hold.

Background and Analysis

The banking industry (commercial banks combined with savings and loan organizations) has experienced a sizable net attrition of charters for more than a decade. (See Figure 1.) During the precrisis era of 2002 to 2007, the industry recorded 704 new bank formations, nearly 2,000 mergers and combinations, and 21 failures.[1] M&A activity during this period averaged 266 transactions per year and featured an average price-to-tangible book value ratio of 222.4 percent.[2] New bank formations were robust, and bank failures were low—or in some years, nonexistent. Merger activity in this period hit its peak in 2006, when there were 299 merger transactions with an average price-to-tangible book value ratio reaching nearly 250 percent.

Figure 1



Merger activity tumbled when the financial crisis hit in 2008. The average price-to-tangible book value ratio fell to 129.1 percent, while the average annual volume of transactions slid to 146 over the 2008-2011 period. New bank formations declined rapidly, from 73 in 2008 to

[1] The analysis in this article is primarily based on the M&A data compiled by SNL Financial. The data for recent periods also include transactions that are pending.

[2] For purposes of this article, the term combinations include the merger of bank and thrift charters within the existing common ownership structure of a multi-bank holding company. In contrast, the terms merger and M&A activity are synonymous and exclude charter combinations within multi-bank holding companies.

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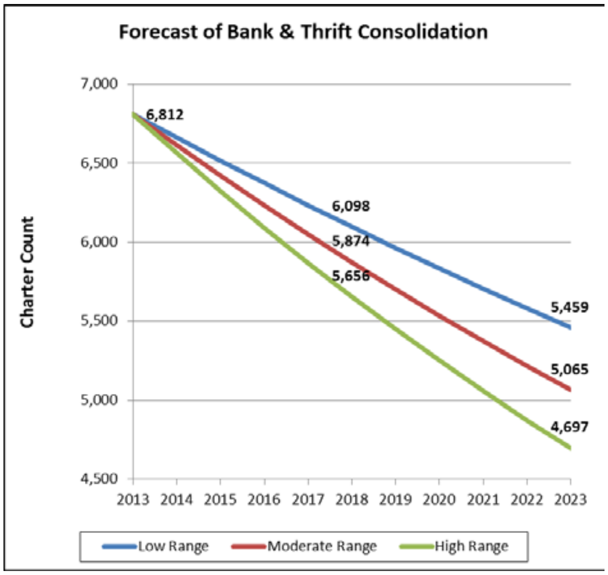
zero in 2011. Moreover, bank failures spiked during the crisis—reaching a peak of 157 failures in 2010. As a result of this activity, the number of industry charters declined from 8,305 at year-end 2008 to 7,357 at year-end 2011.

During the years 2012 and 2013, the average price-to-tangible book value remained low at 123.2 percent, while the average annual transactions volume recovered to 227; one new bank formed, and 75 banks failed. By the end of 2013, 6,812 separately chartered banking organizations remained. Thus, the postcrisis period of 2012 and 2013 marked a turning point in terms of the number of transactions; valuations, however, remained depressed in comparison to precrisis levels. During the three periods examined—precrisis, crisis and postcrisis—banking organizations with assets of less than $1 billion were the targets in all but a handful of acquisitions each year.

What lies ahead for M&A activity? A reasonable scenario is to assume that M&A activity returns to and is sustained at its precrisis level. It is also reasonable to assume that new charter formations will be low, given the capacity in the existing banking system. Using a conservative assumption of no new charters, no failures and implementing a 25 percent band on either side, the decline in charters over five years could range from 700 on the low end to 1,200 on the high end, or about 140 to 240 mergers annually. (See Figure 2.)

Figure 2



Base charter consolidation rate is the precrisis average of 2.92 percent. Ranges are ± 25 percent.

Net charters would range from 5,700 to 6,100. If this scenario is extended over 10 years, the number of resulting charters could range from 4,700 to 5,500, suggesting an annual merger band of about 135 to 210 transactions.

Additional Insight: At the end of 2013, 6,146 bank and thrift institutions, or 90 percent of all charters, had $1 billion or less in assets. There were 559 institutions, or 8 percent of total charters, with assets of $1 billion to $10 billion. Finally, there were 107 banking organizations—nearly 2 percent of total charters—with assets of more than $10 billion.

What's Next

Although projecting M&A activity using a precrisis average is illustrative, it's important to note that in the postcrisis period, there are a new range of challenges. Foremost are weaker valuations. Other factors include the unique nonpublic, and often family-held, interests of community banks. Moreover, smaller institutions often do not have access to capital markets, making it difficult to finance M&A transactions except through an exchange of stock. Finally, regulatory issues may occur in the M&A applications process, including competitive considerations, consumer compliance performance issues, Bank Secrecy Act performance and financial considerations. The pace of consolidation will be affected by all of these factors.