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Rising Interest Rates Next Threat to Bank M&A

by Jackie Stewart

Rising interest rates could further muddy the already cloudy waters of bank mergers and acquisitions.

The recent uptick in long-term rates has brought the dire warnings about interest rate risk closer to reality for many community bank executives and could bog down deal negotiations. Banks are holding a lot of long-term securities and loans that pay low rates, and disagreements between buyers and sellers over valuations of those assets could intensify, industry experts say.

With rising rates, "it is important for investment bankers, advisors, seller and buyers to roll up their sleeves and do their homework," says Dory Wiley, president and chief executive of Commerce Street Holdings, an investment banking firm. "It can be an emotional issue."

How increasing interest rates affect consolidation is complex, and outcomes could vary depending on a seller's overall health and its mix of loans and securities.

Evan M. Tomaskovic
Partner, Carl Marks Advisory Group

Higher rates strengthen banks' earnings outlook because they can charge more for credit, experts say. Overall, better profitability will make sellers more attractive to buyers, spurring some M&A activity, says Evan Tomaskovic, a partner at Carl Marks Advisory Group, an investment and advisory firm.

"Improving earnings will help the sellers leverage their position in negotiations," Tomaskovic says.

However, banks bought lots of securities in recent years to offset their declines in lending income. As interest rates fell to "record lows, this translated into record high bond prices," says Charles Thayer, chairman and managing director of Chartwell Capital, a private investment firm. The problem now is those bonds will pay less than new securities and their valuations will fall, Thayer and others say. Existing loans that pay low rates will be considered less valuable, too.

Community banks "with long [securities] durations will take a hit," says Ralph "Chip" MacDonald III, a partner at the law firm Jones Day. This could mean that sellers who have too many long-term investments that pay low interest rates will command lower offers from bank buyers.

During a transaction, the buyer uses mark-to-market accounting to calculate the value of the seller's assets and liabilities based on current market prices. This doesn't result in a cash loss for the bank but could hurt capital ratios, experts say.

Determining a bond portfolio's value is usually easier since there is more data available, while loan portfolios are trickier since "there isn't necessarily an active market for a large pool of small-ticket loans," says Frank Cicero, a managing director and global head of financial institutions investment banking at Jefferies.

A bank's asset mix can also make a big difference. Certain types of bonds do better as rates rise than others, Wiley says. Prepayments on bonds or loans are less likely to happen as rates increase, and that ties up funds that could be loaned out or reinvested at higher rates, he says. Banks with more variable interest rate loans and

investments are better positioned to take advantage of rising rates, other experts say.

Even if rates don't depress the volume of bank M&A, higher rates threaten to extend the time it takes for deals to be completed, Wiley says. The recent uptick in rates has already affected a deal where Commerce Street was a financial advisor, he says. Increasing rates spooked the buyer, which tried to use that potential risk to lower its offer.

"This will cause some buyers to miss deals because they can't effectively deal with" rising interest rates, Wiley adds. Those who "understand asset management and the risk and don't overreact can really go in and grab a few deals that competitors will miss."

Higher interest rates could also affect the pricing of branch sales, MacDonald says. As foot traffic in branches has declined, some banks have downsized their networks by selling unwanted locations. Others have been able to pick up deposits and assets cheaply but that is also likely to end once rates go up, MacDonald says.

There are a few ways that buyers and sellers can handle interest rate risk during an acquisition, experts say. In the deal Commerce Street was working on, the buyer purchased a derivative hedge against future losses, Wiley says. More commonly the takeover target will restructure its investments, such as selling its riskier or longer-term securities, before the deal's closing to reduce its risk, MacDonald says.

HomeTrust Bank in Asheville, N.C., has been active acquirer, buying several banks since 2010 including BankGreenville Financial in South Carolina earlier this year. Armed with strong capital levels after converting to a public company from a mutual thrift last year, the $1.6 billion-asset bank is on the hunt for more deals, says Dana Stonestreet, president and co-CEO of the bank.

HomeTrust executives have been careful about managing the bank's interest rate risk, positioning the duration of its securities portfolio on the short side, Stonestreet says. HomeTrust's investment duration is around nine months while the average for a bank is around two years.

Although executives are still most concerned about credit quality at potential takeover targets, they are paying close attention to the duration of loan and investment portfolios, Stonestreet says. HomeTrust's conservative nature has prepared it to take on some additional interest rate risk, he says.

"It is expensive to stay that short, but it is like an insurance policy," Stonestreet says. "With our risk and capital position, we can deal with interest rate risk from another community bank."

Banks should also expect greater regulatory scrutiny as rates rise, especially of larger deals and ones that involve mergers of equals, MacDonald says.

"Regulators are tougher than they have been in the past," Thayer says. "They want to make sure the surviving bank meets all of their requirements."

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