ERISK COMMENTARY

Managing Merger Risk

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Mergers and acquisitions are a compelling way for banks to try to enhance their franchises and drive the growth that shareholders expect – but some 70% of acquisitions are estimated to destroy shareholder value.

That statistic shouldn't frighten risk managers: their skills can help make sure that mergers create value before, during and after the deal.

For numerous reasons, being able to put numbers on risk, eg, expected loss and economic capital, should increase the value of an acquisition target. A clear view of the target bank's risk profile reduces uncertainty about levels of risk, makes integration less costly, and adds to the acquiring bank's pool of data for calibrating risk models.

The integration of risk management systems is much easier if both banks have objective, quantitative measures for risk because objective systems can be "harmonized" through a calibration process.

Before the deal, risk managers can help the M&A evaluation process by identifying potential risk concentrations or diversification benefits. A more diversified post-merger credit portfolio – likely if the suitor is from out of the region or has a different lending mix – will free up expensive risk capital and give the CEO something new to discuss with investors (along with the usual cost savings and cross-selling synergies).

Risk managers can also help identify how sensitive the deal economics are to key assumptions such as deposit retention rates, cross-sell rates, and expense reduction.

After the deal has closed, risk executives at the acquiring bank should fight the temptation to impose their own way of doing things. Instead, the risk teams should set out clear criteria for judging the "best" components in each bank's system and then use these to assess key competencies in people and processes such as risk rating systems, approval processes, limit setting, economic capital models, pricing models, and risk reporting.

The process of integrating risk management also offers an opportunity to make long-awaited changes, such as upgrading rickety spreadsheet-based models, under the banner of "now we're too big to do things like we used to".

A strategic portfolio review should be completed as soon as possible after the deal closes using risk-adjusted return on capital (RAROC) or economic profit analysis.

RAROC helps the new management team to understand where shareholder value is being created and what actions need to be taken to avoid losses that may lurk in an acquired portfolio or business strategy. Employing RAROC helps with cultural issues, since it establishes an objective performance indicator against which everyone will be judged in the future. RAROC also addresses two worrying problems:

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- **Employee behavior:** One of the big risks in deal integration is that employees will pump up short-term deal volume at the expense of long-term risk-adjusted value. They may be trying in good faith to create the revenue growth and cross-selling synergies promised pre-deal, or they might want to be able to present a "growth story" to the executive team when the next round of strategic planning occurs. Either way, senior management needs to impose the discipline that a RAROC view of the world provides.

- **Customer churn:** The acquisition of a smaller bank by a larger out-of-town institution is often seen by local competitors as an opportunity to steal market share. RAROC helps the merged bank figure out quickly which customers are most valuable so that the bank can guard them carefully.

After the merger settles down, the bank should continue to work towards medium-term consistency in the new, combined risk management process. As time goes on, it will seem less and less acceptable for the credit committee to deliberate in terms of "Old Bank A 'RR4'" rating versus an "Old Bank B 'RR4'" (depending on which division underwrote the deal). The rating system's value depends on its ability to sort loans into better and worse buckets – if that gets blurred, the pricing and profitability measurement system will send the wrong signals to managers.

Mergers are an exciting and confusing time for banks. That's why so many institutions miss a golden opportunity to upgrade their risk management processes during M&A integration. With a new round of deals in full swing, senior executives should make full use of swiftly integrated and upgraded risk processes to ensure shareholders are still pleased by the merger a year or so down the road.

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