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Buyer Beware

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In summer 2008, C.G. Kum was approached by an investment banker about buying 1st Centennial Bank.

Kum, chief executive of First California Financial Group Inc., the Westlake Village parent of First California Bank, thought 1st Centennial's assets would blend seamlessly with his bank's, and he started the due diligence. Over the next few months, though, he noticed 1st Centennial was not as strong as he thought.

"Each time we looked at the company, their financials were deteriorating," Kum recalled. "So we decided that an offer was not in our best interest."

A few months later, however, regulators contacted him to gauge his interest in acquiring the assets and deposits of a bank that was about to fail. That bank, it turned out, was 1st Centennial.

In January of this year, regulators closed 1st Centennial and sold its assets and deposits to First California. Ultimately, Kum said he was "very happy" with the acquisition, but he can't forget how difficult the whole process was, as bankers dug into piles of old loans racing to meet a federally imposed deadline to complete the transaction.

"There was quite a bit of work," he said.

First California was one of the first local banks in this recession to bulk up by buying a failed bank – and one of the first to discover that cheap assets often come with hidden costs.

Among the discoveries: obscure loans that require special handling, dealing with overworked regulators and the nasty task of laying off a failed bank's employees.

Still, those obstacles haven't prevented any number of local banks from getting in on the action, from First California in Westlake Village to California Bank & Trust in San Diego – giving them the chance to become regional powerhouses practically overnight.

Wilshire State Bank, for instance, was a smallish Koreatown bank until this year, when it acquired Mirae Bank. Through the transaction, Wilshire boosted its deposits by \$400 million and its assets by nearly a half-billion dollars, and is now only a bit smaller than Hanmi Bank, the area's largest Korean-American institution.

"We wanted to capture that opportunity for growth," said Alex Ko, chief financial officer of Wilshire Bancorp Inc., the parent of Wilshire State Bank.

And there have been plenty of opportunities.

Since the beginning of 2008, Los Angeles County has had six bank failures – the second most of any county in the United States, according to Business Journal analysis. By asset size, Southern California's failures also far outpace those of all other major metropolitan regions, with spectacular collapses such as IndyMac Bank in Pasadena, which cost the government \$10.7 billion.

Indeed, with many community banks grappling with losses on construction and land loans, there is the prospect that more will fail, which will mean more buying opportunities for banks that just might want to learn some lessons from the market's first movers.

"I don't think we're finished by any means," said Wade Francis, president of Unicon Financial Services Inc.,

a bank consulting firm in Long Beach. "We still haven't seen the fallout yet. The impact of the failures is going to reverberate to the other banks that are still in existence."

Dealing with regulators

Before the acquiring banks can tackle the portfolios, they first must deal with regulators to complete the transaction. For some, that is a burden in and of itself.

Indeed, Kum said that interacting with regulators was the biggest challenge after buying the charred remains of 1st Centennial.

First California had trouble getting timely responses from the Federal Deposit Insurance Corp., the lead regulator on most failures, on a range of matters, including loan data, accounting information and property lease details.

"The process was not as smooth as it could have been. There were many failed institutions coming the FDIC's way and they just did not have the resources to deal with all of them," he said. "Regulators are doing the best they can with the resources they have, but it just seems like the failure of institutions is outpacing the resources."

In the past year, the FDIC has closed more than 100 banks nationwide. The agency said last month that the number of institutions on its "problem list" – banks that could have trouble staying solvent – rose to 416 in the second quarter, which is the highest number in 15 years.

With the rapid rise in the number of failures, the FDIC has faced criticism that it was not adequately prepared to handle the closures.

In the case of First California, the bank, under terms of its acquisition, had 30 days to decide which 1st Centennial loans it wanted to purchase. But, Kum said, it took the FDIC 10 of those 30 days just to provide the necessary data, forcing the bank and regulators to arrange a new time frame for the acquisition.

First California also had trouble getting regulators on the phone when the bank needed to renew the lease on a property that had been owned by 1st Centennial.

FDIC spokesman David Barr defended the agency, saying its handling of failures has gone relatively smoothly despite each being a massive undertaking.

"We're essentially putting together a merger between two institutions over a weekend," he said. "Most banks that try to do this on their own take two to three months to do it."

Nonetheless, the FDIC has been forced to bulk up in Southern California recently to keep pace with the rising number of failures.

In April, the agency, which has run bank seizure operations from its Dallas office, opened a 200,000-square-foot temporary office in Irvine to handle Western U.S. failures and signed a three-year lease with two additional one-year options. It has filled the 15-story building with more than 400 contractors and employees, almost entirely new hires.

Barr said the decision to open an office in Southern California was driven in part by the concentration of failures in the area. "The purpose is to keep a work force close to the assets that we inherit and manage from failed banks," he said.

Loan reviews

Not all banks report problems in working with the FDIC.

"I had a perception that dealing with regulators or government entities was not easy or efficient – it was not true," said Ko, of Wilshire State Bank. "They were very helpful."

Indeed, for many, the biggest obstacle to completing a merger is the review of the failed bank's assets. Consider California Bank & Trust, which has been eyeing buying opportunities in the past year.

The regional bank, which had branches in the San Gabriel Valley and near Pomona, had expressed to regulators its desire to expand its presence in Los Angeles County. So the FDIC began feeding the bank select information about an area institution that was likely to be closed.

On Feb. 6, regulators shut down Alliance Bank, a Culver City institution with a handful of branches scattered across the region, and sold the assets and deposits to California Bank & Trust. (See sidebar page 26.)

It was not finished. In July, the bank acquired the assets of Vineyard Bank, a failed institution based in Rancho Cucamonga.

Through the acquisitions, California Bank & Trust gained more than \$2 billion in assets and 20 new branches.

"Strategically it was to help fill out our footprint," said Frank Lee, executive vice president of the bank.

But the information provided prior to a closure is limited, and executives had plenty of work on their hands when it came time to integrate the new institutions.

"Once you get in the door, the issue is to get information very quickly," Lee said. "What's the pricing mechanism at play in these banks? What kind of loans do they have? What state are they in? More importantly, you find out what customers you have."

There was no shortage of surprises for Lee. Alliance, for instance, had a large portfolio of loans on health care properties. Vineyard, it turned out, had made a number of church loans and had a portfolio of exotic cars.

"Each bank is different in terms of what they have that you don't see at first blush, but as you peel back the onion layers, you find different kinds of businesses," he said. "We're just beginning to unravel them and try to figure them out."

Lee said managing the various portfolios is one of the most significant tasks after the acquisitions. For the unusual portfolios, the bank assigned specialists "who knew at least how to control the credit," Lee said.

In some cases, however, the loan relationships are not worth maintaining. Acquiring banks may sell particular loans, restructure them or simply end the relationship. That can involve the unpleasant task of cutting off longtime customers.

"A lot of times they have to scramble to find a new lender," said Bert Ely, a bank consultant in Alexandria, Va., who noted that entire developments have been put on hold as a result.

No regrets

Despite the difficulty in integrating the failed banks, none of the banks interviewed by the Business Journal said they regretted acquiring the institutions.

Ko, of Wilshire State Bank, said the acquisition of Mirae has literally transformed the bank's standing.

"Now, we are recognized as the strongest bank in our community," he said.

Most, however, cited the difficulty of closing branches and laying off employees as the most harrowing parts of the integration.

"The biggest challenge has been to let go of people," said Ko, who declined to say how many people the bank laid off. "It was not easy."

Most acquiring banks have closed branches after the transactions – Wilshire, for instance, shuttered four locations, while California Bank & Trust closed five – and in virtually every case, that has meant layoffs.

Already, hundreds of people have been laid off from failed Southern California banks.

"There is a very definite human effect there," said Glenn Gray, chief executive of Sunwest Bank, a Tustin institution that has acquired two failed banks this year.

Gray, who has addressed employees immediately after the closure of the failed banks, said the process can be a difficult one for the staff.

"It is an emotional time – they just lost the company they used to work for," he said. "We're normally given an opportunity to address the employees, welcome them to Sunwest Bank, calm their fears, (but) I try to keep it relatively short because these people have just been hit by a storm."

Still, Sunwest, First California, California Bank & Trust and a number of other institutions said they are ready to look at other opportunities, and regulators are shopping potential acquisitions to them.

Indeed, industry insiders predict many more acquisitions still to come. One local banker said hundreds of institutions nationwide could fail before the current turmoil is over, and at least some are expected to be in Southern California.

"We can predict who's going to fail. We can run the numbers just like anyone else," said Gray, who has his eyes on specific local banks.

'Forest fire'

Some contend, though, that continued failures do have one upside. The industry would be purged of many of the most irresponsible lenders – those who extended credit freely and indiscriminately, and who fueled a culture of overbuilding.

"It's like a forest fire," said banking consultant Francis. "After the forest fire, we clean out all the brush and have a good, clear forest for the next 20 years."

In fact, there are so many expected failures that private equity firms have begun eyeing failed banks in the hopes of taking advantage of a potentially lucrative opportunity in the banking industry. To date, fewer than a half-dozen of the acquired institutions have gone to private equity firms but there have been enough that last month the FDIC issued new guidelines for private equity firms interested in acquiring failed banks. Among the rules, nonbank acquirers must maintain higher capital levels than traditional banks.

The highest-profile such deal came early this year when a consortium of private equity firms bought the assets of IndyMac and rechristened it OneWest Bank. Executives have been tight-lipped about efforts to work through IndyMac's problem loans, and they declined to comment for this story.

But the new institution, with more than 30 branches scattered across the region, figures to be one of the largest local players in the L.A. banking industry once the dust settles across a reshaped banking landscape.

U.S. Bank, a large national institution headquartered in Minneapolis, acquired PFF Bank & Trust in Pomona and Downey Savings & Loan in Newport Beach. JPMorgan Chase & Co. acquired Washington Mutual, the Seattle-based savings and loan that was the second largest financial institution in Los Angeles by deposits. In recent months, roughly 200 Washington Mutual branches in Los Angeles have been converted to Chase banks.

But with the challenges of integrating the consolidated banks, not every institution is ready to bite the bullet.

Walter Mix, the former commissioner of the California Department of Financial Institutions, said banks need to be ready to deal with distressed portfolios, change company culture and grow at a time when many others are on the mend.

“Acquiring failed institutions,” he said, “isn’t for everybody.”

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