Reinhart

Are You Overlooking a Major M&A Obstacle?

POSTED:

Jan 22, 2018

RELATED PRACTICES:

[Banking and Finance](https://www.reinhartlaw.com/practices/banking-and-finance)

https://www.reinhartlaw.com/practices/banking-and-finance

RELATED PEOPLE:

[Melissa Y. Lanska](https://www.reinhartlaw.com/people/melissa-lanska)

https://www.reinhartlaw.com/people/melissa-lanska

People often think about the Herfindahl-Hirschman Index (HHI) in relation to its effect on large, public transactions. However, as smaller community banks look to merge with other small banks in their markets or in adjacent communities, the HHI is increasingly becoming an issue. This often overlooked component of a merger could cause significant regulatory impacts on the structure and success of a transaction. For example, one small community bank recently had to withdraw from a bid process because of insurmountable HHI concerns cited by the federal regulators.

What is the HHI?

The HHI is a commonly accepted measure of market concentration that is generally used when evaluating business combinations. It is calculated by squaring the market share of each bank competing in a given market and then summing the resulting numbers. As the number of banks in a market decreases or the disparity in size increases, the HHI will increase proportionately. A moderately concentrated market has an HHI of 1,500 to 2,500 points, and anything greater than 2,500 is considered heavily concentrated. Generally, if an acquisition will increase the HHI by more than 200 points, it will be heavily scrutinized by the federal regulators and may ultimately be rejected.

How Can You Assess Your Bank's HHI Market?

The U.S. Department of Justice and the Federal Reserve created the Competitive Analysis and Structure Source Instrument for Depository Institutions (CASSIDI) to allow financial institutions to easily determine the effect that a proposed merger would have on the market's HHI. It is a simple tool that allows anyone to run the HHI calculation on the financial institution of his or her choosing. The CASSIDI calculation can help bank management teams determine the necessary steps they may have to undertake in order to get a deal approved.

As explained above, the HHI calculation takes into account all banks in a certain market. CASSIDI allows users to search the markets to determine which market that a deal would fall into. However, the DOJ and the Federal Reserve have the ability to amend the market to include a larger or smaller area in the HHI calculation. Therefore, while CASSIDI may be very helpful, it can be an imperfect indicator of the validity of your transaction under the HHI calculation. It is important to contact your local regulator to determine the exact market that would be used for your proposed transaction. Your regulator will be able to assist you in running a more exact calculation if you suspect your proposed transaction may increase the HHI by over 200 points.

Are Credit Unions Included in the HHI?
At this time, the CASSIDI calculation does not include any market share held by credit unions. However, regulators may consider including credit unions in the structural concentration calculations in the event an application exceeds the delegation criteria in a given market. Generally, credit unions may be included in these calculations if two conditions are met: first, the field of membership includes all, or almost all, of the market population, and second, the credit union's branches are easily accessible to the general public. In such instances and at the regulator's discretion, a credit union's deposits will be given 50 percent weight. If a credit union has a significant commercial lending presence and staff available for small business services, then its deposits may be eligible for 100 percent weighting, though such an outcome is very rare.

How Can You Fix an HHI Issue?
If you perform an HHI calculation and find that your proposed transaction will exceed the 200 point threshold, there are a few options to consider. You can assert that there are mitigating factors at play, or that a broader market should be considered. Another common solution is to divest certain legacy or acquired assets. For example, financial institutions will sometimes sell a branch in markets where the two parties compete directly in order to complete a merger. Over the past 40 years, divestiture has become an important antitrust remedy for parties looking to complete their deals. That being said, divestiture may not always be practical in a merger of two small banks with limited branch locations.

Financial institutions continue to see a large volume of merger activity. The current costs of operating a bank indicate that this activity will continue to grow. While the HHI is an obvious concern for large deals, it should be on the radar of small community banks as well. Your bank's board and management team should analyze the anti-competitive effects of any proposed transaction early in the negotiation process.

If you have specific questions, please contact Melissa York.

This article was originally published by BankDirector.