

INFORMATION TO USERS

The most advanced technology has been used to photograph and reproduce this manuscript from the microfilm master. UMI films the text directly from the original or copy submitted. Thus, some thesis and dissertation copies are in typewriter face, while others may be from any type of computer printer.

The quality of this reproduction is dependent upon the quality of the copy submitted. Broken or indistinct print, colored or poor quality illustrations and photographs, print bleedthrough, substandard margins, and improper alignment can adversely affect reproduction.

In the unlikely event that the author did not send UMI a complete manuscript and there are missing pages, these will be noted. Also, if unauthorized copyright material had to be removed, a note will indicate the deletion.

Oversize materials (e.g., maps, drawings, charts) are reproduced by sectioning the original, beginning at the upper left-hand corner and continuing from left to right in equal sections with small overlaps. Each original is also photographed in one exposure and is included in reduced form at the back of the book.

Photographs included in the original manuscript have been reproduced xerographically in this copy. Higher quality 6" x 9" black and white photographic prints are available for any photographs or illustrations appearing in this copy for an additional charge. Contact UMI directly to order.

U·M·I

University Microfilms International
A Bell & Howell Information Company
300 North Zeeb Road, Ann Arbor, MI 48106-1346 USA
313 761-4700 800 521-0600

Order Number 9112970

Teaching bank management by the case study method

Bussing-Burks, Marie Anne, D.A.

Middle Tennessee State University, 1990

Copyright ©1990 by Bussing-Burks, Marie Anne. All rights reserved.

U·M·I
300 N. Zeeb Rd.
Ann Arbor, MI 48106

**TEACHING BANK MANAGEMENT
BY THE CASE STUDY METHOD**

Marie Anne Bussing-Burks

**A dissertation presented to the
Graduate Faculty of Middle Tennessee State University
in partial fulfillment of the requirements
for the degree of Doctor of Arts**

December 1990

TEACHING BANK MANAGEMENT
BY THE CASE STUDY METHOD

APPROVED:

Dissertation Committee:

Ernest B. Kiddy

Major Professor

B. W. Balch

Committee Member

R. J. Rowland

Committee Member

Jack D. Arters

Committee Member

R. J. Rowland

Department Chairman of Economics and Finance

Mary Martin

Dean of the Graduate School

© 1990

Marie Anne Bussing-Burks

ALL RIGHTS RESERVED

ABSTRACT

Teaching Bank Management by the Case Study Method

by

Marie Anne Bussing-Burks

A perennial problem confronting instructors in business courses is the dichotomy between theory and practice. This issue is particularly relevant to banking courses because the financial environment has changed so drastically since deregulation. Cases can make the transition easier, allowing students to relate theoretical material to actual decision making. Banking schools have long incorporated case studies in their curriculum to aid students in the acquisition of bank management skills and decision making abilities.

Because the banking environment is changing so quickly it is difficult to obtain timely case material for banking courses. The problems are becoming much more specialized and my dissertation research involved developing new cases on some highly specific but very pertinent topics.

Each of the cases is accompanied by discussion questions and an instructor solutions unit. All of the studies are suitable for use in a graduate or undergraduate management of financial institutions course.

Following are brief overviews of the instructional case study topics:

1. Bank of New York's Hostile Battle for Irving Bank

On September 25, 1987, Bank of New York shocked the banking industry with a \$1.4 billion hostile bid for Irving Bank. After eighteen months of battle, Irving finally ended its opposition making it the highest-priced acquisition in banking history.

2. The Impact of the Corporate Alternative Minimum Tax on Commercial Banks

The Tax Reform Act of 1986 includes many significant rulings affecting banking institutions, the most complex being the new corporate alternative minimum tax (AMT). For banks, the most commonly incurred item of AMT is tax-exempt income.

3. Strategic Audit: CNB Bancshares, Inc.

CNB Bancshares, Inc. is a regional interstate bank holding company, serving portions of Indiana, Illinois, and Kentucky through 7 subsidiary banks, 31 banking locations, and 705 employees. The audit includes a summary of CNB's business background, strategic managers, financial structure, corporate structure, and corporate resources.

4. The Impact of Tax Reform on Commercial Banks' Municipal Investment Holdings

Under the new rules of the Tax Reform Act of 1986, banks can no longer deduct the interest expense for municipal issues acquired after August 7, 1986. Consequently, banks have been aggressively divesting in municipal securities.

ACKNOWLEDGMENTS

This study has been completed through the cooperation and assistance of my dissertation committee. Also, my husband, Barry, and my parents, W. C. "Bud" and Constance Bussing, supplied encouragement in the writing of this paper, for which I am grateful.

I would like to thank the chairman of my dissertation committee, Dr. Duane B. Graddy, Professor of Economics and Finance, for the significant contributions he provided to the writing of this paper. He devoted much time and effort to a thorough reading of the text. His scholarly advice and suggestions were instrumental in the development of this study and were greatly appreciated.

I extend my gratitude to the members of my dissertation committee: Dr. Kiyoshi Kawahito, Department Chairman and Professor of Economics and Finance, for his invaluable assistance, encouragement, and guidance in writing this paper and throughout the doctoral program; to Dr. Billy W. Balch, Professor of Economics and Finance, for his continued support in preparing this study and his helpfulness as my doctoral class advisor; and to Dr. Jack D. Arters, Professor of Youth Education and School Personnel Services, for his style and organizational suggestions for this paper.

I would also like to express my appreciation to Dr. Reuben Kyle, III, Professor of Economics and Finance, who encouraged and aided my efforts in the doctoral program. Thanks are also extended to the entire Graduate Economics and Finance faculty at Middle Tennessee State University for providing an interesting and challenging academic environment in which to learn.

TABLE OF CONTENTS

ACKNOWLEDGMENTS	ii
LIST OF TABLES	iv
LIST OF FIGURES	vii
Chapter	Page
1. INTRODUCTION	1
2. REVIEW OF RELATED RESEARCH	7
3. CASE STUDY STRUCTURE	18
4. BANK OF NEW YORK'S HOSTILE BATTLE FOR IRVING BANK	19
5. THE IMPACT OF THE CORPORATE ALTERNATIVE MINIMUM TAX ON COMMERCIAL BANKS	95
6. STRATEGIC AUDIT: CNB BANCSHARES, INC.	128
7. THE IMPACT OF TAX REFORM ON COMMERCIAL BANKS' MUNICIPAL INVESTMENT HOLDINGS	190
8. CONCLUSION	221
SELECTED BIBLIOGRAPHY	222

LIST OF TABLES

CHAPTER 4
BANK OF NEW YORK'S HOSTILE
BATTLE FOR IRVING BANK

Table	Page
1. Bank of New York Financial Highlights	26
2. Irving Financial Highlights	27
3. Bank of New York Financial Highlights after Merger	28
4. Select Financial Data, October 1988	29
5. Cost-Benefit Analysis	75
6. Valuation Comparisons, 1987	80

CHAPTER 5
THE IMPACT OF THE CORPORATE ALTERNATIVE MINIMUM TAX
ON COMMERCIAL BANKS

1. Computing the Alternative Minimum Tax	97
2. The Affect of Tax-Exempt Holdings on the Tax Bill	103
3. Book and Taxable Income Computation for Bank D	105
4. AMT Income Tax Computation for Bank D	106
5. AMT Foreign Tax Credit Computation for Bank E	109
6. Tax Equivalent Yields for Municipal Securities	113
7. Book and Taxable Income Computation for Second City Bank	122
8. AMT Income Tax Computation for Second City Bank	123
9. Fourth City's Tax Bill, 1991	126
10. Fourth City's Tax Equivalent Yields for Municipal Securities, 1991	127

CHAPTER 6
STRATEGIC AUDIT: CNB BANCSHARES, INC.

Table	Page
1. CNB Corporate Organization	132
2. CNB Board of Directors	137
3. Executive Compensation	140
4. Total Return to CNB Shareholders, 1984-1988	151
5. CNB Financial Highlights	154
6. CNB Bancshares Consolidated Balance Sheet	155
7. Banking Institutions of St. Louis Federal Reserve District Average Consolidated Balance Sheet	157
8. CNB Bancshares and Industry Peer Balance Sheet as a Percentage of Assets	158
9. CNB Bancshares Consolidated Statement of Income	159
10. Banking Institutions of St. Louis Federal Reserve District Average Consolidated Statement of Income	160
11. CNB Bancshares and Industry Peer Income Statement as a Percentage of Total Interest Income	161
12. CNB Bancshares and Industry Peer Financial Highlights	177
13. CNB Bancshares and Industry Peer Financial Ratio Analysis Computation	181

CHAPTER 7
THE IMPACT OF TAX REFORM ON COMMERCIAL BANKS' MUNICIPAL INVESTMENT HOLDINGS

1. First National Bank Tax Bill	197
2. Second National Bank Tax Bill	198

Table	Page
3. Third National Bank Tax Bill	198
4. Tax Equivalent Yields for Municipal Bond Versus Treasuries	201
5. Holders of Outstanding Municipal Shares	203
6. Survey on the Impact of Tax Reform on Bank Municipal Holdings	207
7. Southern National Bank of Tennessee Tax Bill, 1989	218
8. Southern National Bank of Tennessee Tax Bill, 1990	219

LIST OF FIGURES

CHAPTER 6
STRATEGIC AUDIT: CNB BANCSHARES, INC.

Figure		Page
1.	CNB Organizational Chart	165

CHAPTER 1

INTRODUCTION

Introduction

The objective of my dissertation research is to develop four banking case studies:

1. Bank of New York's Hostile Battle for Irving Bank
2. The Impact of the Corporate Alternative Minimum Tax on Commercial Banks
3. Strategic Audit: CNB Bancshares, Inc.
4. The Impact of Tax Reform on Commercial Banks' Municipal Investment Holdings

Each of the cases is accompanied by several discussion questions and a suggested instructor solutions unit. All of the studies are suitable for use in graduate or undergraduate courses in the management of financial institutions.

The instructional units included here will be particularly useful for me because I plan to teach courses in financial institutions management. Nevertheless, these cases will not only aid my classroom instruction but if published, help others educate their students in banking and finance.

Statement of the Problem

The banking environment is changing so rapidly that it is difficult to obtain timely case material for decision making problems in banking.

The problems are becoming much more specialized and my contribution is to develop new cases on some highly specific but very relevant topics.

Significance of the Study

A dichotomy exists between teaching theory and practical problems in most business courses. This dilemma is particularly evident in banking because things are changing so fast. Cases can make the transition easier by allowing students to relate theoretical material to actual decision making. Banking schools have long incorporated case studies in their curriculum to aid students in the acquisition of bank management skills and decision making abilities.

Each case study in this paper examines crucial issues confronting the banking industry. Following are brief summaries of the case studies:

Bank of New York's Hostile Battle for Irving Bank

Case Summary

On September 25, 1987, Bank of New York shocked the banking industry with a \$1.4 billion hostile bid for Irving Bank. Irving's immediate response was to resist the takeover by activating a variety of defensive strategies. The defensive moves did not deter Bank of New York but thrust the two opponents into heated litigation battles. After eighteen months, Irving finally ended its opposition and agreed to the purchase, making it the highest-priced and most fiercely contested acquisition in banking history.

Student Role

The student assumes the role of a bank analyst concerned with mergers and acquisitions. Akin to what an actual analyst would do, the

student calculates a numerical bank valuation, deciding if the final offer was a fair price for Irving shareholders. In addition, the cases require an analysis of Irving's anti-takeover strategies.

The Impact of the Corporate Alternative Minimum Tax on Commercial Banks

Case Summary

The Tax Reform Act of 1986 includes many significant rulings affecting banking institutions. One of the most important changes, and perhaps the most complex, is the new corporate alternative minimum tax (AMT). The objective of the AMT is to insure that no taxable unit with sizable economic income can avoid paying significant taxes through the use of tax exclusions, deductions, and credits. The AMT taxable base includes items of economic income, many of which are not included in regular taxable income.

For banking institutions, the most commonly incurred item of AMT is tax-exempt income. Once the AMT applies, the bank is in a 20 percent marginal tax bracket with supposedly tax-free income taxed at an effective 15 percent tax rate.

Student Role

Since the passage of the tax reform rulings, the services of banking tax consultants have been in constant demand. Four institutions have requested particular assistance in dealing with one aspect of tax reform, the AMT. The student assumes the role of a bank tax consultant, advising an institution on how the AMT will impact its tax bill.

Strategic Audit: CNB Bancshares, Inc.

Case Summary

CNB Bancshares, Inc. (CNB) is a regional interstate bank holding company, serving portions of Indiana, Illinois, and Kentucky through 7 subsidiary banks, 31 banking locations, and 705 employees. CNB's lead bank is Citizens National, located in Evansville, Indiana.

The case information includes a summary of CNB's business background, strategic managers, financial structure, corporate structure, and corporate resources. Relevant factors affecting the banking industry are highlighted: tax reform, new banking products and services, and interstate merger legislation.

Student Role

The student accepts the role of an outside banking consultant. The consultant is commissioned to perform a financial analysis on CNB as well as to devise an organizational plan to heighten the overall performance of the institution.

The Impact of Tax Reform on Commercial Banks' Municipal Investment

Holdings

Case Summary

Under the new rules of the Tax Reform Act of 1986, banks can no longer deduct the interest expense for municipal issues acquired after August 7, 1986. The Act further mandates that interest on private activity bonds issued after August 7, 1986 be treated as a tax preference for alternative minimum tax purposes.

Due to these new restrictions, banks have been aggressively divesting in municipal securities. Banks have gone from holders of 30 percent of outstanding municipal securities in 1986, to a substantially lower 17 percent in quarter 1-1990.

Student Role

The student is assigned the role of a financial services manager for a large multi-bank holding company, which has four bank subsidiaries. The financial services manager confronts decisions concerning the adjustment of the subsidiary banks' investment portfolios.

Limitations of the Study

The successful implementation of the banking case studies depends heavily on competent instruction. Providing students with the prepared case scenario and answers is simply not enough.

The case studies should be utilized only as an instructional tool. Instructors may choose to include additional questions particularly pertinent to his or her class.

Many of the case questions have no single correct answer. In certain case situations there are numerous plausible solutions. Students may learn from others by participating in a skillfully guided free-flowing case discussion, which requires the instructor be competent in communication and group skills.

The case material does necessitate specialized knowledge on the part of the student. Banking school students should possess most of the prerequisite information required to successfully utilize the cases. Graduate students may want to do some research on banking terms and

issues mentioned in the cases. Instructors may need to provide additional lectures with background reading for undergraduate students.

CHAPTER 2

REVIEW OF RELATED RESEARCH

This chapter describes different types of cases that can be used to bridge the gap between teaching theory and practical problems in business courses. Along with a complete definition of each type of case, its role in bridging the gap to actual decision making is highlighted. Different classifications of the instructional banking cases are also examined in this chapter.

For business instructors interested in obtaining timely case material, a section is included on case development which outlines the steps in writing your own case. Some of the benefits instructors gain by engaging in case writing, such as increased involvement in the business community, are also noted. In order for instructors to make optimum use of cases, a section on case discussion formats for maximum student input, concludes the chapter.

What is a Case

While a review of the literature indicates that there is no generally accepted definition of a case, a prevailing theme exists among authorities--cases involve actual situations brought into the classroom.

Merriam distinguishes between the case method of instruction and historical case analysis. "Case method is an instructional technique whereby the major ingredients of a case study are presented to students for illustrative or problem-solving purposes. Case history--the tracing

of person, group, or institution's past--is sometimes part of a case study."¹

Edge and Coleman discuss the situational theme:

A 'pure' case is a description of a situation that actually took place. The casewriter takes no liberties with the facts other than to disguise the situation by changing names, locations, or other attributes of the situation which are not essential to the management problem. In fact, some cases do not describe actual situations, but describe situations invented by the casewriter to resemble actual events. Also, a few cases are inventions of the casewriter which are not based on a real situation. Thus, there is a spectrum of realism from a fictional state of affairs (often, this is called a problem or an exercise and presents a less complex problem) to a case describing a real set of circumstances.²

Beckman defines a case in the following manner:

A case is a description of a specific situation or incident, which usually requires a decision. It normally includes more than the bare facts of the situation. Varied opinions of individuals involved in the case and background information to which the real decision maker in the case might have access are also provided. A single³ case can range from less than one page to more than fifty pages.

In describing his impression of a well-founded case, Bernhardt writes: "A good case reflects the complexity of actual business communication; it allows for more than one predetermined interpretation of events. The ambiguity is not just a matter of details chosen, but a reflection of the real ambiguity found in most events,

¹Sharon B. Merriam, "The Case Study in Educational Research: A Review of Selected Literature," The Journal of Educational Thought 19, no. 3 (December 1985):205.

²Alfred G. Edge and Dennis R. Coleman, The Guide to Case Analysis and Reporting (Honolulu: System Logistics, Inc., 1978), 3.

³M. Dale Beckman, "Evaluating the Case Method," Educational Forum 36, no. 4 (May 1972):489.

involving multiple perspectives, conflicting values, questionable motives."⁴

Types of Case Studies

Oldham and Forrester contend that there are many types of case studies "ranging from descriptive accounts of empirical research (case histories) to problem-solving cases which include multiple, interrelated factors and complex situations with no single obvious 'right' solution."⁵

The first task of case reading, Ronstadt⁶ maintains, is to determine what type of case you are reading. Each type of case requires a different form of analysis and, consequently, a different kind of reading.

Four classes of cases are identified, along with basic reading instructions:

1. Highly Structured or Technical Problem-Solving Cases

This type of case is generally short with little or no excess information. The facts of a problem are well-ordered and clearly stated. A "best" solution often exists and you are expected to apply some pre-digested tools or model to derive the solution. An example is a short case demonstrating the use of EOQ (Economic, Order Quantity) and ROP (Re-order Point) formulas for inventory management.

⁴Stephen A. Bernhardt, "Replies to Marilyn S. Butler's Article 'A Reassessment of the Case Approach: Reinforcing Artifice in Business Writing Courses,'" The Bulletin of the Association for Business Communication 49, no. 2 (June 1986):1.

⁵Margaret Oldham and Jerry Forrester, "The Use of Case Studies in Pre-experience Business Education: Part 1-The Case Method," The Vocational Aspect of Education 33, no. 85 (August 1981):28.

⁶Robert Ronstadt, The Art of Case Analysis: A Guide to the Diagnosis of Business Situations, 2nd ed. (Dover: Lord Publishing, 1980), 9.

Read the case to determine the appropriate analytic tools. If you already know what formulas or models to apply, review them before reading the case to identify the specific facts or data you need to "set up the problem." Then read the case and identify the necessary data for solution.

2. Short Structural Vignettes

This type of case is generally used in introductory management courses at the undergraduate level. However, you may encounter them in other courses as first-day or in-class cases when your instructor needs a short teaching vehicle for some reason. Again little excess information is presented. The case may vary in length from one-to-ten pages with at most one or two exhibits. A "best" solution usually does not exist in the sense of a right answer that is derived from a formula. However, your instructor probably hopes you will be able to identify and apply one or more management concepts in discussing the case. The application of these concepts will allow you to present a "better" solution or recommendation, than if you analyzed the case without them. Consequently, read the case vignette, searching for possible ways to apply management concepts you have learned recently in your course or concepts you are clearly expected to know from earlier courses.

3. Long Unstructured Cases or Problem/Opportunity Identifying Cases

These unstructured cases may vary in length from ten-to-fifty pages with several exhibits. The case writer has attempted to reflect the reality of a situation by supplying all or nearly all the information associated with the situation. Irrelevant, excess information exists while enough relevant information may not be available. The existence of qualitative factors does not usually permit a "best" solution. The underlying problems and/or opportunities are unclear.

4. Ground-Breaking Cases

Advanced MBA, doctoral, and some executive management classes may encounter cases where both the students and the instructor are engaged in an exploratory mission covering new ground. The terrain is new because the business situations are totally new and little, if any, knowledge exists which is based on systematic research. Relevant concepts, teaching objectives, even approaches to the business problems or opportunities posed by the new situation, have not been identified. As you read these cases, you must be prepared and capable of extending (not just applying) existing, tangentially-related theory or practices in order to build upon existing knowledge. Simultaneously, you must be ready to structure and

organize the case data in completely new ways which may bear little or no resemblance to existing concepts.⁷

Interestingly, the four instructional case studies in this paper conform to Ronstadt's first and third categories:

1. "Bank of New York's Hostile Battle for Irving Bank" falls largely into the third category of long unstructured cases or problem/opportunity identity cases. While there is not necessarily one best anti-takeover strategy, the student is asked to analyze and judge Irving's defensive techniques. The case also calls for the technical problem-solving skills of category one in performing a numerical bank valuation.

2. "The Impact of the Corporate Alternative Minimum Tax on Commercial Banks" agrees with the first category of highly structured or technical problem-solving cases, requiring mathematical alternative minimum tax solutions.

3. "Strategic Audit: CNB Bancshares, Inc." is in the third category of long unstructured or problem/opportunity identity cases. The student devises recommendations to improve the overall performance of CNB. Because the institution is well run, recommendations are not readily apparent.

4. "The Impact of Tax Reform on Commercial Banks' Municipal Investment Holdings" conforms to the first category of highly structured or technical problem-solving cases. Income tax, municipal yield, and interest expense disallowance calculations are all required.

⁷Ibid., 9-10.

Case Development

Writing the Case

Instructors favoring the case method of instruction must decide if they will utilize existing published cases or write their own case studies. Instructor designed case studies lend the advantage of "encouraging closer integration with other parts of the course and of enabling cases to be presented to students in an order which gradually increases the complexity of the material and/or the demands made upon the students."⁸ Writing case studies can be a challenging but rewarding endeavor.

After deciding on a case topic, data may be gathered through interviews, observation, and document analysis.⁹ The case must be prepared to reflect course information and demonstrate theoretical applications. Case scenarios should be based on realistic situations and provide background information about the characters and institutions examined to identify clues to the underlying problems of the organizations.¹⁰

⁸Margaret Oldham and Jerry Forrester, "The Use of Case Studies in Pre-experience Business Education, Part II-Using Case Studies Effectively," The Vocational Aspect of Education 33, no. 86 (December 1981):67.

⁹Merriam, "Case Study," 204.

¹⁰Gary L. Kreps and Linda Costigan Lederman, "Using the Case Method in Organizational Communication Education: Developing Students' Insight, Knowledge, and Creativity through Experience-Based Learning and Systematic Debriefing," Communication Evaluation 34, no. 4 (October 1985):360.

McNair,¹¹ a Harvard Business School case instructor, identifies three structures to maintain when writing cases:

1. Time structure

Because a case is immediately dated as soon as it is written, the writer should attempt to form his prose in the past tense. This avoids the confusion of speaking in the present tense about an incident that is now history.

2. Narrative structure

The events that occur in the case description must be narrated in some kind of understandable pattern.

3. Plot structure

The plot is perhaps the most important structure for the success of a case. The case description must have drama, not just bland narrative.

The plot of the case may be formed a number of ways, Ford describes:

1. The classical case consists of a rather comprehensive record of the various kinds of evidence which bear upon a problem. It includes such information as: social evidences, biographical data, psychological evidence, economic considerations, relational evidences, spiritual evidences, historical data, statistical information, and so on.

2. The unfinished story presents "cliff-hanger" cases. They usually end with "What should Joe Doe (or Jane Jones) do in this case?"

3. The "embryo" case presents just enough information to establish a problem.

¹¹Malcolm P. McNair, "McNair on Cases," Harvard Business School Bulletin reprint (July-August 1971): 2, cited in John L. Schlacter and Lonnie L. Ostrom, "Use of the 'Case Method'," Journal of Business Education 50, no. 4 (January 1975):163.

4. The critical incident case confronts the learner at the explosion point in a problem. It becomes a "now-that-it-has-happened-what-do-I-do?" case.
5. The report analysis case invites learners to study data in reports of various kinds.
6. The psychological "what-do-you-see?" case asks the learner to analyze a picture in the light of psychological factors involved. Sometimes he "reads into the picture" his own problems. Sometimes learners interpret a picture from the viewpoint of persons with vastly different backgrounds.
7. The "impromptu" case spotlights the dynamics of the present situation. The leader calls attention to problems and incidents which develop in the group and uses them as cases.
8. The "ex-post facto" case leads toward evaluation of a decision already made. It becomes not a "what-should-I-do?" case, but a "did-I-act-wisely?"
9. The "baited" case deliberately withholds significant parts of the picture. Learners learn to search further. Sometimes a case deliberately includes insignificant material. Learners learn to "weed out" the unimportant.
10. The educational simulation permits learners to act out their responses to direct, made-up experiences.¹²

All of the four instructional case studies prepared in this paper are written with a "cliff hanger" plot, such as, "What should the banking consultant do in this case?"

Rewards of Case Writing

Important benefits gained by engaging in case writing are noted by Gibson and Cochran:

For the university there are two major benefits that can be derived from case writing activities of the faculty member. First, is frequent contact with the business community. By engaging in this activity, the faculty member demonstrates interest in the business environment of the local community and provides a convenient, effective link to the area. Secondly, as a result of this link, the reputation of the educational system can be enhanced. This is especially important in today's setting of widespread

¹²Leroy Ford, Using the Case Study in Teaching and Training (Nashville: Broadman Press, 1969), 122-23.

disfavor of educational systems in general. Public relations in education is becoming a necessary function and schools of business have a unique opportunity to make a significant contribution.

The individual can take advantage of several more tangible returns. Appreciation for the tasks faced by the business community and renewed enthusiasm for his/her own profession deserves early mention. . . . A second major benefit is increased confidence in one's own abilities to understand the interrelatedness of the many facets of business and in the skill to provide help when needed. Recognition of one's own limitations may be useful to the individual. Work with large corporations has shown that top management desires more than a single discipline such as marketing or accounting. Cases, therefore, can help provide these interdisciplinary insights.

The last two rewards are related. Case writing forces the faculty member to balance knowledge skills with practical skills and helps achieve an outlook outside the university system. It is always convenient to deal only with the familiar even if that is writing for refereed journals. Case writing adds another dimension to the professional life. Finally, the individual benefits by gaining new ideas for more intellectual research pursuits. Certainly, ideas can be generated for further work and perhaps a survey population may have already been developed through case activities.¹³

Case Discussion

Case solutions may be assigned to students as written homework, or they may be assigned as oral presentations. Regardless of how cases are integrated into the curriculum some form of in-class discussion is actually involved.¹⁴

It is imperative that the instructor direct, not dominate, the discussion. Direction may take the form of questions drawing attention to neglected facts; suggestions or inquiries concerning alternative approaches to the problems; or a strategically timed request for a

¹³C. Gibson and Daniel S. Cochran, "Case Writing: An Acceptable Professional Activity or an 'Exercise in Futility'?" Journal of Business Education 57, no. 8 (May 1982):309-10.

¹⁴Kreps, "Case Method," 361.

summary by a discussion member. Consequently, the instructor may guide a disciplined discussion with a maximum of student input.¹⁵

An instructor may implement at least six different discussion formats, Ronstadt¹⁶ maintains:

1. Teacher-to-student: cross examination format

The student's observation, position, or recommendation will be scrutinized by the instructor through a series of questions, thus exposing the underlying logic of the student's stance.

2. Teacher-to-student: devil's advocate format

The instructor may assume a role or position, often an extreme, and ask the student to refute the advocated position. The critical point in this discussion format is for the student to determine if the instructor's position is indeed unjustifiable.

3. Teacher-to-student: hypothetical format

The instructor poses a hypothetical situation which is an extreme outcome of a student recommendation. The student must assess the hypothetical situation in terms of his or her recommendation. Such an analysis may cause a student to modify or reshape the original position.

4. Student-to-student: confrontation and/or cooperation

Students may learn from one another by challenging each other's position on logical grounds. Additionally, in a cooperative discussion, information and viewpoints may be revealed not previously considered when analyzing a case.

¹⁵C. Roland Christensen and Abby J. Hansen, ed., Teaching and the Case Method: Text, Cases, and Readings (Boston: President and Fellows of Harvard College, 1987), 36.

¹⁶Ronstadt, Art of Case Analysis, 30-32.

5. Student-to-student: role playing format

Students assume the various roles in the case and interact with one another. The class reacts to the demonstration, perhaps with heightened sensitivities on how others may actually behave in the given situation.

6. Teacher-to-class: the student format

The instructor may raise a question which is directed at an individual or the entire class, but no one is able to answer the question. Three discussion paths may occur at this impasse: 1) the instructor may provide clues through questioning or supplying additional information; 2) under rare circumstances the instructor may finally supply the answer; 3) the instructor may assume a very silent position until someone in the class or the group itself works out the problem.

CHAPTER 3
CASE STUDY STRUCTURES

The following chapters contain complete instructional case studies:

1. Chapter 4 - Bank of New York's Hostile Battle for Irving Bank
2. Chapter 5 - The Impact of the Corporate Alternative Minimum Tax on Commercial Banks
3. Chapter 6 - Strategic Audit: CNB Bancshares, Inc.
4. Chapter 7 - The Impact of Tax Reform on Commercial Banks' Municipal Investment Holdings

The material for the case studies was obtained largely through research and document analysis. Interviews and survey data were also incorporated to enhance the realism of the case scenario.

Each study is presented in a similar format. A complete case scenario with case questions is provided plus an instructor's solution unit. Many of the technical questions have unique solutions while most discussion questions have more than one answer.

Evaluating results of the case method is particularly difficult. Instructors marking discussion answers must make sure that students know that "comments are intended to assist learning, to stimulate further thought, or to ensure that another point of view is considered, otherwise students may erroneously infer that their answer is 'wrong' or that they must always agree with their teacher if their answer is to meet with his approval."¹

¹Oldham, "Use of Case Studies--Part II," 68-69.

CHAPTER 4

BANK OF NEW YORK'S HOSTILE BATTLE FOR IRVING BANK

Banco is a newly organized New York City firm offering consulting services for banking institutions. It is the first day of your new job at Banco where you have been assigned as an analyst in the Mergers & Acquisition Department. Your boss, Senior Vice President, Constance Koch, asks you to step into her office so she can explain your first assignment. The following discussion ensues.

Ms. Koch:

At Banco we pride ourselves in helping bankers across the country achieve higher performance, maximize profits, and solve a variety of banking problems. There are five departments at Banco: Bank Operations Consolidation, Holding Company Formation and Development, Shareholder & Investor Services, Regulatory Consulting, and Mergers & Acquisitions. I happen to believe that you have joined the most exciting department at Banco, Mergers & Acquisitions.

During the past few years, bank mergers and acquisitions have become an extremely active business. The reasons for the boom in activity are threefold: expected increases in the merged institution's efficiency or profitability, expected tax savings from the merger, and prospects for further expansion due to new interstate banking laws.

It is imperative that we remain aware that any bank, regardless of size or location, can become a takeover target. Our clients must have in place the best takeover defenses and react with well-crafted moves if there is an unwelcomed attack. We must be able to inform our clients if an offer to purchase is a fair price. Furthermore, Banco analysts must be skilled in identifying potential merger partners and performing cost-benefit analyses of the combined mergers.

Bank of New York's recent bid and ultimate acquisition of Irving Bank is an excellent example showing that no banking institution is immune from takeover. At \$23.5 billion, Irving was a slightly larger bank than its \$23.1 billion acquirer. It was not only the

most costly acquisition in banking history at \$1.45 billion, it was also the most fiercely contested. This dramatic takeover provides an excellent case history for developing your analytical skills.

Study the following report entitled, "Summary of Events: Bank of New York's Hostile Battle for Irving Bank," which summarizes the highlights of the acquisition. Prepare a written report for me, concentrating on two main areas:

(1) a numerical bank valuation (Was the final offer a fair price for Irving shareholders?) and

(2) takeover defensive strategies (List the common defensive strategies and rank Irving's implementation of each).

I think you will find the work in the Mergers & Acquisitions Department both challenging and fulfilling. Do you have any questions?

Summary of Events:

Bank of New York's Hostile Bid for Irving Bank

On September 25, 1987, Bank of New York shocked the banking industry with a \$1.4 billion hostile bid for Irving Bank. Irving's immediate response was to resist the takeover by activating a variety of defensive strategies. The defensive moves did not deter Bank of New York but thrust the two opponents into heated litigation battles. The clash lasted for more than twelve months before an agreement in principle to merge was reached.

Traditionally, hostile bids had been unheard of in the banking industry. They simply violated the banking industry's unwritten code of ethics which said bankers do not fight in such a crude and "ungentlemenly" fashion. However, as the marketplace for financial services becomes increasingly competitive and the move toward interstate banking proceeds, few if any banks will be immune from takeover.¹ Hostile takeovers will likely become increasingly common as banking regulatory authorities have indicated that they will approve contested takeovers as long as the acquisitions meet capital adequacy, competition, and other standard regulatory criteria.

What made the battle between Bank of New York and Irving most unusual was the rich heritage of both institutions as well as the immense financial strength of each.

¹Previously, the most publicized takeover attempt was in 1986 when \$52.5 billion First Interstate made a hostile offer for \$107.2 billion BankAmerica Corp. First Interstate finally withdrew its \$3.2 billion bid following Bank America's sale of strategic assets and proposals to issue new capital.

The Bank of New York, founded in 1784 by Alexander Hamilton, is the oldest bank in the nation still conducting business under its original name. Aggressive fifty-seven year old J. Carter Bacot, the instigator of the hostile offer, heads the institution as Chairman and Chief Executive Officer. Joining Bank of New York in 1960, two years after graduating from Cornell Law School, Bacot assumed his current position in 1982.

The Bank of New York, with \$23.1 billion in assets at year end 1987, was the ninth largest banking organization in New York and the twenty-seventh largest in the nation (see table 1). The bank maintained 189 branches in New York State and offices in London, Singapore, Australia, and the Cayman Islands. Its four major areas of business included retail banking, securities processing, trust and investment management, as well as national and international corporate banking. Nonbank subsidiaries included mortgage banking, leasing, and insurance.

Irving Bank, founded in 1851, was named after the famous American author Washington Irving (1783-1859). Irving, slightly larger than Bank of New York with \$23.5 billion in assets at year end 1987, was the eighth largest banking institution in New York and the nation's twenty-fourth largest (see table 2.) Irving Bank held fourteen subsidiary banks led by Irving Trust, which is headquartered in New York City. The subsidiary banks maintained 140 banking offices in New York State and 22 foreign branch and representative offices. Irving's six major areas of business included domestic general banking, foreign general banking, community banking, fiduciary services, service products, and capital markets banking.

For over a decade, the two institutions had toyed with the idea of merging. Curiously, back in 1976 it was Irving who proposed merging with Bank of New York and it was the latter that vetoed the idea. Bacot first began entertaining the thought of buying Irving in 1982, shortly after he became chairman.

Bacot reasoned with each bank's headquarters and operation units only blocks apart on Wall Street there would be tremendous cost savings from merging the institutions into one. Additionally, their combined strengths in trust and securities processing would be enhanced. In 1984, after hiring an investment bank to study the possibility of a merger, and upon their recommendation of the institutions as a unique fit, Bacot approached Irving Chairman, Joseph A. Rice. Bacot unsuccessfully pitched the idea to Rice several times over lunch. After years of polite chitchat, Bacot became fed up and in late 1987, launched what was to be the most fiercely battled takeover in the banking industry.

Many analysts contend that the problem was that Bacot and Rice clearly were not on the same wave length. Bacot, widely described as a highly intelligent man with a keen understanding of the business, has a management style that borders on ruthlessness. Rice, a former engineer who worked for Grumman Corporation, IBM, and ITT, joined Irving in 1967 in corporate planning. His insightful knowledge of computer systems and data processing thrust him to the Presidency in 1974 and in 1984, at age sixty, was named Chairman. "In hindsight, most analysts surmise that Rice with only a five-year tenure ahead, saw himself as a care-taker chairman, unwilling to effect the radical changes needed at the bank to make its profits competitive. When they didn't, Irving's market value

stagnated and Irving became a prime takeover target."² Irving's main problem was overwhelmingly identified as weak management with lack of direction.

As 1987 approached, Bacot was becoming nervous that Bank of New York itself would become a takeover target. With the industry consolidating, Bacot surmised that only the biggest and most profitable banks would survive. He recognized Irving as the one institution to acquire, which would make Bank of New York large and strong enough to fend off unwanted attacks.

In October 1988, after both sides spent an estimated \$60 million in legal and consulting fees, Bacot got what he wanted (see table 4). The combined institution at \$49.3 billion is now the seventh largest banking organization in New York and the twelfth largest in the nation (see table 3).

Was the struggle worth the wait? Only time will tell. Bank of New York estimates cost savings of \$668 million over the next five years, largely from merging the institutions' branch networks and securities processing businesses. Bank of New York believes Irving's strong international banking capabilities will complement its predominantly domestic business. Domestically, Bank of New York claims, a combined entity will have increased resources to compete aggressively for corporate business.³

²Tim Loughran, "The Sad Saga of Irving Bank," Bankers Monthly, 106, no. 1 (January 1989): 61.

³Prospectus -- The Bank of New York Company, Inc. for All Outstanding Shares of Common Stock of Irving Bank Corporation, 18 March 1988, 7.

A complete daily compilation of events in Bank of New York's ongoing bid and ultimate acquisition of Irving is included as an Appendix to this summary. The information is documentary in nature and concerns defensive techniques, tender offers, regulations, and litigation.

Table 1.--Bank of New York Financial Highlights

	1988 3rd qtr.	1987	1986	1985	1984	1983	1982	1981	1980	1979	1978
Total Assets (mil\$)		23,065	20,709	18,486	15,157	12,797	12,724	11,463	10,423	8,994	7,281
Loans (mil \$)		15,313	13,035	11,715	9,907	7,930	7,432	6,925	5,674	4,295	3,503
Deposits (mil\$)		17,126	15,113	12,369	10,528	9,560	8,873	8,079	8,319	6,870	5,927
Net Income (mil \$)		103	155	130	108	91	73	58	49	44	37
Net Interest Margin		3.8%	4.2%	4.2%	4.1%	4.2%	4.1%	3.6%	3.3%	3.5%	3.8%
Return on Average Assets		.5%	.8%	.7%	.8%	.7%	.6%	.5%	.5%	.5%	.6%
Return on Average Common Stockholder's Equity		9.0%	16.5%	15.0%	15.6%	15.5%	15.4%	13.5%	13.1%	12.6%	12.8%
Per Share Data(\$):											
Book Value		33.65	31.76	28.38	27.88	25.39	23.05	21.11	19.68	18.7	17.58
Earnings		2.97	4.97	4.26	4.27	3.80	3.39	2.83	2.50	2.35	2.07
Dividends	.45	1.71	1.56	1.40	1.26	1.15 3/4	1.08 3/8	1.01 3/4	.93	.83 3/4	.81 3/4
Payout Ratio		57.6%	31.4%	32.9%	29.5%	30.5%	32.0%	36.0%	37.2%	35.6%	39.5%
Prices - High		45 7/8	46 3/4	34 7/8	24 1/2	22 1/8	18 1/2	15 7/8	12 1/2	14 1/2	12 3/8
- Low		24 1/2	32 7/8	23 1/4	17 1/2	15 3/4	12 1/8	11	9	10 1/2	9 1/2

Source: "Bank of New York," in Standard NYSE Stock Reports (New York: Standard & Poor's Corp., November 1988), 282.

Table 2.--Irving Financial Highlights

	1988 3rd Qtr.	1987	1986	1985	1984	1983	1982	1981	1980	1979	1978
Total Assets (mil \$)		23,534	24,233	21,651	18,982	18,586	19,514	18,227	18,090	16,702	13,975
Loans (mil \$)		14,427	13,793	12,565	11,047	10,363	9,959	9,972	8,591	7,276	6,831
Deposits (mil \$)		15,551	15,328	14,027	13,477	12,609	14,153	14,006	14,164	13,525	11,103
Net Income (mil \$)		def. 193 ^a	128	116	98	93	81	97	85	68	55
Net Interest Margin		2.9%	3.3%	3.2%	3.1%	3.1%	3.2%	3.6%	3.8%	3.7%	3.4%
Return on Average Assets		not meaningful	.6%	.6%	.5%	.5%	.4%	.5%	.5%	.4%	.4%
Return on Average Common Stockholders Equity		not meaningful	13.1%	12.9%	11.6%	11.9%	12.3%	16.0%	15.9%	14.2%	12.3%
Per Share Data (\$):											
Book Value		40.91	54.08	49.56	45.56	42.37	39.43	36.69	32.81	29.52	26.91
Earnings		def. 10.83 ^a	6.83	6.14	5.11	4.86	4.57	5.51	4.85	3.89	3.14
Dividends	.605	2.24	2.08	1.96	1.84	1.76	1.68	1.52	1.36	1.22	1.12
Payout Ratio		not meaningful	30.5%	31.9%	36.0%	36.2%	36.8%	27.6%	28.0%	31.4%	35.7%
Prices-High		78 1/2	59 1/4	44 1/8	34 1/4	26 3/4	25 5/8	29	23 7/8	19 3/8	17 7/8
-Low		37 3/4	41	31 5/8	23 1/8	20 5/8	16 1/2	23 3/8	15	14 3/8	13 1/2

Source: "Irving Bank," in Standard NYSE Stock Reports (New York: Standard & Poor's Corp., November 1988), 1254.

^aLesser Developed Country (LDC) Loans: Irving decided to make additions to its credit loss allowance in the second and fourth quarters totaling \$450 million more than our normal additions to this account. These additions produced a net loss of \$193.3 million, or \$10.83 per share, for year 1987 but provided an aggregate credit loss allowance of \$702.1 million, or 4.64% of total loans.

Table 3.--Bank of New York Financial Highlights after Merger

	<u>1989^a</u>	<u>1988</u>
Total Assets (mil \$)	49,280	25,643
Loans (mil \$)	35,186	18,017
Deposits (mil \$)	34,171	18,899
Net Income (mil \$)	51 ^b	213
Return on Average Assets	.1%	.8%
Return on Average Share- holders' Equity	.6%	15.6%
Per Share Data (\$):		
Earnings	.24	5.61
Dividends	1.97	1.83
Payout Ratio	820.8% ^c	32.6%
Market Value at Year End	40 1/4	37
At Year End		
Common Shares	67,896,094	63,308,045
Outstanding Employees	14,883	17,766

Source: The Bank of New York Company, Inc. Annual Report 1989 (The Bank of New York, 48 Wall Street, New York, New York), 1.

Above amounts include the results of Irving from 29 November 1988.

^aDuring 1989, \$108 million in cost savings were realized as a result of the merger.

^bDuring the third quarter a special \$600 million addition was made to the allowance for loan losses (LDC loans at \$400 million plus non-LDC loans at \$200 million).

Without the special item, 1989 earnings would have been a record \$440.7 million. This is compared to \$213.0 million reported in 1988.

^cBefore the special provision for loan losses, fully-diluted earnings per share would have been \$5.95. This would have resulted in a more consistent payout ratio of 33.1%.

Table 4.--Select Financial Data, October 1988

<u>Irving^a</u>	
Beta95
Shares Outstanding	18,938,947
Market price on October 13th	\$74.875
Value of merger offer	\$77.00
<u>Bank of NY^b</u>	
Beta94
Shares outstanding	32,990,681
Market price on October 13th	\$36.00
<u>Miscellaneous</u>	
Short-term Treasury bill rate	7.34%
S & P 500 annual market return	13.88%
Anticipated combined dividend (D ₀) if Bank of NY and Irving merged	\$2.69 ^c

Sources: ^a"Irving Bank," in Standard NYSE Stock Reports (New York: Standard & Poor's Corp., November 1988), 1254.

^b"Bank of New York," in Standard NYSE Stock Reports (New York: Standard & Poor's Corp., November 1988), 282.

^cThe Bank of New York Company, Inc. Form S-4 (The Bank of New York, 48 Wall Street, New York, New York), xxi. Filed with the Securities and Exchange Commission on 14 November 1988.

At 8:00 a.m. the following workday, Ms. Koch buzzes you on the phone. She proceeds:

How are you coming on the Irving Acquisition report? Do you have any questions on the material?

I just received a call from Banco's President. Next month he wants the Mergers & Acquisitions Department to sponsor a seminar, "How to Prepare for a Hostile Takeover Attempt," for senior bank management.

I think the information you are preparing on Bank of New York's acquisition of Irving could be an interesting presentation to include in the seminar program. Bankers need to know how to structure a takeover defense while positioning to receive the most adequate offer.

I'll need the report by the end of the week so I can have time to review it. If it is high quality work, we will put you on the program!

Stop by my office if you need any help. Bye.

APPENDIX

September 25, 1987: BANK OF NY INITIATES A \$1.4 BILLION HOSTILE BID FOR IRVING BANK.

Bank of NY is offering to purchase all Irving outstanding common shares which it doesn't already hold. Bank of NY currently owns 4.9 percent of the approximately eighteen million Irving common shares, a stake it has been acquiring over the past four years. The offer is \$80 a share for 47.4 percent of Irving's shares and 1.9 shares of Bank of NY common stock for each remaining Irving share.

Investors responded favorably to the announcement during the day's NYSE trading activity in both stocks. Irving's stock rose an overwhelming \$25.875 to close at \$78.125. Bank of NY stock increased \$1.50, to a close of \$43.375.

Irving's management, however, did not respond so favorably. Chairman of Irving, Joseph A. Rice, in a letter to employees, expressed his displeasure with Bank of NY and the unwelcomed offer:

That the Bank of New York would proceed as a hostile raider surprises us, and suggests that the Bank of New York is perhaps interested in protecting themselves from takeover rather than seeking to create a stronger banking institution. . . . Management has long believed that the long-term interests are better served by Irving Bank remaining independent to continue the tradition of growth and quality banking that all the staff has striven to achieve.⁴

October 1, 1987: UNDER NEW YORK STATE BUSINESS CORPORATION LAW A SHAREHOLDER ACQUIRING MORE THAN 20 PERCENT OF STOCK IN A TARGET

⁴Irving Employee Letter from Joseph A. Rice, Quoted in Robert Guenther, "Bank of New York Breaks a Staid Code With Irving Bid," The Wall Street Journal, 28 September 1987, 2(E).

ORGANIZATION, WITHOUT THE APPROVAL OF ITS BOARD OF DIRECTORS, MAY NOT MERGE THE TWO ORGANIZATIONS FOR A PERIOD OF FIVE YEARS.⁵

Rice voiced his disapproval of the Bank of NY offer and discussed the state law as an impediment to the hostile offer in a letter to shareholders. Undoubtedly, Rice is hoping Irving shareholders will side against the bid because if Bank of NY obtains a controlling interest in Irving it could use its share to vote a new board that would approve the merger.

October 9, 1987: THE IRVING BOARD FORMALLY REJECTS BANK OF NY'S BID AND ADOPTS A "POISON PILL" SHAREHOLDER RIGHTS PLAN.

Irving directors unanimously rejected Bank of NY's bid as inadequate. Rice commented further saying Irving's value "greatly exceeds" the \$80 a share offered by Bank of NY.⁶

The adopted shareholders rights plan permits Irving shareholders to purchase shares of the surviving firm's stock for half price in the event of a merger, unless these rights are redeemed by Irving's board at one cent apiece before a single person or group acquires 20 percent of Irving's common stock. The rights are to be issued on October 19th to stock of record that date. One right shall be distributed for each outstanding share.

⁵Section 912 of the New York Business Corporation Law, Referenced in Prospectus -- THE BANK OF NEW YORK COMPANY, INC. FOR ALL OUTSTANDING SHARES OF COMMON STOCK OF IRVING BANK CORPORATION, 18 March 1988, Section B.

⁶Joseph A. Rice Quoted in Robert Guenther, "Irving Bank's Board Rejects Takeover Bid," Wall Street Journal, 12 October 1987, 4(E).

October 19, 1987: THE BLACK MONDAY STOCK CRASH RESULTS IN A 26 PERCENT DECLINE IN IRVING'S STOCK PRICE.

Irving closed at \$48.50, down a sizable \$16.875 from the previous Friday. Bank of NY closed at \$31.75, down \$6.00.

November 2, 1987: FOR PROTECTION IN THE EVENT OF A TAKEOVER BY BANK OF NY, IRVING ADOPTS GENEROUS SEVERANCE BENEFITS FOR ALL 10,200 EMPLOYEES AND EXPANDS ITS GOLDEN PARACHUTES TO INCLUDE 49 EXECUTIVES.

Compensation packages would become available if an individual is terminated or if an individual's duties are diminished within two years of a merger.

Employees qualifying for compensation would receive one month's pay for each year of service. Individuals earning at least \$40,000 a year would be guaranteed six months' salary, while those earning more than \$60,000 a year would be guaranteed one year's wages. The cap for all severance benefits would equal twice an employee's annual salary.

Golden parachutes were expanded from a group of twelve executives designated in 1985 to cover forty-nine top managers. Executives qualifying for compensation would receive a very lucrative payment approximating three times their average annual taxable earnings for the previous five years.

November 20, 1987: BANK OF NY REDUCES ITS BID FOR IRVING, REFLECTING THE DEPRESSED VALUE OF EACH BANK'S STOCK SINCE THE BLACK MONDAY CRASH.

Bank of NY is offering \$68 a share to 39 percent of Irving holders and 2.4 shares of Bank of NY stock for each remaining Irving share. The stock exchange portion of the offer would vary so that its value would

remain at \$68 a share. The revised offer is valued at \$1.25 billion, versus the original \$1.4 billion offer.

Irving stock closed at \$50.875, up \$2.125. Bank of NY closed at \$28.375, up \$.375.

December 15, 1987: IRVING FORMALLY REJECTS BANK OF NY'S REVISED BID.

Joseph A. Rice noted in a letter to Irving shareholders that the new \$68 offer "was even worse for Irving's shareholders than Bank of New York's original proposal. The Irving board strongly believes that Irving's shareholders, not those of Bank of New York, should realize the long-term profit values the bank expects to achieve."⁷

January 11, 1988: IRVING HIRES COMPETITOR, J. P. MORGAN & CO., AS A SPECIAL ADVISER TO FEND OFF BANK OF NEW YORK.

Irving already employs Goldman, Sachs & Co. as an adviser for the hostile takeover attempt but added Morgan because of its specific knowledge in banking anti-takeover strategies.

January 25, 1988: FOR THE SECOND TIME, BANK OF NY REDUCES ITS BID FOR IRVING.

Bank of NY is now offering 1.575 shares of its stock plus \$15 in cash for each outstanding share of Irving. The revised offer is valued at \$60 a share, or \$1.08 billion. The value of this offer will fluctuate depending upon the market value of Bank of NY's stock. Bank

⁷Irving Stockholder Letter from Joseph A. Rice, Quoted in "Irving Bank Rejects Bank of New York's \$1.25 Billion Offer," The Wall Street Journal, 16 December 1987, 46(E).

of NY's initial September offer was valued at \$80 a share, or \$1.4 billion, which was reduced to \$68 a share, or \$1.25 billion in November.

Bank of NY has not been given access to Irving's records. Consequently, the bank has been making needed financial assumptions using publicly available statements and documents.

Information Irving publicly disclosed last week caused Bank of NY to reevaluate its assumptions and subsequently reduce its offer. Irving released certain details on loan portfolios and real estate which indicated lower values than initially assumed by Bank of NY. Furthermore, last week Irving substantially increased its loan losses to lesser developed countries. Irving recorded a \$176 million net loss for the fourth quarter of 1987, sharply reducing its common equity.

Irving closed at \$52.50, down \$1.75. Bank of NY closed at \$28.75, up \$.25.

February 2, 1988: IRVING FILES SUIT IN STATE COURT AGAINST THE NEW YORK STATE BANKING DEPARTMENT.

Irving claims that the State Banking Department deputy superintendent, a former employee of Bank of NY, is participating in the department's consideration of Bank of NY's application to merge with Irving.

Irving further argues that the State Banking Department was preparing to rule on the merger application before it was given adequate time to respond to the application.

February 3, 1988: IRVING IS TRIUMPHANT IN SUIT AGAINST THE NEW YORK STATE BANKING DEPARTMENT.

The former employee of Bank of NY is prohibited from participating in the merger deliberations. Additionally, the State Banking Department is required to give Irving ten days notice before ruling on the application.

February 4, 1988: IRVING HOLDS TALKS WITH BUYERS CONCERNING A NEW ISSUE OF CONVERTIBLE PREFERRED STOCK.

When converted, the new issue would increase the number of Irving common shares outstanding and make it very burdensome for Bank of NY to acquire Irving at its current \$60 a share offer.

February 5, 1988: BANK OF NY BRINGS SUIT IN THE NEW YORK STATE SUPREME COURT TO THWART IRVING FROM ISSUING NEW CONVERTIBLE PREFERRED SHARES.

Bank of NY claims the issue would cause dilution of earnings per share to existing Irving shareholders.

February 16, 1988: IRVING FORMALLY REJECTS BANK OF NY'S OFFER, VALUED AT \$60 A SHARE.

Joseph A. Rice stated that the revised bid was "even worse" for Irving shareholders than the two earlier offers from Bank of NY.⁸

February 25, 1988: THE FEDERAL RESERVE BOARD AND THE NEW YORK STATE BANKING BOARD APPROVE BANK OF NY'S APPLICATIONS TO ACQUIRE IRVING.

The Fed granted its approval on the condition that Bank of NY will issue stock to cover the cash portion of the tender offer, which

⁸Joseph A. Rice Quoted in "Bank of New York Co.'s Bid of \$60 a Share is Rejected," The Wall Street Journal, 17 February 1988, 5(E).

currently would be \$264 million. Furthermore, the Fed required that 60 percent of the stock must be issued by Bank of NY before the merger.

The New York State Banking Board approval was unconditional.

Bank of NY plans to continue with the bid and will nominate a slate of sixteen directors at Irving's annual meeting, scheduled for April 21st.

February 26, 1988: WITH BANK OF NY UNSUCCESSFUL IN ITS SUIT TO THWART THE STOCK ISSUANCE, IRVING PLACES A \$100 MILLION NEW PREFERRED ISSUE WITH FIFTEEN FRIENDLY INSTITUTIONAL BUYERS.

Irving sold 1,001,000 shares of the new issue, adding the proceeds to general corporate funds. Each share of preferred is convertible after three years into 1.471 shares of common stock, or at a conversion price equal to \$68 a share.

Until the preferred shares conversion feature expires, its holders have voting rights along with common stockholders, on all matters. Each share of convertible preferred carries 1.471 votes. The preferred shares are not under mandatory redemption but may be redeemed by Irving after five years.

The dividend rate on the preferred shares for the first five years is 8.75 percent, and thereafter will be adjusted every forty-nine days under the Dutch auction system (an auction in which the seller continuously lowers the offering price until a level can be found that clears the market).

Additionally, the new convertible preferred shares carry a special provision which prevents Bank of NY from merging with Irving within

three years of a takeover, unless two-thirds of the holders waive the provision.

Due to the shares' voting privileges and power to prevent a merger for three years, they have justly been nicknamed "poison preferred shares".

March 1, 1988: IRVING REQUESTS THE FEDERAL RESERVE TO STAY THE APPROVAL ORDER FOR BANK OF NY TO ACQUIRE IRVING.

Irving challenged the Federal Reserve on the acquisition objecting to Bank of NY's capital position, its managerial resources, and Bank of NY's operation plans for certain Irving subsidiaries. Irving also claims that the Bank of NY did not comply with the Community Reinvestment Act. The Act requires that lending activities not be withheld from certain groups or geographic areas within a bank's market.

March 8, 1988: THE FEDERAL RESERVE DENIES IRVING'S REQUEST FOR A STAY.

March 16, 1988: IRVING BOARD AMENDS ITS SHAREHOLDER PURCHASE RIGHTS PLAN.

The purchase rights plan adopted October 9, 1987, enables Irving shareholders to purchase shares of the surviving firm's stock for half price in the event of a merger. Irving's board was allowed to redeem the rights at one cent apiece before a single person or group acquires 20 percent of Irving's common stock.

Under the amended plan, the rights cannot be redeemed if a majority of the sixteen-member board are not current directors, unless the new directors are elected by holders of at least two-thirds of Irving's common shares outstanding.

The effect of the amendment is to prevent any new directors who run on a platform proposing a merger from redeeming the rights and consequently depriving shareholders of the protections of the rights, unless the directors are elected by the two-thirds of outstanding common holders.

March 17, 1988: BANK OF NY FILES A SUIT IN NEW YORK STATE SUPREME COURT TO DEFEAT IRVING'S ENTIRE SHAREHOLDER RIGHTS PLAN.

Bank of NY claimed the plan is a desperate attempt to prevent Irving shareholders from accepting their offer, is illegal, and should be overturned.

March 18, 1988: BANK OF NY ANNOUNCES NOTICE OF ITS OFFER TO PURCHASE ALL OUTSTANDING SHARES OF COMMON STOCK OF IRVING AT 1.575 SHARES OF BANK OF NY COMMON STOCK AND \$15 CASH PER SHARE.

Under the Fed's approval for the merger, March 28th is the first day Bank of NY can increase its holdings in Irving, henceforth, the tender offer for Irving technically began today. The tender offer is due to expire on April 15th.

March 23, 1988: IRVING VALUES ITSELF AT \$82 TO \$107 A SHARE.

Although Irving closed at \$57.375, Goldman Sachs & Co., Irving's investment advisor, valued Irving's true after-tax value at \$82 to \$107 a share. This is the first time Irving has publicly estimated its value, although the bank has always claimed its stock value is much higher than offered by Bank of NY.

The valuation was contained in state court documents filed in connection with Irving's lawsuit seeking a declaratory judgement upholding

certain of its anti-takeover defenses. No details were released on how such values were derived or explanation why the market didn't value the stock so highly.

March 24, 1988: IRVING'S ANNOUNCEMENT THAT IT WAS HOLDING TALKS WITH THIRD PARTIES CONCERNING A POSSIBLE FRIENDLY MERGER CAUSES IRVING'S STOCK PRICE TO SOAR UPWARD.

Irving closed at \$66.25, up a lofty \$6.25. Bank of NY closed at \$31.75, up \$1.125.

March 28, 1988: IRVING ADOPTS A "FLIP IN" PROVISION AGAINST BANK OF NY IN ITS SHAREHOLDER RIGHTS PLAN.

The key feature adopted allows Irving shareholders, except Bank of NY, to exercise rights and buy \$400 of Irving stock for \$200 once a single person or group obtains 20 percent of Irving's common stock. The original poison pill, adopted October 9, 1987, was only exercisable if the two banks were merged into one, enabling one to purchase shares of the surviving firm's stock for half price.

Bank of NY claims the "flip in" provision is illegal and plans to get a ruling against it as part of a pending suit in New York State Supreme Court against the legality of the original shareholder rights plan.

The "flip in" provision, if upheld, would be extremely dilutive, and most likely would force Bank of NY to abandon its takeover plan.

April 13, 1988: BANK OF NY EXTENDS ITS OFFER FOR IRVING.

The tender offer of \$15 cash plus 1.575 of Bank of NY shares for each Irving share, scheduled to expire April 15th, was extended to April 21st.

April 18, 1988: IRVING HOPES FOR WHITE KNIGHT IN BANCA COMMERCIALE ITALIANA./NEW YORK SUPREME COURT RULES AGAINST AN AMENDMENT TO IRVING'S SHAREHOLDER RIGHTS PLAN.

Irving management announced and endorsed a \$65 a share cash offer for 51 percent of its shares by Banca Commerciale Italiana. With \$60 billion in assets, Banca Commerciale is Italy's second largest banking institution.

Banca Commerciale's offer is conditioned upon a minimum of one-third of Irving shares being tendered, Irving's slate of directors being elected at the upcoming annual meeting, and various regulatory approvals.

Irving announced that it would reschedule its annual meeting from April 21st to April 23rd, in order to give shareholders an opportunity to consider Banca Commerciale's friendly offer.

Irving closed at \$60.375, down \$1.00. Bank of NY closed at 31.125, down \$.125. Thus, Bank of NY's offer for Irving at 1.575 shares of its common stock and \$15 cash per share is valued at about \$64, \$1 less than Banca Commerciale's offer. Analysts suggest Bank of NY's offer is more valuable because it has Federal Reserve approval to merge.

Additionally, a New York State Supreme Court judge struck down the amendment to Irving's shareholder rights plan adopted on March 16, 1988. The amendment stated that rights could not be redeemed if a majority of the sixteen member board are not the current directors or aren't elected

by holders of at least two-thirds of Irving's common shares outstanding. This amendment was originally designed by Irving with the intent of preventing a new board elected by fewer than two-thirds of shareholders from thwarting its anti-takeover rights defense.

April 19, 1988: BANCA COMMERCIALE'S APPLICATION TO MERGE WITH IRVING MAY FACE LENGTHY REGULATORY REVIEW BY THE FEDERAL RESERVE./BANK OF NY EXTENDS ITS OFFER FOR IRVING.

In an internal New York Fed memo, Federal Reserve attorney Bradley K. Sabel said that the Fed would "revisit" the policy issues posed by the fact that Istituto per la Ricostruzione, an Italian government agency, is majority owner, 67 percent, in Banca Commerciale.⁹ The agency also owns stakes in over one-hundred commercial businesses. The controversy is explained as follows:

U.S. law prohibits common ownership of banking and commercial companies on the ground that a failure of a commercial business could endanger the solvency of its banking sibling. The issue in the Bank Commerciale application is whether foreign government-owned banks should be exempt from the restrictions that apply to domestic ownership of U.S. banks.¹⁰

Although the Fed has not indicated how long it might take to review the application, it is doubtful that Banca Commerciale would receive a decision before six months.

⁹New York Federal Reserve Memo dated April 19, 1988, from Bradley K. Sabel, Quoted in Robert Guenther, "Irving, Italian Bank Face New Hurdle to Linkup as Fed 'Revisits' Policy Issues," The Wall Street Journal, 28 April 1988, 4(E).

¹⁰Robert Guenther, "Irving, Italian Bank Face New Hurdle to Linkup as Fed 'Revisits' Policy Issue," The Wall Street Journal, 28 April 1988, 4(E).

Bank of NY extended its tender offer for Irving from its April 21st deadline to the following day, due to the rescheduling of the Irving annual meeting.

April 20, 1988: BANCA COMMERCIALE REVISES ITS OFFER FOR IRVING.

Banca Commerciale increased the dollar value of its offer by \$10 a share but decreased the number of shares it is interested in purchasing. The original April 18th offer was for \$65 a share and 51 percent of shares, with the new offer at \$75 a share with a 45 percent stake. The revised bid increased the value of the offer by \$20 million, to \$637.5 million.

Banca Commerciale's original offer, just two days prior, was poorly received by Irving investors, causing Banca Commerciale to immediately increase the dollar value of the bid. The new offer didn't seem to stir Irving investors. Irving closed at \$61, up only \$.25.

April 21, 1988: IN YET ANOTHER RESCHEDULING, IRVING POSTPONES ITS ANNUAL MEETING FROM APRIL 23RD TO JUNE 13TH.

Irving officials maintain the reason for the postponement is to give shareholders additional time to consider Banca Commerciale's revised friendly offer, as well as Bank of NY's tender.

Bank of NY filed suit in New York state court to force Irving to hold its annual meeting on April 23rd.

April 22, 1988: NEW YORK STATE COURT ORDERED IRVING TO HOLD ITS ANNUAL MEETING ON MAY 6TH./BANK OF NY EXTENDS ITS OFFER FOR IRVING.

The new date for an annual meeting actually represents a compromise between Irving and Bank of NY. Irving had rescheduled its

meeting from April 23rd to June 13th, when Bank of NY filed suit to have it moved back to April 23rd.

At the May 6th meeting, Irving holders of record as of March 4th will vote in the proxy fight between Bank of NY and Irving for control of the board of directors.

Due to expire tomorrow, Bank of NY extended its tender offer for Irving until April 29th.

April 29, 1988: BANK OF NY EXTENDS ITS OFFER FOR IRVING.

Due to expire today, Bank of NY extended its tender offer for Irving until May 6th.

Bank of NY is offering 1.575 shares of its stock plus \$15 cash for each Irving share, valued at about \$63 a share. Currently, Bank of NY has a 49 percent stake in Irving as a result of its offer and open market purchases.

Irving closed at \$60.625, down \$2.00. Bank of NY closed at \$30.125, down \$1.125.

May 2, 1988: BANCA COMMERCIALE INCREASES ITS OFFER FOR IRVING.

Banca Commerciale is offering to purchase 51 percent of Irving shares at \$75 a share. It would also pay 7 percent annual interest on the purchase price from May 31st until the stock is actually paid for. Banca Commerciale's earlier offer was for 45 percent of Irving's share at \$75 a share, without any interest payments.

Irving maintains that the Banca Commerciale offer is superior in value to the alternative \$63 Bank of NY offer. Irving shareholders may still side with the Bank of NY offer because it has Federal Reserve

approval and it may be months before the Fed reaches a decision on Banca Commerciale's application.

Currently, Bank of NY holds a 58 percent stake in Irving due to its offer and open market purchases. Bank of NY's offer for all shares in Irving is conditioned on receiving two-thirds of Irving's 18.7 million shares outstanding.

May 5, 1988: TWO-THIRDS OF ISSUE HOLDERS OF POISON PREFERRED SHARES WAIVE THE PROVISION THAT WOULD PREVENT BANK OF NY FROM MERGING WITH IRVING WITHIN THREE YEARS OF ACQUIRING CONTROL./IRVING SELLS ITS INTEREST IN BANCA DELLA SVIZZERA ITALIANA FOR \$390 MILLION.

In anticipation of winning the proxy fight at tomorrow's annual meeting, Bank of NY convinced the required two-thirds of issue holders of the \$100 million poison preferred shares to waive the provision that would prevent Bank of NY from merging with Irving within three years of acquiring control. This issue had been brought to market in February and placed with fifteen institutional buyers, supposedly friendly to Irving.

Additionally, Irving sold its 39 percent equity interest in Switzerland-based bank, Banca della Svizzera Italiana, at a price of \$390 million. Irving estimates that the pre-tax gain from the sale will equal \$136 million. The funds are to be applied to a special \$10 a share cash dividend, if Irving shareholders accept the Banca Commerciale offer.

May 6, 1988: IRVING HOLDS ITS ANNUAL MEETING./BANK OF NY EXTENDS ITS TENDER OFFER.

Irving's annual meeting was adjourned until May 24th, at which time election inspectors will report the results on the proxy fight between Irving and Bank of NY to control the Irving board.

Due to expire today, Bank of NY extended its offer for Irving until May 17th.

May 16, 1988: PRELIMINARY VOTE TALLIES INDICATE THAT IRVING'S SIXTEEN INCUMBENTS WIN REELECTION TO THE BOARD AT A 52-48 PERCENT MARGIN OVER BANK OF NY'S SLATE.

Interestingly, today Bank of NY has about 56 percent of Irving's shares tendered to it plus a 4.9 percent stake in Irving from open market purchases. The 52-48 percent tally loss suggests that some investors may have voted with Irving but later sold shares on the open market or tendered to Bank of NY.

The Bank of NY offer is conditional on receiving two-thirds of tendered shares, so Bank of NY may still choose to opt out of the offer, as the loss of the Board puts Bank of NY in a depressed position. "Bank of New York said that it was 'disappointed' by the results of the proxy fight and that it is 'reviewing all its options, including the termination of its offer'."¹¹

If Bank of NY would have captured control of the board, its anti-takeover rights could have been immediately redeemed by the board before the purchase of shares actually transpired. If the rights are

¹¹Bank of New York Official Quoted in Robert Guenther, "Irving Bank Defeats Suitor in Proxy Fight," The Wall Street Journal, 17 May 1988, 3(E).

exercised, it would be extremely dilutive and would be very expensive for Bank of NY to proceed with the offer.

Furthermore, under New York state law, without approval from the target organization's board a merger of two organizations is prevented for five years.

The Federal Reserve deadline for Bank of NY merging with Irving expires on May 25th, unless granted an extension.

May 17, 1988: BANK OF NY OFFERS A CONDITIONAL SWEETENED TENDER OFFER IF IRVING DROPS ITS ANTI-TAKEOVER DEFENSES./BANK OF NY EXTENDS ITS OFFER FOR IRVING.

Bank of NY decided to proceed with the offer giving Irving's board until May 20th to lower its anti-takeover defenses and accept a higher offer of \$15 cash and 1.675 shares of Bank of NY stock for each Irving share, an offer valued at \$67 a share. If not accepted, Bank of NY will proceed with its lower offer of \$15 cash and 1.575 shares of Bank of NY stock, an offer valued at \$64 a share.

Bank of NY officials said the anti-takeover defenses and loss of the proxy fight weren't enough to make them drop their bid. Referring to the NY state law that says without approval from the target organization's board a merger of two organizations is prevented for five years, Chairman of Bank of NY, J. Carter Bacot comments, "We would've preferred to have won the proxy contest, but we're prepared to run the bank as a subsidiary."¹²

¹²J. Carter Bacot Quoted in Robert Guenther, "Bank of New York Slightly Boosts Offer for Irving," The Wall Street Journal, 18 May 1988, 6(E).

Due to expire today, Bank of NY extended its offer for Irving until May 24th.

May 19, 1988: ANTICIPATING AN ACQUISITION, BANK OF NY ISSUES NEW STOCK, A CONDITIONAL REQUIREMENT SET BY THE FED FOR A MERGER BETWEEN BANK OF NY AND IRVING.

Bank of NY sold \$75 million of adjustable-rate (dividend rate is adjusted quarterly based upon a U.S. Treasury security benchmark) noncumulative preferred stock and \$75 million of 9.75% fixed-adjustable-rate (initial dividend rate is 9.75% for the first three years and will be adjusted quarterly based upon a U.S. Treasury security benchmark after December 1, 1991) noncumulative preferred stock.

May 20, 1988: IRVING FORMALLY REJECTS BANK OF NY'S CONDITIONAL SWEETENED TENDER OFFER FOR \$15 CASH AND 1.675 SHARES OF BANK OF NY IF IRVING WOULD DROP ITS ANTI-TAKEOVER DEFENSES.

The offer of \$15 cash plus 1.575 shares of Bank of NY stock for each Irving share now stands until May 24th, unless extended.

May 23, 1988: UNDER THE FOURTH SET OF TERMS, BANCA COMMERCIALE ISSUES A BID FOR IRVING.

Banca Commerciale increased its offer \$5 a share, from its May 2nd revision, to \$80 a share for 51 percent of Irving shares. It will also pay 7 percent annual interest from May 31st until closing.

May 24, 1988: BANK OF NY FILES SUIT IN NEW YORK STATE SUPREME COURT CLAIMING THAT PROXIES AT THE IRVING ANNUAL MEETING HAD BEEN TALLIED IMPROPERLY./BANK OF NY EXTENDS ITS OFFER FOR IRVING.

Bank of NY claims that the independent inspector of the Irving board elections had incorrectly disqualified votes representing one million shares, a sufficient number to reverse the slim 52-48 percent Irving win. Bank of NY is seeking to invalidate Irving's action and have its slate of directors installed. Nevertheless, today Irving reconvened the annual meeting and installed its sixteen incumbent directors.

Bank of NY won a forty-five day extension from the Federal Reserve on its bid to acquire Irving. Bank of NY subsequently extended its tender offer to Irving until May 28th.

May 26, 1988: U.S. DISTRICT COURT COMPELS BANK OF NY TO EXTEND ITS TENDER OFFER AND PROVIDE A NEW PROSPECTUS TO IRVING SHAREHOLDERS.

Bank of NY originally said that it wanted to purchase all Irving shares and subsequently merge the two banking institutions. Due to the loss of Bank of NY's slate for Irving's board, the Irving anti-takeover rights plan, and the current New York State anti-takeover law, a merger appears unlikely. Consequently, Bank of NY later stated that it was interested in purchasing the Irving shares tendered to it, provided at least two-thirds were tendered and will simply run Irving as a subsidiary until a merger is possible.

Irving brought suit against the Bank of NY stating it had violated federal securities law by adjusting the number of shares it is interested in purchasing.

The U.S. District Court reserved judgement as to whether Bank of NY should amend its disclosure documents filed with the SEC to reflect the fact that it might purchase fewer shares. The court did compel Bank

of NY to extend its tender offer and provide a new prospectus to Irving shareholders to clarify the terms of the proposed acquisition.

Due to expire May 28th, Bank of NY extended its tender offer for Irving to June 4th.

May 31, 1988: BANCA COMMERCIALE RECEIVES APPROVAL FROM THE BANK OF ITALY, THAT COUNTRY'S BANK REGULATOR, TO PURCHASE 51 PERCENT OF IRVING.

Banca Commerciale is still waiting approval concerning the merger from the Federal Reserve, a most crucial approval which may take months to receive. The bank is also awaiting approval from the New York State Banking Department and clearance from the Italian government to exchange lire for dollars when purchasing Irving shares.

June 3, 1988: DUE TO EXPIRE TOMORROW, BANK OF NY EXTENDS ITS OFFER FOR IRVING UNTIL JUNE 25TH.

The extended offer is for \$15 cash plus 1.575 shares of Bank of NY stock for each share of Irving.

June 9, 1988: BANCA COMMERCIALE'S OFFER, DUE TO EXPIRE TODAY, WAS EXTENDED TO JUNE 29TH.

The bank's offer is for \$80 a share, for 51 percent of Irving. It will also pay 7 per cent annual interest from May 31st to the date of closing. Although the offer is supported by Irving's board, at the close of business yesterday only slightly more than one million shares out of 18.7 million outstanding had been tendered to Banca Commerciale.

June 15, 1988: BANK OF NY OFFERS A CONDITIONAL SWEETENED TENDER OFFER IF IRVING WILL DROP ITS ANTI-TAKEOVER DEFENSES.

Bank of NY's stated offer is for \$15 cash and 1.575 shares of its stock for each Irving share, about a \$67 share value. The conditional offer is for the same amount of cash, \$15, but increases the shares to 1.675 of Bank of NY stock if Irving will drop its anti-takeover defenses.

Additionally, the conditional offer would give shareholders a special cash dividend of \$2.50 just before completion of the offer from proceeds of Irving's sale of the Swiss bank, Banca della Svizzera Italiana. Participation rights valuing \$2.50 a share would also be distributed from the gain from the proposed sale of Irving's headquarters at One Wall Street. Including the cash dividend and participation rights, the conditional offer is valued at \$75 a share.

Both Irving and Bank of NY have proposed the sale of Irving headquarters (the sale never materialized).

The sweetened offer was discussed at a forty minute meeting between Bacot and Rice at Irving headquarters. Bacot had indicated on earlier occasions interest to speak to Rice, but Rice had refused formal communication. This was the first meeting between the chairmen since the offer began ten months ago.

Irving closed at \$70.125, up a full \$3.875. Bank of NY shares fell \$.75, to \$33.00.

June 23, 1988: BANK OF NY GIVES IRVING UNTIL NOON TODAY TO ACCEPT ITS SWEETENED CONDITIONAL TENDER OFFER.

If Irving refuses the conditional offer, Bank of NY will proceed with its hostile offer and will request a prompt ruling on its lawsuits

which ask that Irving's proxy results be overturned and its anti-takeover defenses dismantled.

June 24, 1988: IRVING DID NOT RESPOND TO BANK OF NY'S CONDITIONAL ULTIMATUM./BANK OF NY EXTENDS ITS TENDER OFFER.

Due to expire tomorrow Bank of NY extended its tender offer to July 8th. The offer of \$15 cash plus 1.575 shares is back into effect.

June 27, 1988: BANCA COMMERCIALE EXTENDS ITS TENDER OFFER.

Due to expire June 29th, Banca Commerciale extended its offer for Irving until July 25th. The offer is for \$80 a share plus interest payments, for 51 percent of Irving.

July 5, 1988: BANCA COMMERCIALE EXTENDS FIFTH OFFER FOR IRVING.

Banca Commerciale is now offering \$80 a share, plus warrants valued at \$4 a share, for 51 percent of Irving. It will also pay Irving holders 7 percent interest from May 31st to the date of closing. As suspected, Irving officials immediately supported the bid.

Irving holders would receive one warrant for every four shares of Irving. Each warrant would permit shareholders to purchase one share of Irving at \$65, over the next seven years.

Banca Commerciale's offer is conditioned on Irving's "flip-in" provision remaining in place. The feature allows Irving shareholders, except Bank of NY, to exercise rights and buy Irving stock for half the market price once a single person or group obtains 20 percent of Irving's common stock.

Irving closed at \$71.375, up \$.125. Bank of NY shares closed at \$36.125, up \$1.25.

July 6, 1988: THE STATE SUPREME COURT FOR NEW YORK COUNTY RULED AGAINST IRVING'S "FLIP IN" PROVISION SAYING IT DISCRIMINATED UNFAIRLY AGAINST BANK OF NY.

Judge Herman Cahn of the State Supreme Court for New York County issued a preliminary injunction against Irving's "flip-in" provision adopted on March 28, 1988. This being the first time a "flip-in" provision had been ruled on in the New York courts, Cahn said the feature discriminated unfairly against Bank of NY.¹³

Irving plans to appeal the decision. Owen A. Brady, Vice President, Public and Investor Relations, for Bank of NY, said the bank will wait to act on the tender offer until they hear the outcome of the appeal. He said, "We couldn't attempt a merger if there is a possibility that Irving will win the appeal."¹⁴ The "flip-in" provision would make it extremely expensive and virtually impossible for Bank of NY to acquire Irving, if the feature would hold.

Consequently, the amended poison pill of March 16, 1988 remains binding.

July 7, 1988: A STATE SUPREME COURT APPOINTED REFEREE RECOMMENDS THAT A 425,000 SHARE BLOCK OF VOTES SHOULD HAVE BEEN COUNTED IN FAVOR OF BANK OF NY RATHER THAN IRVING./BANK OF NY EXTENDS TENDER OFFER./IRVING REQUESTS THE STATE SUPREME COURT TO REQUIRE BANK OF NY TO POST A \$256.5

¹³Judge Herman Cahn Cited in Robert Guenther, "Judge Rules Against Irving in Takeover Bid," The Wall Street Journal, 7 July 1988, 2(E).

¹⁴Owen A. Brady, Bank of New York, New York, NY. Telephone Interview, July 1988.

MILLION BOND BEFORE THE INJUNCTION AGAINST IRVING'S "FLIP IN" PROVISION IS MADE EFFECTIVE.

The court appointed referee said 425,000 votes should have gone to Bank of NY rather than Irving in the May 6th proxy fight for control of Irving's board. The recommendation however would not overturn the outcome of the May 6th election, which in a 52-48 percent margin reelected all sixteen incumbent Irving directors.

Due to expire tomorrow, Bank of NY extended its tender offer to Irving until August 12th.

Irving asked Judge Cahn to require Bank of NY to post a \$256.5 million bond before yesterday's injunction against Irving's "flip-in" provision is made effective. Irving claims this amount represents the potential loss to its shareholders if Banca Commerciale isn't able to purchase Irving. Banca Commerciale's offer is conditional upon the "flip-in" provision against Bank of NY remaining in place. Judge Cahn has Irving's stance under consideration.

Banca Commerciale's offer is highest per share at \$80 a share, plus \$4 in warrants, and 7 percent annual interest payment from May 31st to date of closing, for 51 percent of Irving. Bank of NY closed at \$35 today, making its offer of \$15 cash and 1.575 shares of its own stock for each Irving share worth a lower \$70.125.

July 11, 1988: BANK OF NY WINS A SIXTY DAY EXTENSION FROM THE FED TO ACTIVATE ITS OFFER FOR IRVING.

Federal Reserve approval for Bank of NY to acquire Irving expired on July 9th. Due to the litigation in process Bank of NY won an additional sixty day extension on its bid.

August 2, 1988: BANK OF NY CALLS THE PREFERRED STOCK IT ISSUED IN CONNECTION WITH THE IRVING PROPOSAL.

The 9.75 percent fixed-adjustable noncumulative \$75 million preferred shares were originally issued on May 19, 1988, as a condition set by the Fed for the Irving offer. The shares were called by Bank of NY as the institution claims it can replace the financing at a later date on more favorable terms.

August 19, 1988: THE FEDERAL RESERVE PLACES MAJOR OBSTACLE IN BANCA COMMERCIALE'S FRIENDLY OFFER.

The Fed ruled that Istituto per la Ricostruzione Industriale, which owns approximately 60 percent of Banca Commerciale, is a bank holding company under U.S. law. The U.S. law prohibits joint ownership of banks and industrial companies. Consequently, if Banca Commerciale were to purchase Irving, Istituto would have to supply detailed financial information to the Fed on the one-hundred plus industrial companies it has an interest in. Additionally, Istituto would most likely have to divest some of its non-banking companies.

Irving officials were surprised at the ruling as it was the first time the Fed has applied the Bank Holding Company Act to a foreign government-owned bank. Privately-owned foreign banks long have had to comply with the act but the Fed previously had exempted government-owned foreign banks.

August 29, 1988: BANCA COMMERCIALE ENDS ITS BID FOR IRVING.

Banca Commerciale has ended its \$840 million friendly bid for 51 percent of Irving, citing the ruling by the Fed to subject Istituto to the Bank Holding Act.

Irving hinted that it will search for another friendly merger partner but stated it still has no interest in Bank of NY's offer.

August 30, 1988: IRVING WINS STAY ON "FLIP IN" PROVISION.

New York appeals court judge, Justice Herman Cahn stayed a lower-court ruling striking down Irving's anti-takeover "flip-in" provision. The stay lasts until the date the New York State Appellate Division announces its decision on Irving's appeal.

September 7, 1988: BANK OF NY WINS A NINETY DAY EXTENSION FROM THE FED TO ACTIVATE ITS OFFER FOR IRVING.

Due to expire tomorrow, the Fed granted Bank of NY its third extension to pursue its hostile offer for Irving.

September 8, 1988: BANK OF NY EXTENDS ITS OFFER FOR IRVING.

As anticipated, Bank of NY's offer for Irving, which expired today was extended. The new offer runs until October 1st.

Irving closed at \$68.625, up \$1.50. Bank of NY fell \$.125 to close at \$34.625.

September 20, 1988: IRVING ASKS U.S. CIRCUIT COURT OF APPEALS TO OVERTURN THE FED'S APPROVAL OF BANK OF NY'S HOSTILE BID.

Irving filed suit in a Washington, D.C. federal appeals court challenging the Fed's approval.

September 30, 1988: BANK OF NY EXTENDS ITS OFFER FOR IRVING.

Bank of NY extended its tender offer for Irving shares to October 22nd.

Bank of NY owns 4.9 percent of Irving and to date, approximately 52 percent of Irving shares have been tendered.

October 4, 1988: STATE APPELLATE COURT AFFIRMED THE DECISION STRIKING DOWN IRVING'S ANTI-TAKEOVER "FLIP-IN" PROVISION.

Bank of NY officials cheered the decision hoping it would make Irving more amenable to a settlement. As for other New York corporations, it may make them reconsider their anti-takeover defenses or reincorporate in Delaware. In Delaware flip-in provisions have been upheld by the courts.

Bank of NY was not required to post the \$256.5 million bond requested by Irving.

October 5, 1988: IRVING CHAIRMAN, RICE, AGREES TO RECOMMEND THAT THE BOARD ACCEPT BANK OF NY'S HOSTILE BID.

The revised terms call for Irving shareholders to receive \$15 in cash, 1.675 Bank of NY shares and a \$5 warrant to buy Bank of NY shares for each Irving share held. The agreement is valued at \$77.15 a share.

Bank of NY's previous hostile offer was for \$15 cash and 1.575 of its shares, valued at \$70 a share.

October 7, 1988: IRVING BOARD APPROVED \$1.45 BILLION ACQUISITION BY BANK OF NY.

Irving shares closed at \$75.875, up \$1.125, while Bank of NY shares rose \$.875 to \$35.75.

October 20, 1988: RICE TO RECEIVE GENEROUS COMPENSATION PACKAGE.

Today it was announced that the departing Irving Chairman will receive more than \$2.5 million over the next year. Rice will receive a \$1.7 million payment within ten days of the completion of the takeover. A payment of \$625,000 will be rewarded as a one-year consulting contract. In return for the lucrative compensation package, Rice must retire once the takeover is completed.

November 3, 1988: FEDERAL RESERVE EXTENDS THE DEADLINE FOR BANK OF NY TO MERGE WITH IRVING.

The Fed granted Bank of NY an extension until December 9th because the SEC hasn't yet approved its revised tender offer for Irving.

November 15, 1988: BANK OF NY EXTENDS TENDER OFFER FOR IRVING SHARES.

Bank of NY extended its tender offer for all outstanding shares of Irving that it doesn't own to November 29th. The offer is provided at least two-thirds of Irving's eighteen million plus shares outstanding are tendered.

November 28, 1988: FEDERAL RESERVE GAVE FINAL APPROVAL FOR BANK OF NY TO MERGE WITH IRVING.

The Fed didn't impose any new restrictions for the merger.

November 29, 1988: BANK OF NY'S STAKE IN IRVING TOTALS 91 PERCENT AT END OF TENDER OFFER.

The tender offer for Bank of NY to purchase Irving expired today. Under the tender, Bank of NY holds 16,306,809 Irving shares. Together with the 888,634 it already owned, Bank of NY owns 91 percent of Irving.

December 30, 1988: BANK OF NY ACQUISITION OF IRVING IS COMPLETED.

At a shareholder meeting, Irving shareholder's approved the transaction. Bank of NY paid \$15 cash, 1.67 of its shares, plus a \$5 warrant for each Irving share. The companies expect to merge in the first half of 1989.

January 4, 1989: BANK OF NY ASKED IRVING EXECUTIVES TO TRADE GOLDEN PARACHUTES FOR EMPLOYEE CONTRACTS OF APPROXIMATELY EQUAL VALUE.

Bank of NY claims it desires to retain the core of Irving executives to ensure management stability. Rice's departure was part of the merger agreement. To date, only two Irving executives--Vice Chairman David Taylor and Robert A. Falise, Executive Vice President for Legal Affairs--have been fired by Bank of NY.

February 1, 1989: BANK OF NY FIRES THIRTY-EIGHT EMPLOYEES.

The dismissals involved employees of both Irving and Bank of NY and were reportedly proportional to the size of each bank's international division. Bank of NY is likely to seek more dismissals in an effort to cut costs in the merged institution.

May 1989: BANK OF NY CHARGES FORMER IRVING EMPLOYEE OF EMBEZZLEMENT.

Burleigh W. Rose, a former employee of Irving, along with two Citibank associates, have been accused of embezzling more than \$5.5 million from Irving over the past eight years. The three individuals allegedly have spent the funds on homes in Florida, San Francisco, and New Jersey as well as on expensive gifts for friends. Bank of NY has filed a civil lawsuit against the three hoping to retrieve some of the funds.

The missing funds were only suspected on May 11th when a new Irving employee in the employee benefit trust division discovered a suspicious pattern in payments of three checks totaling \$278,000. An investigation revealed that Rose had created fictitious transactions while an employee in Irving's securities collection area from 1981 to 1985 and subsequently in the employee benefit trust division. Checks were made payable to the two Citibank employees and deposited in the Citibank branches where Rose's accomplices worked.

Bank of NY indicated new controls have been put in place within Irving to prevent a recurrence.

October 9, 1989: THE BANK OF NY/IRVING MERGER COMPLETED.

The combined institution will be known as the Bank of New York.

References

- "Acquisition of Irving Bank Completed for \$1.45 Billion." The Wall Street Journal, 3 January 1989, sec. C:11(E).
- "After Irving, What Next?" ABA Banking Journal, 80, no. 12 (December 1988):7.
- The Anatomy of a Takeover Bid: The Battle for Irving Bank." The Bankers Magazine, 171, no. 6 (November-December 1988):30-31.
- Andrews Suzanna. "Just How Hostile Is Carter Bacot?" Institutional Investor 23, no. 2 (February 1989): 56-62.
- Austin, Douglas V. "Fighting for Independence." ABA Banking Journal, 79, no. 5 (May 1987):38-39.
- "Bank of New York Co. Calls \$75 Million Issue of Preferred Shares." The Wall Street Journal, 3 August 1988, 29(E).
- The Bank of New York Company, Inc. Annual Report 1987. The Bank of New York, 48 Wall Street, New York, New York.
- The Bank of New York Company, Inc. Annual Report 1988. The Bank of New York, 48 Wall Street, New York, New York.
- The Bank of New York Company, Inc. Annual Report 1989. The Bank of New York, 48 Wall Street, New York, New York.
- The Bank of New York Company, Inc. Form 10-K 1988. The Bank of New York, 48 Wall Street, New York, New York.
- The Bank of New York Company, Inc. Form 10-K 1989. The Bank of New York, 48 Wall Street, New York, New York.
- The Bank of New York Company, Inc. Form S-4. The Bank of New York, 48 Wall Street, New York, New York. Filed with the Securities and Exchange Commission on 14 November 1988.
- "The Bank of New York Company, Inc." In Moody's Bank & Finance Manual, 920-26. New York: Moody's Investors Service, Inc., 1989.
- "The Bank of New York Company, Inc." In Moody's Bank & Finance Manual, 929-33. New York: Moody's Investors Service, Inc., 1988.
- "Bank of New York Co.'s Bid of \$60 a Share Is Rejected." The Wall Street Journal, February 17, 1988, 5(E).
- "Bank of New York Deadline." The Wall Street Journal, 4 November 1988, sec. C:18(E).

- "Bank of New York Elects Chevalier Vice Chairman." The Wall Street Journal, 23 January 1989, sec. B:5(E).
- "Bank of New York Extend to Sept. 30 Offer for Irving Bank." The Wall Street Journal, 9 September 1988, 22(E).
- "Bank of New York Extends the Deadline for Its Irving Offer." The Wall Street Journal, 6 June 1988, 2(E).
- "Bank of New York Extends Irving Bank Offer to June 4." The Wall Street Journal, 27 May 1988, 29(E).
- "Bank of New York Extends Offer Until Next Thursday." The Wall Street Journal, 14 April 1988, 10(E).
- "Bank of New York Extends Tender Offer for Shares of Irving." The Wall Street Journal, 20 April 1988, 10(E).
- "Bank of New York Extends Tender Offer for 3 Weeks." The Wall Street Journal, 4 October 1988, sec. A:12(M).
- "Bank of New York Files Suit." The Wall Street Journal, 18 March 1988, 30(E).
- "The Bank of New York." In Moody's Bank & Finance Manual, 933-34. New York: Moody's Investors Service, Inc., 1988.
- "The Bank of New York." In Moody's Bank & Finance Manual, 926-27. New York: Moody's Investors Service, Inc., 1989.
- "Bank of New York." In Standard NYSE Stock Reports, 282. New York: Standard & Poor's Corp., November 1988.
- "Bank of New York." In Standard NYSE Stock Reports, 282. New York: Standard & Poor's Corp., February 1989.
- "Bank of New York." In Standard NYSE Stock Reports, 282. New York: Standard & Poor's Corp., May 1989.
- "Bank of New York." In Standard NYSE Stock Reports, 282. New York: Standard & Poor's Corp., August 1989.
- "Bank of New York." In Standard NYSE Stock Reports, 282. New York: Standard & Poor's Corp., November 1989.
- "Bank of New York." In Standard NYSE Stock Reports, 282. New York: Standard & Poor's Corp., February 1990.
- "Bank of New York Merger is Cleared by Fed Board." The Wall Street Journal, 29 November 1988, sec. C:18(E).

- Bank of New York Merger." The Wall Street Journal, 10 October 1989, sec. A:8(E).
- "Bank of New York Offering Securities as Required by Fed." The Wall Street Journal, 20 May 1988, 3(E).
- "Bank of New York Says Its Offer for Irving Stands." The Wall Street Journal, 21 October 1987, 4(E).
- "Bank of New York Unit Lays Off 18 Employees." The Wall Street Journal, 27 January 1989, sec. B:2(E).
- "Bank of New York Wins Fed Extension for Hostile Irving Bid." The Wall Street Journal, 11 July 1988, 8(E).
- "Bank of New York's Offer for Irving Bank Advances." The Wall Street Journal, 18 November 1987, 7(E).
- "Bank of New York's Stake Totals 91% at End of Offer." The Wall Street Journal, 30 November 1989, sec. C:20(E).
- "The Bank Takeover Targets Sweepstakes." Bankers Monthly 106, no. 5 (May 1989):75-79.
- Berton, Lee. "Irving's Board Clears Merger At \$1.45 Billion." The Wall Street Journal, 10 October 1988, sec. A:6(E).
- "'But You Said You Loved Me Once' 'Oh, Shut Up.'" The Wall Street Journal, 13 January 1988, 23(E).
- Cates, David C. "Bank Analysis for a Takeover Era." Bank Administration 64, no. 12 (December 1988):18-21.
- Darnell, Jerome C. "Bank Mergers: Price Paid to Marriage Partners." Federal Reserve Bank of Philadelphia Business Review (July 1973):16-25.
- Davidson, Kenneth M. Megamergers: Understanding Corporate Acquisitions. Cambridge, Mass.: Ballinger Publishing, 1985.
- "Deadline for Data on Bid for Irving Bank Extended," The Wall Street Journal, 30 October 1987, 12(E).
- "Fed Chief Cautions Panel About Bank Takeovers." The Wall Street Journal, 25 February 1988, 3(E).
- "Financing Business." The Wall Street Journal, 13 April 1988, 45(E).
- Finch, Peter. "Joe Rice's Fight to Fend Off Bank of New York." Business Week, 28 March 1988, 44(E).

"Firm Extends Tender Offer for Irving Bank to June 28." The Wall Street Journal, 10 June 1988, 12(E).

"For Sale on Wall Street: Anything but the Street." The Wall Street Journal, 10 April 1989, sec. B:1(E).

Graddy, Duane B., and Austin H. Spencer. Managing Commercial Banks: Community, Regional and Global. Englewood Cliffs, N.J.: Prentice-Hall, 1990.

Guenther, Robert. "Banca Commerciale Raises Bid for 51% of Irving to \$80 a Share, or \$755 Million." The Wall Street Journal, 24 May 1988, 3(E).

_____. "Bank New York Cuts Irving Bid to \$60 a Share." The Wall Street Journal, 26 January 1988, 6(E).

_____. "Bank of New York Breaks a Staid Code With Irving Bid." The Wall Street Journal, 28 September 1987, 2(E).

_____. "Bank of New York Charges Three in Embezzlement." The Wall Street Journal, 12 June 1989, sec. B:12(E).

_____. "Bank of New York Faces Daunting Task." The Wall Street Journal, 7 October 1988, sec. A:7(E).

_____. "Bank of New York Files Supplement to Merger Papers." The Wall Street Journal, 6 November 1987, 11(E).

_____. "Bank of New York Fires 38 and More Dismissals Slated." The Wall Street Journal, 2 February 1989, sec. B:12(E).

_____. "Bank of New York Gets Extension on Irving Bid." The Wall Street Journal, 25 May 1988, 4(E).

_____. "Bank of New York and Irving to Hold Talks on Merger." The Wall Street Journal, 22 April 1988, 2(E).

_____. "Bank of New York Offers to Boost Its Bid for Irving." The Wall Street Journal, 16 June 1988, 6(E).

_____. "Bank of New York Plan to Buy Irving Is Faulted by U.S." The Wall Street Journal, 22 October 1987, 26(E).

_____. "Bank of New York Says It might Drop Hostile Irving Offer." The Wall Street Journal, 30 June 1988, 45(E).

_____. "Bank of New York Sees Rising Profit After Its Merger." The Wall Street Journal, 17 February 1989, sec. B:11(E).

_____. "Bank of New York Sets a Deadline for Irving Offer." The Wall Street Journal, 23 June 1988, 49(E).

- _____. "Bank of New York Slightly Boosts Offer for Irving." The Wall Street Journal, 18 May 1988, 6(E).
- _____. "Bank of New York Sues to Block Issue of Stock by Irving." The Wall Street Journal, 8 February 1988, 31(E).
- _____. "Court Referee Favors Bank of New York in Proxy Fight Over Irving Holder Vote." The Wall Street Journal, 8 July 1988, 2(E).
- _____. "Court's Decision Against Irving Tactic in Takeover Fight is Upheld on Appeal." The Wall Street Journal 5 October 1988, sec. A:6(E).
- _____. "Departing Chairman of Irving Bank Corp to Get \$2.5 Million." The Wall Street Journal, 21 October 1988, sec. B:6(E).
- _____. "Fed Ruling on Irving Bank Offer Creates Snag for Government Agency in Italy." The Wall Street Journal, 22 August 1988, 4(M).
- _____. "Irving Bank Board to Consider Search for Friendly Suitor." The Wall Street Journal, 7 September 1988, 46(E).
- _____. "Irving Bank Corp. Steps Up Defense Against Takeover." The Wall Street Journal, 29 March 1988, 6(E).
- _____. "Irving Bank Defeats Suitor in Proxy Fight." The Wall Street Journal, 17 May 1988, 3(E).
- _____. "Irving, Bank of New York Both Claim Victory in Fight to Control Irving Board." The Wall Street Journal, 9 May 1988, 4(E).
- _____. "Irving Bank of New York Could Reach Accord Yet, as Some Headway Is Cited." The Wall Street Journal, 23 May 1988, 2(E).
- _____. "Irving, Bank of New York Keep Slugging." The Wall Street Journal, 15 September 1988, 6(E).
- _____. "Irving Bank Offers Golden Parachutes to All Its Workers." The Wall Street Journal, 25 November 1987, 19(E).
- _____. "Irving Bank Puts Per-Share Value at \$82 to \$107." The Wall Street Journal, 23 March 1988, 21(E).
- _____. "Irving Bank Says Proxy Was Altered in Fight for Board." The Wall Street Journal, 29 June 1988, 30(E).
- _____. "Irving Bank Seeks Buyer for New Issue to Avert Hostile Takeover, Sources Say." The Wall Street Journal, 5 February 1988, 6(E).
- _____. "Irving Bank Sues New York Agency, Bank of New York." The Wall Street Journal, 3 February 1988, 13(E).

- _____. "Irving Bank's Board Rejects Takeover Bid." The Wall Street Journal, 12 October 1987, 4(E).
- _____. "Irving Bank's Chairman Agrees to Recommend Acceptance of Bank of New York's Hostile Bid." The Wall Street Journal, 6 October 1988, sec. A:3(E).
- _____. "Irving Bank's Dividend Rise Is Thwarted." The Wall Street Journal, 21 April 1988, 2(E).
- _____. "Irving Forecasts Improved 1988 Results in Bid to Thwart Bank of New York Offer." The Wall Street Journal, 5 April 1988, 10(E).
- _____. "Irving Gets \$65-a-Share Offer for 51% Aimed at Thwarting Bank of New York." The Wall Street Journal, 19 April 1988, 3(E).
- _____. "Irving, Italian Bank Face New Hurdle to Linkup a Fed 'Revisits' Policy Issues." The Wall Street Journal, 28 April 1988, 4(E).
- _____. "Irving Officials Tapped by Bank of New York." The Wall Street Journal, 5 January 1989, sec. B:5(E).
- _____. "Irving Ordered to Move Date of Its Meeting." The Wall Street Journal, 25 April 1988, 4(E).
- _____. "Irving, Target of Bank of New York, Holds Talks With Others; Stock Jumps." The Wall Street Journal, 25 March 1988, 5(E).
- _____. "Irving to Sell Stake in BSI in Plan Tied to Friendly Suitor." The Wall Street Journal, 2 May 1988, 24(E).
- _____. "Irving's Chairman Expresses Concerns Over Takeover Bid." The Wall Street Journal, 2 October 1987, 22(E).
- _____. "Irving's Chairman Rice Rejected Deal Offered by Hostile, Friendly Bidders." The Wall Street Journal, 23 September 1988, 4(E).
- _____. "Irving's Chief Rules Out Using Asset Sale, 'White Knight' to Ward Off Hostile Offer." The Wall Street Journal, 14 October 1987, 22(E).
- _____. "Italian Bank Alters Its Bid to Acquire Irving Common." The Wall Street Journal, 3 May 1988, 29(E).
- _____. "Italian Concerns Sweetens Offer for Irving Bank." The Wall Street Journal, 6 July 1988, 4(E).
- _____. "Italian Suitor Won't Raise Bid for Irving, Clearing Way for Bank of New York Offer." The Wall Street Journal, 29 April 1988, 3(E).

- _____. "Judge Rules Against Irving in Takeover Bid." The Wall Street Journal, 7 July 1988, 2(E).
- _____. "Lenders of Irving, Bank of New York to Discuss Battle." The Wall Street Journal, 14 June 1988, 18(E).
- _____. "Limited Use of Hostile Bank Takeovers Expected Despite Regulatory Go-Ahead." The Wall Street Journal, 1 March 1988, 10(E).
- _____. "Midlantic to Buy New York Banks for \$291 Million." The Wall Street Journal, 2 March 1989, sec. A:4(E).
- _____. "Offer for Irving Is Cut By Bank of New York." The Wall Street Journal, 23 November 1987, 5(E).
- _____. "Proxmire Asks Fed to Scrutinize Bid for Irving Bank." The Wall Street Journal, 22 February 1988, 6(E).
- _____. "Regulator Backs Italian Bank's Bid to Control Irving." The Wall Street Journal, 1 June 1988, 10(E).
- _____. "Takeover Defense at Irving Bank Survives First Vote." The Wall Street Journal, 5 May 1988, 32(E).
- _____. "Two Big Banks' Results Mixed in First Quarter." The Wall Street Journal, 14 April 1989, sec. C:8(E).
- Guenther, Robert, and Laura Colby. "Italian Bank Ends Bid for 51% of Irving Stock." The Wall Street Journal, 30 August 1988, 3(E).
- _____. "Italian Firm to Provide Data on Irving Offer." The Wall Street Journal, 23 August 1988, 4(M).
- Guenther, Robert, and Taylor, Robert E. "Bank of New York's Bid Is Cleared by Federal, State Regulators." The Wall Street Journal, 26 February 1988, 4(E).
- "Irving Bank Amends Rights Plan to Thwart Bank of New York Bid." The Wall Street Journal, 17 March 1988, 12(E).
- Irving Bank Corporation Annual Report 1987. Irving Bank Corporation. One Wall Street, New York, New York.
- "Irving Bank Corporation." In Moody's Bank & Finance Manual, 1103-8. New York: Moody's Investors Service, Inc., 1988.
- Irving Bank Corporation Third Quarter 1988. Irving Bank Corporation, One Wall Street, New York, New York.
- "Irving Bank Hires Rival to Help Battle Hostile Bid." The Wall Street Journal, 12 January 1988, 19(E).

- "Irving Bank." In Standard NYSE Stock Reports, 1254. New York: Standard & Poor's Corp., November 1988.
- "Irving Bank Makes Private Placement of Preferred Stock." The Wall Street Journal, 24 February 1988, 45(E).
- "Irving Bank Rejects Bank of New York's \$1.25 Billion Offer." The Wall Street Journal, 16 December 1987, 46(E).
- "Irving Bank Rejects Bank of New York's Friendly Merger Plan." The Wall Street Journal, 24 June 1988, 27(E).
- "Irving Bank Wins Round in Bank of New York Duel." The Wall Street Journal, 4 February 1988, 3(E).
- "Irving, Case Gives the Fed a Chance to Set Precedents." The Wall Street Journal, 25 September 1988, 6(E).
- "Irving Expands Suit Filed to Bar Takeover by Bank of New York." The Wall Street Journal, 27 September 1988, 61(E).
- "Irving Trust Co." In Moody's Bank & Financial Manual 1108-9. New York: Moody's Investor's Service, Inc., 1988.
- "Irving Wins Stay of Ruling on Anti-Takeover Measure." The Wall Street Journal, 31 August 1988, 34(E).
- "Irving's Chairman Urges Takeover Offer Be Halted." The Wall Street Journal, 10 November 1987, 10(E).
- Jenkins, Holman. "Farewell to Courtly Bank Mergers." Insight, 2 November 1987, 42.
- "Just Call the Man a Leading Indicator." The Wall Street Journal, 2 February 1989, sec. B:1(E).
- Kerwin, James S. and Robert A. Robinson. "Charting a Bank's Value: Number Analysis and Beyond." ABA Banking Journal 78, no. 7 (July 1986):40-42.
- Loughran, Tim. "The Sad Saga of Irving Bank." Bankers Monthly, 106, no. 1 (January 1989): 59-61.
- Mandula, Mark S. "Buy, Sell, or Merge?" ABA Banking Journal 80, no. 3 (March 1988):36-42.
- "Midlantic Announces Definitive Pact to Buy New York State Banks." The Wall Street Journal, 16 May 1989, sec. A:4(E).
- Miller, Frederic A. "Is Irving Worth the Wait?" Business Week, 12 October 1987, 162.

- Miller, William D. "Emerging Patterns on Mergers." ABA Banking Journal 80, no. 10 (October 1988):27-30.
- _____. "A Total View of Bank Value." The Bankers Magazine 169, no. 6 (November-December 1986):32-38.
- Morgan, Bruce W. "Analyzing Acquisition Terms." Bank Administration 65, no. 7 (July 1989):28-30.
- Moynihan, Jonathan. "Making Acquisitions Work for Shareholders." Bank Administration 65, no. 9 (September 1989):14-19.
- "Net Gain of 10% Is Posted by Company for 4th Period." The Wall Street Journal, 20 January 1989, sec. C:19(E).
- O'Rourke, Daniel. "Bank vs. Bank: The Hostile Takeover (And How to Fight It)." Bank Administration, 64, no. 1 (January 1988):16-21.
- _____. "The Fed's Green Light for Hostile Bank Takeovers." Mergers & Acquisitions 23, no. 5 (March-April 1989):37-41.
- "Orders Issued Under Sections 3 and 4 of the Bank Holding Company Act/The Bank of New York Company, Inc., New York, New York." Federal Reserve Bulletin, 74 (April 1988): 257-273.
- "Pact Is Reached to Acquire Firm's Credit-Card Business." The Wall Street Journal, 19 October 1989, sec. A:4(E).
- "Proposed Settlement in Irving Trust Case is Cleared by Judge." The Wall Street Journal, 30 October 1989, sec. C:5(E).
- Prospectus -- The Bank of New York Company, Inc. for All Outstanding Shares of Common Stock of Irving Bank Corporation, 18 March 1988.
- Prospectus -- The Bank of New York Company, Inc., Preferred Stock, 6 April 1988.
- Puckett, Richard H. "What is a Bank Worth?" Bank Administration 63, no. 7 (July 1987):44-45.
- Quackenbush, Christopher, and Scott E. Willkomm. "Is Your Bank Somebody's Bullseye?" ABA Banking Journal 82, no. 3 (March 1990):68-72.
- Rappaport, Alfred. "Capital Budgeting Approach to an Exchange-of-Shares Acquisition." Mergers & Acquisitions 10, no. 3 (Fall 1975):27-29.
- _____. "Do You Know the Value of Your Company?" Mergers & Acquisitions 14, no. 1 (Spring 1979):12-17.
- "Request to Get Information on Takeover Bid Is Denied." The Wall Street Journal, 10 December 1987, 43(E).

- Severson, Mark A. "Establishing a Fair Purchase Price." Bank Administration 65, no. 2 (February 1989):48-49.
- Sinkey, Joseph F., Jr. Commercial Bank Financial Management. 2nd ed. New York: Macmillan Publishing Company, 1986.
- Smith, Brian W., and Timothy E. Keehan. "How to Prepare for a Hostile Takeover." The Bankers Magazine 171, no. 5 (September-October 1988):5-10.
- Smith, Randall. "Here's a Guarantee You Can't Always Take to the Bank." The Wall Street Journal, 17 March 1989, sec. C:1(E).
- Stapp, Andrew W. "How Much is That Target Worth?" ABA Banking Journal 80, no. 7 (July 1988):44.
- Svare, J. Christopher. "Regionals Embrace the Merger-of Equals Approach." Bank Management 66, no. 2 (February 1990):24-28.
- Terry, Ronald, and Merrill C. Sexton. "Valuation of Banks in Acquisitions." The Bankers Magazine 158, no. 3 (Summer 1975):86-88.
- "Three Irving Ex-Directors Decline Seats on Board." The Wall Street Journal, 1 February 1989, sec. B:9(E).
- "The Undoing of Irving." The Economist, 6 August 1988, 66.
- "Waiting Game." Forbes, 3 October 1988, 192-93.
- Wines, Dick. "How Much Is Your Bank Worth?" Bankers Monthly 105, no. 7 (July 1988):61-64.
- Wooden, James H. "The Structural Outlook for Commercial Banks." The Bankers Magazine 171, no. 3 (May-June 1988):53-55.

INSTRUCTOR ANSWER UNIT

QUESTION 1: Bank Valuation

The purpose of the valuation process is to establish a price for negotiations. In this instance, we want to discern the present value of Bank of NY, the present value of Irving, and the synergistic present value of the combined merger.

Using the analytical framework suggested in Joseph Sinkey's, Commercial Bank Financial Management, displayed in table 5, the following conclusions about the merger were derived:

1. The benefit of the combined merger is a positive value. Consequently, Bank of NY and Irving are worth more as a merged institution than individually.

2. Irving shareholders did well in the payoff. Irving stock had an actual value of only \$55.37 while they received payment of approximately \$77 a share. This difference is explained by the synergistic benefits of the combined merger, however, Irving shareholders may have been able to hold out and receive even a higher price from Bank of NY.

3. Bank of NY shareholders made a fantastic deal on the Irving shares. The analysis indicates that for the benefits of a combined merger Bank of NY should only have been willing to pay up to \$2,689,269,437 for Irving. The final payoff at \$1,458,298,919 ($\$77 \times 18,938,947$) was an excellent buy for Bank of NY.

Bank of NY's exceptional purchase price of Irving is rather uncommon for the banking merger transactions of the 1980s. Most banks pay a price that is so high that results in decreased shareholder value for the acquirer. Jonathan Moynihan, Vice President of Manhattan

Banking Consulting Group, studied the top 250 bank mergers from 1980 to 1987. He explains:

Most acquirers pay significantly too much for their acquisitions and are then incapable of recapturing the premiums paid through such value-creating steps at cost reduction. As a result, 80% of acquirers suffer stock price dilution relative to their non-acquiring peers.¹⁵

Mr. Moynihan's study also showed proximity as among the strongest determinants of success. The closer the acquired bank is geographically to the acquirer the higher the likelihood for value creation.¹⁶ No doubt Bank of NY's and Irving's close proximity, being located just a few buildings apart, was a main component of the synergistic benefits anticipated by Bank of NY, and will propel the stock value in the future.

Some benchmark reference indices for valuation are listed in table 6. These valuation figures are appealing because they are easy to calculate; however, they also are lacking because they fail to capture significant intricacies of banking institutions. Both Irving's price to book values and price to market value are slightly below the median merger premium in banking acquisitions for 1987. These figures, although not all inclusive, do point in the direction of the reasonable price Bank of NY paid for the Irving shares.

The reading list at the end of this suggested solution, "Bank Valuation," lists numerous sources students might consider in pursuing further research.

¹⁵Jonathan Moynihan, "Making Acquisitions Work for Shareholders," Bank Administration 65, no. 9 (September 1989): 19.

¹⁶Ibid.

Table 5.--Cost-Benefit Analysis

Variable	NY	Irving	NY + Irving
Expected Dividend(D_1)	\$ 1.96	\$ 2.62	\$ 2.93
Required Rate of Return on Stock(K)	.1349	.1355	.1352
Growth Rate (g)	.0906	.0880	.0895
Share Price (P_0)	\$44.24	\$55.37	\$64.11
Number of Shares Outstanding(N)	32,990,681	18,938,947	64,713,417
Total Market Value ($V=P_0 \times N$)	\$1,459,507,727	\$1,048,649,495	\$4,148,777,164

$$\begin{aligned} \text{Benefit} - \text{Cost} &= (V_{\text{NY} + \text{Irving}} - V_{\text{NY}} - V_{\text{Irving}}) - (P_{\text{Irving}} - V_{\text{Irving}}) > 0 \\ &= (\$4,148,777,164 - \$1,459,507,727 - \$1,048,649,495) - (P_{\text{Irving}} - \$1,048,649,495) \\ &= \$1,640,619,942 - P_{\text{Irving}} + \$1,048,649,495 > 0 \\ &= \$2,689,269,437 - P_{\text{Irving}} > 0 \end{aligned}$$

Benefit of the combined merger = \$1,640,619,942

Breakeven purchase price = \$2,689,269,437

Source: Calculated using the algorithm suggested by Joseph F. Sinkey, Jr., in Commercial Bank Financial Management, 2nd ed. (New York: Macmillan Publishing Company, 1986), 687-710.

Table 5.--Notes: Bank of NY

	87	86	85	84	83
Retention Rate(RR)	.424	.686	.671	.705	.695
xROE	.090	.165	.150	.156	.155
=Growth Rate	.0382	.1132	.1007	.1100	.1077
	82	81	80	79	78
Retention Rate(RR)	.680	.640	.628	.644	.605
xROE	.154	.135	.131	.126	.128
=Growth Rate	.1047	.0864	.0823	.0811	.0774

Growth Rates x Declining Weights = Weighted Average Growth Rate (g)

.0382	x	.1818	=	.0069
.1132	x	.1636	=	.0185
.1007	x	.1455	=	.0147
.1100	x	.1273	=	.0140
.1077	x	.1091	=	.0118
.1047	x	.0909	=	.0095
.0864	x	.0727	=	.0063
.0823	x	.0545	=	.0045
.0811	x	.0364	=	.0030
.0774	x	.0182	=	.0014

1.0000

.0906

[declining weights estimated by sum of years' digit method]
[10/55=.1818, 9/55=.1636, etc.]

$$D_1 = D_0(1+g) \quad [\text{note: Quarterly dividend of } \$.45]$$

$$D_1 = \$1.80 (1 + .0906) = \$1.96$$

$$K = R_f + b_i (K_m - R_f)$$

$$K = .0734 + .94(.1388 - .0734)$$

$$K = .1349$$

$$P_0 = D_1 / (K - g)$$

$$P_0 = \frac{\$1.96}{.1349 - .0906} = \$44.24$$

$$V = P_0 \times N$$

$$V = \$44.24 \times 32,990,681 \text{ shares} = \$1,459,507,727$$

Table 5.--Notes: Irving

	86	85	84	83	82
Retention Rate (RR)	.695	.681	.640	.638	.632
xROE	.131	.129	.116	.119	.123
=Growth Rate	.0910	.0878	.0742	.0759	.0777
	81	80	79	78	
Retention Rate (RR)	.724	.720	.686	.643	
xROE	.160	.159	.142	.123	
=Growth Rate	.1158	.1145	.0974	.0791	

Growth Rates x Declining Weights = Weighted Average Growth Rate(g)

.0910	x	.2000	=	.0182
.0878	x	.1778	=	.0156
.0742	x	.1556	=	.0115
.0759	x	.1333	=	.0101
.0777	x	.1111	=	.0086
.1158	x	.0889	=	.0103
.1145	x	.0667	=	.0076
.0974	x	.0444	=	.0043
.0791	x	.0222	=	.0018

1.0000

.0880

[declining weights estimated by sum of years' digit method]
[9/45=.2000, 8/45=.1778, etc.]

$$D_1 = D_0(1+g) \quad [\text{note: Quarterly dividend of } \$0.605]$$

$$D_1 = \$2.42 (1 + .0880) = \$2.63$$

$$K = R_f + b_i (K_m - R_f)$$

$$K = .0734 + .95 (.1388 - .0734)$$

$$K = .1355$$

$$P_0 = D_1 / (K - g)$$

$$P_0 = \frac{\$2.63}{.1355 - .0880} = \$55.37$$

$$V = P_0 \times N$$

$$V = \$55.37 \times 18,938,947 \text{ shares} = \$1,048,649,495$$

Table 5.--Notes: Irving (Goldman Sachs & Co. valuation)

Instructors may choose to pose the question to students, "How did Goldman Sachs & Co., value Irving's stock at \$82 to \$107 a share? What were the assumptions?"

$$P_o = D_o(1+g)/(K-g)$$

$$P_o(K-g) = D_o(1+g)$$

$$K-g = D_o(1+g)/P_o - K$$

$$-g = D_o(1+g)/P_o - K$$

$$g = K - D_o(1+g)/P_o$$

\$82 valuation

$$g = .1355 - \frac{\$2.42(1+g)}{\$82}$$

$$g = .1355 - .029512 - .029512g$$

$$1.029512g = .105988$$

$$g = .102950$$

check:

$$P_o = \frac{\$2.42(1+.102950)}{.1355 - .102950}$$

$$P_o = \frac{\$2.669139}{.032550}$$

$$P_o = \$82.00$$

\$107 valuation

$$g = .1355 - \frac{\$2.42(1+g)}{\$107}$$

$$g = .1355 - .022617 - .022617g$$

$$1.022617g = .112883$$

$$g = .110386$$

check:

$$P_o = \frac{\$2.42(1+.110386)}{.1355 - .110386}$$

$$P_o = \frac{\$2.687134}{.025114}$$

$$P_o = \$107.00$$

If Goldman Sachs & Co. utilized market data to derive the required rate of return on Irving stock (K) of 13.55%, the investment advisor assumed a growth rate between 10.2950% and 11.0386% for Irving.

Table 5.--Notes: Bank of NY + Irving

<u>Irving Mkt. Value \$1,048,649,495</u>	= .4181 Irving weight
<u>Total Mkt. Values \$1,459,507,727 + \$1,048,649,495</u>	
	$\frac{.5819 \text{ NY weight}}{1.0000}$

$$g = .0906 (.5819) + .0880 (.4181) = .0895$$

$$D_1 = D_0 (1+g) \quad [\text{note: Anticipated combined dividend of } \$2.69]$$

$$D_1 = \$2.69 (1 + .0895) = \$2.93$$

$$K = R_f + b_i (K_m - R_f)$$

$$b_i = .94 (.5819) + .95 (.4181) = .9442$$

$$K = .0734 + .9442 (.1388 - .0734)$$

$$K = .1352$$

$$P_0 = D_1 / (K - g)$$

$$P_0 = \frac{\$2.93}{.1352 - .0895} = \$64.11$$

$$V = P_0 \times N$$

$$V = \$64.11 \times (32,990,681 \text{ Bank of NY shares}) + (18,938,947 \text{ Irving shares} \times 1.675)$$

$$V = \$64.11 \times 64,713,417 \text{ combined shares}$$

$$V = \$4,148,777,164$$

Table 6.--Valuation Comparisons, 1987

	Irving	Median Merger Premium ^a in Banking Acquisitions
Price to Book	77/40.91 = 1.88	2.13
Price to Market	77/74.875 = 1.03	1.35

^aSource: James H. Wooden, "The Structural Outlook for Commercial Banks," The Bankers Magazine 171, no. 3 (May - June 1988): 54.

Reading List

Bank Valuation

- "The Bank Takeover Targets Sweepstakes." Bankers Monthly 106, no. 5 (May 1989):75-79.
- Cates, David C. "Bank Analysis for a Takeover Era." Bank Administration 64, no. 12 (December 1988):18-21.
- Darnell, Jerome C. "Bank Mergers: Price Paid to Marriage Partners." Federal Reserve Bank of Philadelphia Business Review (July 1973):16-25.
- Kerwin, James S., and Robert A. Robinson. "Charting a Bank's Value: Number Analysis and Beyond." ABA Banking Journal 78, no. 7 (July 1986):40-42.
- Mandula, Mark S. "Buy, Sell, or Merge?" ABA Banking Journal 80, no. 3 (March 1988): 36-42.
- Miller, William D. "Emerging Patterns on Mergers." ABA Banking Journal 80, no. 10 (October 1988): 27-30.
- _____. "A Total View of Bank Value." The Bankers Magazine 169, no. 6 (November-December 1986): 32-38.
- Morgan, Bruce W. "Analyzing Acquisition Terms." Bank Administration 65, no. 7 (July 1989): 28-30.
- Moynihan, Jonathan. "Making Acquisitions Work for Shareholders." Bank Administration 65, no. 9 (September 1989): 14-19.
- Puckett, Richard H. "What Is a Bank Worth?" Bank Administration 63, no. 7 (July 1987): 44-45.
- Rappaport, Alfred. "Capital Budgeting Approach to an Exchange-of-Shares Acquisition." Mergers & Acquisitions 10, no. 3 (Fall 1975): 27-29.
- _____. "Do You Know the Value of Your Company?" Mergers & Acquisitions 14, no. 1 (Spring 1979): 12-17.
- Severson, Mark A. "Establishing a Fair Purchase Price." Bank Administration 65, no. 2 (February 1989): 48-49.
- Sinkey, Joseph F., Jr. Commercial Bank Financial Management. 2nd ed. New York: Macmillan Publishing Company, 1986.
- Stapp, Andrew W. "How Much Is That Target Worth?" ABA Banking Journal 80, no. 7 (July 1988): 44.

- Svare, J. Christopher. "Regionals Embrace the Merger-of Equals Approach." Bank Management 66, no. 2 (February 1990): 24-28.
- Terry, Ronald, and Merrill C. Sexton. "Valuation of Banks in Acquisitions." The Bankers Magazine 158, no. 3 (Summer 1975): 86-88.
- Wines, Dick. "How Much Is Your Bank Worth?" Bankers Monthly 105, no. 7 (July 1988): 61-64.
- Wooden, James H. "The Structural Outlook for Commercial Banks." The Bankers Magazine 171, no. 3 (May-June 1988): 53-55.

QUESTION 2: Takeover Defensive Strategies

The directors of a banking institution owe a fiduciary duty of care and loyalty to bank shareholders. "Directors are protected by the business judgement rule which protects any board decision made on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the shareholders."¹⁷ Consequently, they are generally under no obligation to sell the bank if they maintain that an offer is unfair or inadequate and not in the best interests of the shareholders. It is imperative, however, that the board of directors retain a skilled independent banking consultant to determine if an offer price may be deemed fair. A wise defensive strategy is to regularly have a stock valuation performed on the bank. Knowing the value of the institution will enable the board to more quickly discern the adequacy of unsolicited offers.

If the board of directors chooses to resist an offer, a variety of defensive strategies may be implemented.

1. Regulatory Process

Acquisitions are controlled by either the Change in Bank Control Act or the Bank Holding Company Act, depending on the identity and structure of the bidder. Following is a detailed description of the regulatory approval authorities:

Under the Bank Holding Company Act (BHCA), any bidder that is not a BHC must register as such through the Federal Reserve Board (Board): (1) prior to the acquisition of 25 percent or more of the voting stock of a bank of BHC; (2) prior to obtaining control of the

¹⁷Brian W. Smith and Timothy E. Keehan, "How to Prepare for a Hostile Takeover," The Bankers Magazine 171, no. 5 (September-October 1988):9.

majority of the target bank or BHC's directors or trustees; or (3) determines that the bidder will exert a controlling influence over the bank or BHC's management or policies. Any bidder that is already a BHC also must file Board if it seeks to acquire more than 5 percent of the target's voting stock. An individual, a group of individuals, and anyone else not constituting a "company" seeking control of a bank or BHC must file for approval under the Change in Bank Control Act (CBCA) if it acquires 10 percent or more of the target's voting stock. Any purchase of stock exceeding 25 percent, however, automatically triggers the application of the BHCA.

The review of the application by the Board requires that appropriate notice be given to the target institution's primary regulator, which then may submit its views and recommendations with respect to the proposed acquisition. The Board subsequently rules on the application based on, among other things, the competitive effects of the acquisition, the financial and managerial resources of the acquirer, and the convenience and needs of the community. Although the Board occasionally delegates its decision-making authority to the Federal Reserve Banks, the Board usually will rule on most contested takeovers.¹⁸

The regulatory process itself tends to be very lengthy and this in itself provides the banking institution an opportunity to work on its defensive strategies. Additionally, the target bank may object to the substance of the acquisition application in written comments to the Federal Reserve. "For instance, the target may claim that the acquisition reduces competition, the acquirer's financial resources are inadequate, the acquisition does not respond to the community's convenience and needs, and/or the acquirer has not complied with the Community Reinvestment Act."¹⁹ Any hearing provided is at the discretion of the Federal Reserve under the BHCA and hearings are not held under the CBCA.

¹⁸Ibid., 6.

¹⁹Ibid.

2. Filing Under Securities Law

If the offer includes the securities of the bidder as part of the application, the securities Act of 1934 may require registration with the Securities and Exchange Commission.

"A common defensive measure for the target, following a review of the acquirer's disclosure documents, is to commence a lawsuit alleging violations by the acquirer of the disclosure, antifraud, and other requirements of the 1934 Act, the margin regulations, antitrust statutes, or state takeover laws, assuming that appropriate grounds for such allegations exist."²⁰ A suit may be filed in federal or state court, depending upon the nature of the allegations.

3. Poison Pill Rights Plan

A poison pill rights plan is created by the bank's board of directors. The typical plan involves the target issuing to its shareholders one future right for each share of common stock the holder currently owns. The right becomes exercisable upon a takeover or the occurrence of another specified event, commonly referred to a flip-in or flip-over event. "When triggered, the rights entitle the holders (other than the hostile acquirer) to purchase the target's or acquirer's stock (depending on whether the triggering event was a flip-in or flip-over event) at a bargain price."²¹ A successful purchaser must suffer the dilution from the exercise of these rights or attempt to purchase the rights before exercised, either way forcing hostile bidders to consider negotiated terms.

²⁰Ibid., 8.

²¹Ibid.

In certain instances poison pill rights plans do not hold up in court. Such a plan generally has a much better chance of being upheld if it was in place by a target before any hostile bid is made. Additionally, under certain state laws such plans are not permissible. Finally, if the rights plan would adversely affect a bank's capital situation or create tremendous debt within an institution, the federal bank regulators may challenge.

4. Issuing New Shares of Stock

A common defensive strategy is for bank boards to authorize a class of "blank check" preferred stock to issue in the event of an unwanted takeover attempt. Such shares may carry special voting rights too. They would dilute the voting power of existing shareholders, including an unwanted hostile holder.

5. Golden Parachutes

Golden parachutes are lucrative financial contracts for a banking institution's top executives which go into effect if the individuals are fired or demoted as a result of a hostile takeover.

6. White Knights and White Squires

A white knight is a friendly party who purchases outright or takes a substantial equity position in the target to defeat a hostile bidder.

Often out-of-state banks may be prohibited from becoming white knights due to interstate banking restrictions. Banks may then search for a group of friendly white squires. White squires band together, each purchasing a small block of stock not constituting control but together have the cumulative effect of blocking a hostile attempt.

7. Disaggregation

Disaggregation involves the target bank selling its most valuable assets, or possibly least synergistic assets, to appear less attractive to a hostile bidder or to use the equity for restructuring.

8. Self-tender for Stocks

A self-tender for stock by the incumbent directors may frustrate a hostile bid. This is a legally sound defensive move providing directors obtain the necessary regulatory approvals to bid. In a majority of instances individual directors will not possess the financial strength to outbid an institutional buyer. Consequently, this defense is generally used in only small banking institutions.

9. Litigation

Litigation opportunities should be used whenever possible to thwart a hostile bidder. The beneficial purposes of litigation are twofold. Firstly, the litigation will afford the target more time to implement defensive tactics. Secondly, litigation may provide the target access to judicially sanctioned discovery which could produce information beneficial to its defense.²²

It should be noted that if the board of directors decide to sell the bank, the directors role is similar to that of an auctioneer. The directors must strive to obtain the best possible price for their shareholders.

²²Daniel O'Rourke, "Bank vs. Bank: The Hostile Takeover (And How to Fight It)," Bank Administration 64, no. 1 (January 1988):19.

Irving Takeover Defensive Strategies

The following rankings are subject to opinion and are only to be used as a base for classroom discussion and/or grading.

1. Regulatory Process

x | above average
1
Irving challenged the Federal Reserve on the acquisition objecting to Bank of NY's capital position, its managerial resources, Bank of NY's operation plans for certain Irving subsidiaries, and that the bank did not comply with the Community Reinvestment Act.

Although none of Irving's challenges did thwart the Fed from giving approval for the merger, Irving exhausted this defensive strategy.

2. Filing Under Securities Law

x | above average
1
On May 26, 1988, Irving brought suit against the Bank of NY stating it had violated federal securities law by adjusting the number of shares it was interested in purchasing. Initially, Bank of NY said it wanted to purchase all Irving shares and merge the institutions. It later stated it was interested in purchasing the Irving shares tendered to it, provided at least two-thirds were tendered and run Irving as a subsidiary until a merger was possible. The U.S. District Court required Bank of NY to extend its tender offer and provide a new prospectus to Irving shareholders to clarify the terms of the proposed acquisition.

Although the courts ruling was mild and did not result in any lengthy litigation, Irving insightfully attempted this defensive move.

3. Poison Pill Rights Plan

x | above average
 The initial shareholder rights plan adopted enabled Irving shareholders to purchase shares of the surviving firm's stock for half price in the event of a merger. Irving's board was allowed to redeem the rights at one cent apiece before a single person or group acquires 20 percent of Irving's common stock.

Under an amended plan, the rights could not be redeemed if a majority of the sixteen member board were not current directors, unless the new directors were elected by holders of at least two-thirds of Irving's common shares outstanding.

Irving attempted a "flip-in" provision specifically against Bank of NY in its shareholder rights plan. The feature allowed all Irving holders, except Bank of NY, to exercise their rights and buy Irving stock for half the market price once a bidder obtained 20 percent of Irving's common stock. The "flip-in" condition was ruled illegal in State Supreme Court saying it discriminated unfairly against Bank of NY.

The "flip-in" condition was an excellent strategy on Irving's part because (1) no "flip-in" provision had ever been ruled on before in a New York court and (2) if upheld the provision would have been extremely dilutive and most likely forced Bank of NY to abandon its takeover plan.

x | average 4. Issuing New Shares of Stock

Irving skillfully attempted this takeover defense. On February 26, 1988, Irving placed a \$100 million new preferred issue

with fifteen supposedly friendly institutional buyers. Each of the 1,001,000 shares was convertible after three years into 1.471 shares of common stock, or at a conversion price equal to \$68 a share. When converted, the new issue would increase the number of Irving common shares outstanding and make it more burdensome for Bank of NY to acquire Irving.

Each share of convertible preferred carried 1.471 votes. Additionally, the convertible preferred shares held a special provision which prevented Bank of NY from merging with Irving within three years of a takeover, unless two-thirds of the holders waive the provision.

Just days after issuing the stock, Bank of NY convinced the required two-thirds of issue holders to waive the provision that would prevent Bank of NY from merging with Irving for three years.

The takeover defense was masterfully designed; however, the buyers were not so friendly and loyal to Irving.

5. Golden Parachutes

x | average Irving adopted lucrative golden parachutes for forty-nine of its top managers. Executives qualifying for compensation received a payment approximating three times their average annual taxable earnings for the previous five years. It was reported that Mr. Rice, Irving chairman, received more than \$2.5 million.

Irving went so far as to adopt minimal severance benefits for all 10,200 employees.

Irving did an adequate job in preparing golden parachute packages for its executives; however, if an institution is interested in buying another parachutes tend not to be a large deterrent. Golden parachutes are only exercisable if the executive is fired or demoted as a result of a hostile takeover.

6. White Knights and White Squires

below average
-
x

In retrospect it is easy to say that Irving made a deal with an unsuitable white knight, Banca Commerciale, because of the Fed's ruling. On August 19, 1988, the Fed ruled that the Italian government-owned Istituto per la Ricostruzione Industriale, which owns a majority interest in Banca Commerciale, is a bank holding company under U.S. law. If Banca Commerciale would have gone ahead with the purchase of Irving, Istituto would have had to supply detailed financial information to the Fed on the one-hundred plus industrial companies it has an interest in. Additionally, Istituto most likely would have had to divest some of its non-banking companies. It was not surprising on August 29, 1988, when Banca Commerciale ended its bid for Irving, citing the Fed's ruling.

Privately-owned foreign banks long have had to comply with the U.S. Bank Holding Company Act but the Fed previously had exempted government-owned foreign banks. Nevertheless, Irving officials should not have been too shocked by the ruling against Istituto. On April 19 1988, just one day after Irving announced Banca Commerciale's offer, the Fed stated it would have to consider if a foreign government-owned bank should be exempt from the Bank Holding Company Act.

On the optimistic side, there was a possibility that Istituto would not have been considered a bank holding under U.S. law. Furthermore, Banca Commerciale's bid lasted for a full four months and could have possibly deterred Bank of NY. Nevertheless, a domestic banking institution, where the Fed would have most likely quickly approved a merger, would have been the clear choice.

7. Disaggregation

x | below average
 Quite possibly, it was not feasible for Irving to sell a major subsidiary or bank equipment and maintain efficient operation of the organization. The sale of Banca della Svizzera Italiana, at a price of \$390 million, may have been a minor attempt at disaggregation.

8. Self-tender for Stock

x | not implemented
 Irving did not attempt this defensive strategy. Undoubtedly, due to the immense financial strength of Irving it would not have been possible for the directors to purchase the majority of bank stock.

9. Litigation

x | above average
 Irving's litigation attempts to stall and/or thwart the take-over were numerous. The following actions, although frequently unsuccessful, were skillfully executed:

1. Irving was triumphant in its state court suit against the New York State Banking Department. The State Banking Department deputy superintendent, a former employee of Bank of NY, was prohibited from participating in merger deliberations.

2. Irving filed suit in a Washington, D.C. federal appeals court challenging the Fed's approval of Bank of NY's hostile bid. The suit was unsuccessful.

3. Irving appealed the State Supreme Court ruling against Irving's "flip-in" provision. The State Appellate Court affirmed the decision striking down the "flip-in" stipulation.

Irving certainly had well-founded optimism that the appeal would uphold the "flip-in" condition. It was the first time a "flip-in" provision had been ruled on in the New York courts.

4. Irving asked the State Supreme Court to require Bank of NY to post a \$256.5 million bond due to the injunction against Irving's "flip-in" provision. Irving claimed the amount represented the potential loss to its shareholders if Banca Commerciale wasn't able to purchase Irving. Banca Commerciale's offer was conditional upon the "flip-in" provision against Bank of NY remaining in place.

No such ruling against Bank of NY was ever issued.

On the whole the takeover defenses were well attempted. Irving did make a fatal move in collaborating with Banca Commerciale. A domestic banking institution, which would have received quick Federal Reserve approval, could have rescued Irving from the hostile bidder.

The following reading list entitled "Anti-Takeover Defensive Strategies" should be helpful to students interested in this topic.

Reading List

Anti-Takeover Defensive Strategies

- Austin, Douglas V. "Fighting for Independence." ABA Banking Journal 79, no. 5 (May 1987):38-39.
- Davidson, Kenneth M. Megamergers: Understanding Corporate Acquisitions. Cambridge, Mass.: Ballinger Publishing, 1985.
- Mandula, Mark S. "Buy, Sell, or Merge?" ABA Banking Journal 80, no. 3 (March 1988): 36-42.
- O'Rourke, Daniel. "Bank vs. Bank: The Hostile Takeover (And How to Fight It)." Bank Administration 64, no. 1 (January 1988):16-21.
- Quackenbush, Christopher, and Scott E. Willkomm. "Is Your Bank Somebody's Bullseye?" ABA Banking Journal 82, no. 3 (March 1990):68-72.
- Smith, Brian W., and Timothy E. Keehan. "How to Prepare for a Hostile Takeover." The Bankers Magazine 171, no. 5 (September-October 1988): 5-10.

CHAPTER 5

THE IMPACT OF THE CORPORATE ALTERNATIVE MINIMUM TAX ON COMMERCIAL BANKS

Banking institutions feeling the tremendous impact of the Tax Reform Act of 1986 have taken a sophisticated approach to dealing with the complicated issues--hiring expert banking tax consultants to advise them on the complex laws. Since the passage of the tax reform rulings your services as a banking tax consultant have been in constant demand. Four institutions: First City Bank, Second City Bank, Third City Bank, and Fourth City Bank have requested particular assistance in dealing with one aspect of tax reform, the alternative minimum tax.

Following is an overview of the alternative minimum tax succeeded by their questions.

Introduction

The Tax Reform Act of 1986¹ includes many significant rulings affecting banking institutions. One of the most important changes and perhaps the most complex is the new corporate alternative minimum tax (AMT). The objective of the AMT is to insure that no taxable unit with sizable economic income can avoid paying significant taxes through the use of tax exclusion, deductions, and credits. The old add-on-minimum tax, 15 percent tax based on tax preference after an exemption, paid in addition to the regular corporate tax, fell short of this objective and

¹Congress, House, Tax Reform Act of 1986, 99th Cong., H.R. 3838, Public Law 99-514 (22 October 1986).

was replaced by the AMT effective with tax year 1987. The AMT taxable base includes items of economic income, many of which are not included in regular taxable income. A 20 percent tax rate is imposed on the alternative taxable income to derive the AMT. Taxpayers must compute both their alternative minimum tax and their regular income tax, and will be subjected to the greater of the two amounts.

In this description of the AMT the following will be examined: the rules and computation of the AMT; examples showing how the AMT may affect a bank's tax position; and planning strategies bankers are implementing to cope with the new tax.

Computation of the Alternative Minimum Tax

The computation of the AMT, discussed in section fifty-five of the Internal Revenue Code (IRC), is detailed in table 1.

Adjustments are added to or subtracted from regular taxable income, while preferences are always added in the determination of tentative alternative minimum taxable income (AMTI). After a positive adjustment for the book income calculation any AMT net operating loss (NOL) is deducted. The AMTI will then be reduced by a \$40,000 exemption² before being multiplied by the 20 percent AMT rate. This tax figure may be further reduced by an AMT foreign tax credit to derive tentative AMT. Finally, the regular tax (net of foreign tax credits) must be subtracted in order to arrive at the AMT (minimum tax).

²The exemption is reduced by 25 percent of the excess of AMTI over \$150,000; consequently, the exemption disappears altogether when minimum taxable income exceeds \$310,000.

$$\$310,000 - \$150,000 = \$160,000 \text{ excess}$$

$$\$40,000 \text{ exemption} - 25 \text{ percent} \times \$160,000 = \$0 \text{ exemption}$$

Technically, the tax levied by section fifty-five is equal to the excess of the tentative AMT over the regular tax. In practice, corporations will be subject to the higher of the tentative AMT or the regular tax.

The AMT (minimum tax), to the extent that it is paid as a result of deferral preferences (items that do not result in a permanent exclusion of income for regular tax purposes), can be used as a credit against the regular tax in future years. This AMT credit can only reduce the regular tax liability to an amount not less than tentative AMT. The credit may be carried forward indefinitely, but no carryback is permitted.

Table 1.--Computing the Alternative Minimum Tax

Regular taxable income	
+ AMT adjustment items	
+ AMT preference items	
<hr/>	
= Tentative AMTI	
+ Book income adjustment ^a	
- AMT NOL (limited to 90 percent of AMTI)	
- Exemption	
<hr/>	
= AMTI	
x 20 percent	
<hr/>	
= Tentative AMT before credits	
- AMT Foreign tax credits	
<hr/>	
= Tentative AMT	
- Regular tax (net of foreign tax credits)	
<hr/>	
= AMT (minimum tax) ^b	

^aIn tax years after 1989, the adjusted current earnings adjustment will replace the book income adjustment.

^bUnder stringent limitations the AMT (minimum tax) may be reduced by the investment tax credit.

AMT Adjustment Items

Because certain items are valued differently for the AMT and for regular tax purposes, adjustments act as an averaging device to avoid being taxed twice on the same income. Consequently, adjustments are distinguished from preferences in that sometimes adjustment items may be positive and at other times negative. Preferences are always positive, adding the difference between how an item is treated for regular tax purposes and under the AMT.

Section fifty-six of the IRC lists the numerous corporate adjustments required to arrive at the AMTI. Following are adjustments which may be encountered by banking institutions:

Accelerated depreciation on real and personal property placed in service after 1986 (other than property placed in service after 1986 that qualifies for a transitional exception to the rules of the 1986 Tax Reform Act). This adjustment is not relevant if the alternative method of depreciation under the accelerated cost recovery system (ACRS) is chosen. The adjustment for real property is the amount of regular tax depreciation over depreciation on a forty year straight-line basis. For personal property, the adjustment is the excess of regular tax depreciation over depreciation computed using the limited declining balance method ($1\frac{1}{2}$ times the straight line rate) switching to the straight line method when it results in a larger allowance, as permitted under the asset depreciation range (ADR) system. When property acquired after 1986 (other than transition property) is disposed of, any

gain or loss for AMT purposes will be computed according to the adjusted basis for depreciable property allowed under the minimum tax.

AMT Preference Items

Tax preferences are discussed in section fifty-seven of the IRC. The preferences most commonly incurred by banks under prior law which continue to be treated as preferences under the AMT include:

Reserve method deductions for bad debts in excess of an amount computed had the institution maintained its bad debt reserve on the basis of actual experience.³

The excess of accelerated depreciation over straight-line on real property for pre-1987 additions.

The Tax Reform Act of 1986 adds the following preferences which could affect banks:

The portion of the regular tax deduction which exceeds a property's adjusted basis for which the corporation took a charitable contribution deduction.

Tax exempt interest on private-activity bonds (non-governmental purpose bonds) issued after August 7, 1986, reduced by an related interest expense disallowed for regular tax purposes. An exception is provided for interest on bonds issued on behalf of charitable and other qualified section 501 (c)(3) organizations as well as

³The Tax Reform Act of 1986 mandates a phased-in elimination of the reserve method bad debt deduction for banks with assets exceeding \$500 million. Details of the phased-in elimination are discussed in section 585(c) of the IRC.

bonds refunding pre-1986 issues. Such private activity AMT issues includes bonds financing mass commuting facilities, qualified multi-family residential rental projects, facilities to furnish water (other than irrigation), and sewage disposal facilities.

Business Untaxed Reported Profits.

Tax experts agree⁴ the most significant component of the AMT that impacts banking institutions is the business untaxed reported profits adjustment. A description of the adjustment is included in section fifty-six(c)(1) of the IRC. For years 1987, 1988, and 1989 a book income adjustment (BIA) is used to calculate business untaxed reported profits. After 1989, the BIA is replaced by the adjusted current earnings adjustment.

As described in section fifty-six(f), the BIA is equal to one-half of the excess of adjusted net book income over tentative AMTI. The BIA is a non-adjustment type preference, as it can never reduce AMTI.

The adjusted net book income is generally the income before federal and foreign income tax (state and local taxes are allowable deductions in determining adjusted net book income) as shown in the taxpayers "applicable financial statement." If foreign income taxes are deducted rather than used as credits, such taxes reduce the adjusted net

⁴Lloyd G. Ator, Jr. and Paul Claytor, "Commercial Banking and the TRA," Journal of Accountancy 163, no. 4 (April 1987):107; James W. Haugh, "The Impact of Tax Reform on Banks," Magazine of Bank Administration 62, no. 11 (November 1986):8; William A. Rogers and Jeffrey M. Herman, "Banks and the New Alternative Minimum Tax," Bankers Monthly 103, no. 12 (December 1986):15, Steve Twersky, "Tax Exempts of Little Value While Paying Alternative Minimum Tax" (Memphis: First Tennessee Financial Services Group, 30 January 1989), photocopied.

book income. Corporations having more than one financial statement, the "applicable" statement for establishing net book income is chosen on the following priority system:

1. Financial statements filed with the SEC
2. Certified audited income statements used for credit purposes, to report to shareholders, or for any other substantial nontax purpose
3. Financial statements provided to federal or state governments or agencies
4. A noncertified report or financial statement used for credit purposes, sent to shareholders, or used for any other substantial nontax purpose

The net book income is the income or loss reported on the applicable financial statement regardless of whether or not such amount is taken into consideration for other federal income tax purposes. Book income includes all tax-exempt interest, consequently, the BIA is particularly detrimental to the banking industry which has historically been a major holder of tax-exempt securities. Banks will not only be subject to bond interest as a 100 percent preference if it is of the AMT variety, all other tax-exempt interest will be calculated in the BIA (i.e., one-half of book income over the tentative AMTI). Another item which may typically increase net book income above tentative AMTI are dividends received for which a regular tax deduction is allowed.

Starting in 1990, the BIA will be replaced. The new adjustment, adjusted current earnings (ACE), increases (or unlike the BIA decreases)

AMTI by 75 percent of the difference between ACE and tentative AMTI. The BIA and ACE totals remain virtually identical for banks, with the main factor in 1990 being the excess rate will rise from 50 to 75 percent.⁵

Impact of the AMT on a Banking Institution's Tax Position

The Basic AMT Calculation

Investments in tax-exempt securities will generate potential AMTI through the business untaxed reported profits adjustment. This possibility constitutes the commercial banks' greatest exposure to the AMT.⁶ Therefore, the illustration in table 2 is a basic example, assuming tax-exempt income as the only adjustment item (with no AMT issues) and displaying its affect on a banking institution's tax bill.

As a general rule of thumb, for pre-1990 years, banks will be subject to the AMT when tax-free income exceeds 58.3 percent of book income.⁷ In table 2, Bank B carries book income of \$1,000,000 for the year with \$583,333 in tax-exempt income, the break-even point where no AMT (minimum tax) is paid. Accordingly, regular income tax and the tentative AMT for Bank B are equal at \$141,667.

Bank A assumes a sizable proportion of tax-exempt income at \$650,000 with book income of \$1,000,000. The institution is subject to

⁵BIA and ACE total calculations should be treated similar for case analysis. The minute discrepancies are detailed in section fifty-six(g) of the IRC.

⁶Ator, "Commercial Banking and the TRA," 107.

⁷Twersky, "Alternative Minimum Tax."

the higher AMT of \$135,000 versus the regular income tax of \$119,000, resulting in an AMT (minimum tax) to be paid of \$16,000.

Finally, Bank C posits a scenario where tax-exempt income totals only \$300,000, with book income of \$1,000,000. The tentative AMT of \$170,000 is of no significance to Bank C which is subject to the higher regular income tax of \$238,000.

Consequently, as evidenced by the illustrations, not all banking institutions will be subject to the AMT. Those generating a high percentage of tax-free income to book income (58.3 percent and above) will most likely be affected by the AMT.

Table 2.--The Affect of Tax Exempt Holdings on the Tax Bill

	Bank A	Bank B	Bank C
Book income	\$1,000,000	\$1,000,000	\$1,000,000
Tax-exempt income	<u>-650,000</u>	<u>-583,333</u>	<u>-300,000</u>
Taxable income	\$ 350,000	\$ 416,667	\$ 700,000
Regular tax (34 percent)	<u>\$ 119,000</u>	<u>\$ 141,667</u>	<u>\$ 238,000</u>
Book income	\$1,000,000	\$1,000,000	\$1,000,000
Tentative AMTI	<u>-350,000</u>	<u>-416,667</u>	<u>-700,000</u>
Excess	\$ 650,000	\$ 583,333	\$ 300,000
BIA (50 percent of excess)	\$ 325,000	\$ 291,667	\$ 150,000
Tentative AMTI	<u>350,000</u>	<u>416,667</u>	<u>700,000</u>
AMTI	\$ 675,000	\$ 708,334	\$ 850,000
Tentative AMT (20 percent)	<u>\$ 135,000</u>	<u>\$ 141,667</u>	<u>\$ 170,000</u>
AMT (minimum tax) to be paid (Tentative AMT less regular tax)	\$ 16,000	\$ 0	None

A major point bankers must remember is that once the AMT does apply the banking institution assumes a 20 percent marginal tax. Additional taxable income would be taxed at a 20 percent rate with municipal income taxed at half this rate. Hence, supposedly tax-free securities would be taxed at a 10 percent (20 percent x 50 percent) rate.

Beginning in 1990, the AMT situation for banks is intensified when the ACE takes effect with an excess rate of 75 percent. As the general rule of thumb, institutions will then be subject to the AMT when tax-free income exceeds only 48.3 percent of book income.⁸ Once the AMT does apply, the so called tax-free securities would be taxed at a 15 percent (20 percent x 75 percent) rate.

A Comprehensive AMT Computation with Credit Carryforward

Table 3 illustrates Bank D's book and regular income tax calculations for 1988. During the year Bank D reported \$400,000 of tax-exempt interest earned from post-August 7, 1986 private activity bonds plus an additional \$10,000,000 of interest derived from municipal bonds. The difference between the bank's book and regular tax calculations for depreciation totaled \$300,000. An amount of \$2,000,000 was the dividends received deduction taken for tax, but not book purposes. Finally, a total of \$1,550,000 in miscellaneous timing differences⁹ accounted for the difference in book income of \$18,800,000 and regular taxable income of \$4,550,000.

⁸Ibid.

⁹Tax law permits some items to be reported in different periods for taxable income than usually recognized in financial statements. For example, rent collect in advance is generally included in taxable income earlier than it is included in financial reporting income.

Table 3.--Book and Taxable Income Computation for Bank D

Book income before Federal income tax	\$18,800,000
Tax-exempt private activity bond interest	(400,000)
Other tax-exempt bond interest	(10,000,000)
Excess of tax over book depreciation	(300,000)
80 percent dividends received deduction	(2,000,000)
Other timing differences	(1,550,000)
Taxable income	<u>\$ 4,550,000</u>

The computation of Bank D's AMT is exhibited in table 4. Following are the adjustment/preference items added to regular taxable income to derive the AMTI of \$12,025,000: \$300,000 of adjusted depreciation, \$400,000 of interest earned from private activity issues, and \$6,775,000 from the BIA. At the 20 percent rate the gross AMT computes to \$2,405,000.

Bank D's total tax liability is \$2,405,000. The AMT (minimum tax) paid is \$858,000, the amount in excess of the \$1,547,000 regular tax liability.

As a general rule, the AMT (minimum tax) to the extent that it is paid as a result of deferral preferences--but not from preferences that result from permanent exclusion of income for regular tax purposes--may be used as a credit against the regular tax in future years.¹⁰ This rule is only violated when the credit includes one or more items of exclusion in its base and the AMT (minimum tax) is still less than the sum of deferral preferences times the AMT 20 percent rate.

¹⁰Investment tax credits never reduce the AMT (minimum tax) for credit carryforward purposes.

Table 4.--AMT Income Tax Computation for Bank D

	Regular	AMT	Recomputed AMT for exclusion items
Regular taxable income	\$4,550,000	\$4,550,000	\$4,550,000
Adjustment/preference items			
Depreciation	--	300,000	
Tax-exempt private activity bond interest	--	400,000	400,000
AMTI before BIA	--	5,250,000	4,950,000
BIA			
50 percent x (\$18,800,000- \$5,250,00)	--	6,775,000	--
Regular taxable income	<u>\$4,550,000</u>		
AMTI		<u>\$12,025,000</u>	<u>\$4,950,000</u>
Regular tax (34 percent)	\$1,547,000	--	--
Gross AMT (20 percent)	--	\$ 2,405,000	\$ 990,000
AMT (minimum tax)	858,000	--	\$0 ^a
Total tax liability	<u>\$2,405,000</u>	<u>\$ 2,405,000</u>	
AMT credit carryforward (AMT of \$858,000-recomputed AMT of \$0)	\$ 858,000		

^aThe recomputed AMT (minimum tax) is any positive amount resulting from the recomputed gross AMT less the regular tax. The recomputed AMT (minimum tax) equals zero because the recomputed gross AMT of \$990,000 is less than the regular tax of \$1,547,000.

Common deferral preferences include those related to depreciation, bad debts, and the BIA adjustment. The exclusion preferences which may be encountered by banks are the appreciated property charitable deduction and tax-exempt interest from private activity bonds. The BIA is not treated as an exclusion item, even though it may include permanent differences between regular taxable income and AMTI, namely the dividends received deduction and tax-exempt bond interest. After 1989, when the BIA is replaced by the ACE, tax-exempt interest and the

dividends received deduction along with other excludable income portions of the preference, will be classified as exclusions.

The AMT credit carryforward is calculated by subtracting from the AMT (minimum tax) paid, the amount of recomputed AMT (minimum tax) that would be payable had only exclusion items been taken into account. The only exclusion item for Bank D was \$400,000 of tax-exempt private purpose interest; consequently, the recomputed AMT (minimum tax) for exclusions totaled zero because the recomputed gross AMT is less than the regular tax. Therefore, the entire AMT (minimum tax) of \$858,000 is a credit carryforward.

The entire AMT (minimum tax) is carried forward despite the fact that the exclusion item of \$400,000 of private purpose interest is totaled in the base. The basis of this occurrence is illustrated by applying the alternative method of computing the AMT credit, a calculation which will always be satisfied. The AMT credit carryforward is the lessor of: the total of deferral preferences times the AMT rate of 20 percent; or the actual AMT (minimum tax). The deferral preferences of \$7,075,000 (\$300,000 of adjusted depreciation plus \$6,775,000 for the BIA) times 20 percent equals \$1,415,000. The actual AMT (minimum tax) of \$858,000 is the lessor of the totals, and the previously derived correct credit.

The AMT credit can only reduce the regular tax liability to an amount not less than tentative AMT. While the credit may not be carried back, it may be carried forward indefinitely. In the event that the AMT credit can be utilized it will restore a portion of the regular tax benefits lost to the AMT.

Net Operating Losses

NOLs for AMT purposes are calculated by subtracting tax preference items from the regular tax NOL. An alternative minimum tax net operating loss (AMT NOL) cannot offset more than 90 percent of the AMTI.

As an illustration, assume a bank has a 1988 regular taxable income of \$100,000. Its deductions for the year total \$125,000, of which \$20,000 are preference items. The bank's NOL for regular tax purposes is \$25,000; however, the AMT NOL equals \$5,000 (\$25,000 regular NOL-\$20,000 preference items).

Foreign Tax Credits

The alternative minimum tax foreign tax credit (AMT FTC) may be used to reduce the AMT; however, the AMT FTC cannot offset more than 90 percent of the tentative minimum tax (computed before any adjustments for the AMT NOL). Consequently, neither the AMT NOL nor the AMT FTC, either separately or combined, may reduce the AMT by more than 90 percent. FTC carryforwards are permitted for excess amounts.

To determine the extent to which FTCs may offset AMTI the following calculation is applied:

$$\left(\frac{\text{Foreign source AMTI} \times \text{AMT before credits}}{\text{Total AMTI}} \right) \times 90 \text{ percent maximum FTC offset}$$

As the equation illustrates, items of tax preference must be sourced as domestic or foreign. For the BIA, the amount will be considered from domestic sources in the same ratio, as all other alternative minimum taxable income for the taxable year is from sources within the U.S. Beginning in 1990, items included in ACE will be sourced on an item-by-item basis.

Table 5 illustrates the use of the AMT FTC for Bank E. The tentative AMT before the AMT FTC is \$500,000, less the maximum AMT FTC offset of \$122,727, resulting in an AMT of \$377,273. It is important to note that the maximum AMT FTC deduction is permitted because it does place the AMT below the acceptable floor limitation of \$110,000. With a tentative AMT before the application of any AMT NOL of \$1,100,000, the AMT floor is calculated to make sure that the FTC does not reduce tentative AMT below 10 percent of this amount.

Table 5.--AMT Foreign Tax Credit Computation for Bank E

Bank E carries \$5,500,000 in AMTI of which \$1,500,000 is from foreign sources. The institution incurred an AMT NOL of \$3,000,000 plus \$300,000 of regular FTCs.

AMTI before NOL		\$5,500,000
AMT NOL deduction		
Maximum AMT NOL allowable (90 percent X 5,500,000=4,950,000)		
AMT NOL	3,000,000	-3,000,000
AMTI		<u>2,500,000</u>
AMT rate		X 20%
Tentative AMT before AMT FTC		<u>500,000</u>
Maximum AMT FTC offset	(1,500,000 X 500,000) (5,500,000)	X 90 percent = -122,727
Limitation without regard to AMT NOL		
AMTI	\$5,500,000	
AMT rate	x 20%	
	<u>1,100,000</u>	
Limitation rate	x 10%	
AMT floor	\$ 110,000 ^a	
AMT		<u><u>\$ 377,273</u></u>

^aThe maximum AMT FTC is permitted because it does not place the AMT below the floor limit.

Investment Tax Credit

The regular investment tax credit (ITC) is repealed for property placed in service after January 1, 1986; however, ITC carryovers from pre-1987 years may offset up to 25 percent of tentative AMT. Furthermore, the ITC, when combined with the AMT NOL and the AMT FTC, cannot reduce the tentative AMT to an amount lower than 10 percent of the tentative AMT without regard for the AMT NOL and AMT FTC.

As a basic illustration, assume a banking institution has a regular tax of \$0 and a tentative AMT before credits of \$450,000. The bank may use up to \$112,500 of ITCs (25 percent x 450,000), which would reduce the AMT liability to \$337,500. The AMT (minimum tax) credit for carryforward purposes total the entire \$450,000 (assuming all deferral preferences) because as previously discussed the ITC may never reduce the minimum tax credit.

Planning Strategies to Cope with the AMT

The AMT definitely complicates a banking institution's tax planning. "Even where AMT is due entirely to deferrals, and can ultimately be recouped through AMT credit carryforwards, there will be a tax prepayment compared to the regular tax system. . . . The task of preparing quarterly estimated tax payments is more complex under TRA [Tax Reform Act], requiring estimates of both AMT and regular tax incomes. Corporations erring in predicting the incidence of AMT for a given year may end up substantially overpaying estimated taxes. Others

who fail to consider an AMT situation may be faced with significant underpayment penalties."¹¹

Banking institutions must attempt to avoid the AMT or to at least minimize the overall negative tax effects. Some important strategies for AMT planning follow:

(1) Banks subject to the AMT will pay tax on taxable obligations at a marginal rate of 20 percent. Many institutions which have paid the AMT in earlier years may choose wise investments in taxable obligations to utilize prior years' AMT credits against the regular tax.

(2) Banks may choose to maintain a portfolio of tax-exempt securities, predominated with municipals acquired on or before August 7, 1986 or "bank-qualified issues (both high yielding because they are permitted an interest expense deduction), at a level where gross AMT just equals the regular tax. When an institution would otherwise be subject to the AMT, selling the lower-yielding municipals is advised.

Mike Heflin, Manager of the Financial Services Group for First Tennessee bank (\$5 billion assets), maintains that when banks anticipate being subject to the AMT, selling the lower-yielding municipal bonds is the most predominate strategy employed.¹² The tax equivalent yields on municipals for Bank F, which is in a hypothetical 20 percent tax bracket and Bank G, which is subject to the AMT are displayed in table 6. As

¹¹Joseph H. Anthony, "The New Corporate Alternative Minimum Tax," CPA Journal 57 (December 1987):73.

¹²Mike Heflin, "Coping with the Alternative Minimum Tax" (Memphis: First Tennessee Financial Services Group, 30 September 1986), photocopied.

shown, the tax equivalent yields are notably lower for Bank G due to the AMT. Not only is Bank G in a 20 percent tax bracket but the institution must pay a 10 percent effective tax rate on municipal securities.

If a bank anticipates an AMT situation, the municipal yields which will be sold may vary according to market conditions. For example, the tax equivalent yield on a 7 percent municipal is only 7.88 percent when the bank is subject to the AMT. With April 3, 1989 Treasuries at 8.87 percent for the thirteen week bill and 8.84 percent for the twenty-six week security, funds could be put to more effective use in taxable securities.

(3) If a bank anticipates it will be in an AMT position only temporarily, the institution should, if possible, avoid incurring the AMT liability due to exclusion preferences. If such preferences can be moved into the regular tax year or the AMT can be avoided by accelerating income, the preferences will escape taxation. In the following example which illustrates the situation, Bank T assumes private activity tax-exempt interest as the exclusion preference:

In 1988, T has regular taxable income of zero and \$100 of AMTI, the difference representing \$100 of tax-exempt interest on private activity bonds. In 1989, T has \$500 of regular taxable income and \$600 of AMTI, the difference again being attributable to tax-exempt interest. If T does nothing, in 1988 it will owe tax of \$20 (20 percent x \$100), and in 1989, tax of \$170 (\$500 x 34 percent, which is greater than \$600 x 20 percent). No MTC [minimum tax credit carryforward] will be available from 1988 because tax-exempt interest is an exclusion preference, so the total tax T pays over the two-year period will be \$190 (\$20 + \$170).

If T is able to accelerate \$200 of income from 1989 to 1988, however, the additional \$20 of tax paid on the tax-exempt interest will disappear. In such case, the tax in 1988 would be \$68 (because \$200 x 34 percent is greater than the AMT of \$300 x 20 percent) and the tax in 1989 would be \$102 (because \$300 x 34 percent is greater than \$400 x 20 percent). The total tax paid would thus be only \$170

(\$68 + \$102), exactly 34 percent of regular taxable income over the two-year period.¹³

Table 6.--Tax Equivalent Yields for Municipal Securities

Tax-free yield	Tax equivalent yield	
	Bank F (20 percent bracket)	Bank G (Subject to AMT)
4.0 percent	5.0 percent	4.5 percent
5.0	6.25	5.63
6.0	7.5	6.75
7.0	8.75	7.88
8.0	10.0	9.0

Source: Mike Heflin, "Coping with the Alternative Minimum Tax" (Memphis: First Tennessee Financial Services Group, September 30, 1986), photocopied.

Note: Calculations assume municipal securities do not carry an interest expense deduction.

Conclusion

Under the Tax Reform Act of 1986 banks must compute their AMT taxable base which includes items of economic income, many of which are not included in regular taxable income. A 20 percent tax rate is levied on the AMT income to derive the AMT. Banks must calculate both their AMT and their regular income tax and will be subjected to the greater of the two amounts.

For banking institutions the most commonly incurred item of the AMT is tax-exempt income. Generally, banks will be affected by the AMT when tax-free income exceeds 58.3 percent of book income. Once the AMT applies, the bank is in a 20 percent marginal tax bracket with

¹³Jay H. Zimble, "The Corporate Alternative Minimum Tax: Another Look," Taxes 65, no. 12 (December 1987):853.

supposedly tax-free income taxed at an effective 10 percent tax rate, one-half the marginal rate. The situation is aggravated due to tax law changes as of year 1990 when institutions will be subject to the AMT when tax-free income exceeds only 48.3 percent of book income; consequently, when in the AMT, tax-free securities will be taxed at an effective 15 percent rate.

Clearly, the predominate strategy by banking institutions has been the selling off of lower yielding municipals when subject to the AMT. Prior to tax reform changes in 1985, banks held 35 percent of the municipal market. As the impact of tax reform was phased in, banks lowered their holdings of municipals to a substantially lower 17 percent of the market for first quarter 1990. While not all banks have been or will be subject to the AMT, the overwhelming majority of banks have found the AMT to have a significant impact on tax planning. It is likely that the banking industry will liquidate the municipal portfolio even further in an attempt to avoid the AMT as we enter the 1990 tax year and the minimum tax liability on municipal securities becomes even more burdensome.

Questions

1. First City Bank carries \$5,950,000 in AMTI for tax year 1988. The institution inquires by what dollar amount could a FTC reduce the AMT?
2. Second City Bank is beginning to prepare its 1989 tax returns and is interested in knowing if it will be permitted an AMT credit.

During 1989, Second City reported the following:

- (1) The amount of \$1,226,400 was the dividends received deduction taken for tax, but not book purposes.
 - (2) The difference between Second City's book and regular tax for depreciation totaled \$175,000.
 - (3) The amount of \$212,296 was used as an appreciated property charitable deduction.
 - (4) The total of \$550,000 of Post-August 7, 1986 private activity bond interest was tallied.
 - (5) An amount of \$575,079 of other municipal bond interest was shown.
 - (6) Book income before Federal income tax was \$3,256,974 with taxable income at \$518,199.
3. In 1989 Third City Bank has \$10,500,000 in AMTI before any NOL. For the year the bank has AMT NOLs totaling \$11,633,000. Consequently, the banking institution believes it will have no tentative minimum tax liability because it plans to use all the AMT NOLs to offset AMTI. The bank requests your assistance in preparing the 1989 tax return.
4. In early 1991, the accounting officer at Fourth City Bank, Wilfred Charles, projects estimates for book income for the tax year 1991. From careful analysis Mr. Charles forecasts the following scenarios:
- (1) The optimistic scenario of \$3,000,000 book income has a 25 percent chance of occurrence.

(2) The most likely scenario of \$2,525,000 book income has a 50 percent chance of occurrence.

(3) The pessimistic scenario of \$1,950,000 book income has a 25 percent chance of occurrence. He also reveals that tax-exempt income is forecasted to remain roughly the same under all conditions at \$1,400,000.

Mr. Charles, familiar with how gravely the AMT can affect a bank's tax bill, is most anxious for your opinion as to Fourth City's probable AMT situation. He divulges select information:

(1) Fourth City's municipal portfolio is mainly composed of three very large issues, a low 4.4 percent municipal and a 6.5 and 7.2 percent issue.

(2) The newly issued thirteen week Treasury bills went at 7.16 percent with twenty-six week bills at 7.05 percent.

REFERENCES

- "Alternative Minimum Tax Changes." Practical Accountant 19, no. 11 (November 1986):53.
- "AMT: Enter the Book Income Formula." Journal of Accountancy 162, no. 5 (November 1986):110.
- "AMTI Uncut by Non-AMT Deductions Yielding No Benefit." Journal of Taxation 67, no. 4 (October 1987):272.
- Anthony, Joseph A. "The New Corporate Alternative Minimum Tax." CPA Journal 57 (December 1987):68-74.
- Anthony, Joseph H., and Steven C. Dilley, "The Tax Pressure on Financial Reporting." Taxes 66 (June 1988):466-77.
- "Applicable Financial Statement for AMT Purposes Determined." Journal of Taxation 69, no. 1 (July 1988):52-53.
- Ator, Lloyd G., Jr., and Paul Claytor. "Commercial Banking and the TRA." Journal of Accountancy 163, no. 4 (April 1987):102-7.
- Brown, Robert M., and Donald J. Mason. "Temporary Regs on the Corporate AMT Book Income adjustment Are Issued." Journal of Taxation 67, no. 2 (August 1987):72-78.
- Cash, L. Stephen, and Thomas L. Dickens. "Planning for the Alternative Minimum Tax." The Bankers Magazine 173, no. 3 (May-June 1990):51-55.
- Cofield, Glenn. "Year-End Tax Planning for Financial Institutions: The First Year under the New Tax Law." Memphis: First Tennessee Financial Services Group, 21 September 1987. Photocopied.
- De Merville, Wig. "Impact of the Tax Reform Act of 1986 on Capital Budgeting." Taxes 65 (November 1987):758-63.
- Dworin, Lowell. "Impact of the Corporate Alternative Minimum Tax." National Tax Journal 40 (September 1987):505-13.
- Englebrecht, Ted. D., and Anthony Billings. "Tax Reform 1986: Implications for Financial Institutions." The Bankers Magazine 170, no. 1 (January- February 1987):30-37.
- Ernst & Whinney. Tax Reform-1986: An Analysis of Provisions Relating to the Financial Services Industry. U.S.A.: Ernst & Whinney, no. x58055, 1986.

- Finley, J. D., and Preston Hofer. "New Minimum Tax Credit May Render Prior Planning Techniques Obsolete." Journal of Taxation 67, no. 3 (September 1987):158-160.
- Fiore, Nicholas J. "The AMT after the TRA: Strategies for Minimizing the Minimum Tax." Journal of Accountancy 163, no. 3 (March 1987):8.
- Geekie, Russell W. "Emerging Issues Task Force's Response to Accounting Issues Raised by AMT Provisions under TRA 86." CPA Journal 58 (March 1988):64.
- Gelfand, Matthew D., and Gerald A. Hanweck. "The Effect of Tax Reform on Banks." The Bankers Magazine 169, no. 1 (January-February 1986): 59-66.
- Gleckman, Howard, and Barbara Star. "The Minimum Tax: It's the Bottom Line That Counts." Business Week, 16 June 1986, 92.
- Gould, Arthur L. "The Corporate Alternative Minimum Tax: A Search for Equity Through a Maze of Complexity." Taxes 64 (December 1986): 783-800.
- Haight, G. Timothy. "Passive Losses and the Alternative Minimum Tax under Tax Reform." CPA Journal 57 (August 1987):64-67.
- Haspel, Ahron H., and Mark Wertlieb. "New Law Makes Sweeping Changes to Corporate Minimum Tax." Journal of Taxation 66, no. 1 (January 1987):22-28.
- Haugh, James W. "Accounting for Alternative Minimum Tax: Part 1." Magazine of Bank Administration 64, no. 2 (February 1988):6-8.
- _____. "Accounting for Alternative Minimum Tax: Part 2." Magazine of Bank Administration 64, no. 3 (March 1988):8.
- _____. "Accounting for the Alternative Minimum Tax: Part 3." Magazine of Bank Administration 64, no. 4 (April 1988):8.
- _____. "The Impact of Tax Reform on Banks." Magazine of Bank Administration 62, no. 11 (November 1986):8.
- Heflin, Mike. "Coping with the Alternative Minimum Tax." Memphis: First Tennessee Financial Services Group, 21 September 1987. Photocopied.
- _____. "Effects of the Senate Tax Bill on Tax-Exempt Securities for Financial Institutions." Memphis: First Tennessee Financial Services Group, 12 May 1986. Photocopied.
- King, Ralph, Jr. "Last Laugh." Forbes, 22 February 1988, 100.

- Konstas, Panos. "Banks and Tax-Exempt Securities in the New Tax Environment." Banking and Economic Review (November-December 1986):7-11.
- Neubig, Thomas S., and Martin A. Sullivan. "The Implications of Tax Reform for Bank Holdings of Tax-Exempt Securities." National Tax Journal 40 (September 1987):403-18.
- "New Regs Issued on Net Book Income for Corporate ATM." Journal of Taxation 67, no. 1 (July 1987):39-41.
- "New Tax Law Hits Banks Many Ways." ABA Banking Journal 80, no. 12 (December 1988):16-18.
- Petersen, John E. "Examining the Impacts of the 1986 Tax Reform Act on the Municipal Securities Market." National Tax Journal 40 (September 1987):393-402.
- Rogers, William A., and Jeffrey M. Herman. "Banks and the New Alternative Minimum Tax." Bankers Monthly 103, no. 12 (December 1986):15.
- Saunders, Laura. "Paper Profits, Real Taxes." Forbes, 22 September 1986, 94.
- Shaviro, Daniel. "Perception, Reality and Strategy: The New Alternative Minimum Tax." Taxes 66 (February 1988):91-113.
- Stern, Harry L. "Planning for the Corporate Alternative Minimum Tax." Management Accounting 69, no. 9 (March 1988):44-47.
- Stone, Theodore B., and Robert B. Coplan. "Planning for the New Corporate Alternative Minimum Tax." Practical Accountant 20, no. 8 (August 1987):21.
- Stout, Gary R., and Earl J. Weiss. "Alternative Tax NOLs After the Tax Reform Act of 1986." Journal of Taxation 68, no. 1 (January 1988):48-52.
- "Trends in the Holdings of Municipal Securities." New York: Public Securities Association, First Quarter 1990. Photocopied.
- Twersky, Steve. "Tax Exempts of Little Value While Paying Alternative Minimum Tax." Memphis: First Tennessee Financial Services Group, 30 January 1989. Photocopied.
- Urnikis, Marian S. "The New Tax Law: What It Means for Your Bank." ABA Banking Journal 78, no. 11 (November 1986):56.
- U.S. Congress. House. Tax Reform Act of 1986. 99th Cong., H.R. 3838, Public Law 99-514 (22 October 1986).

- Valenti, Stephen P. "How to Evaluate Financial Statements under the New Tax Law." Credit and Financial Management 89, no. 8 (September 1987):22-24.
- Weatherington, Richard. "Banks Take a Hit from Tax Reform." Bankers Monthly 103, no. 10 (October 1986):27.
- Wiesner, Philip J. "The TRA's Alternative Minimum Tax (Part 1): How Book Income Can Increase Tax Liability." Journal of Accountancy 165, no. 1 (January 1988):28-37.
- Wiesner, Philip J., and Sherri P. Nadeau. "Alternative Minimum Tax (Part 2): More Headaches Than Aspirin." Journal of Accountancy 165, no. 2 (February 1988):54-63.
- Zimmler, Jay H. "The Corporate Alternative Minimum Tax: Another Look." Taxes 65 (December 1987):846-861.

INSTRUCTOR ANSWER UNIT

QUESTION 1: First City Bank

\$5,950,000	AMTI
x .20	AMT rate
<u>\$1,190,000</u>	Tentative AMT before AMT NOL or AMT FTC

In the absence of AMT NOLs or AMT FTCs, First City's tentative minimum tax liability would equal \$1,190,000.

The FTCs cannot be used to reduce the liability to less than \$119,000 whether or not First City has any AMT NOLs. This is due to the law that FTCs cannot offset more than 90 percent of the tentative minimum tax, with regard to FTCs and AMT NOLs.

QUESTION 2: Second City Bank

Table 7.--Book and Taxable Income Computation for Second City Bank

Book income before Federal income tax	\$3,256,974
Tax-exempt private activity bond interest	(550,000)
Other tax-exempt bond interest	(575,079)
Excess of tax over book depreciation	(175,000)
80 percent dividends received deduction	(1,226,400)
Appreciated property charitable deduction	<u>(212,296)</u>
Taxable income	\$ 518,199

QUESTION 2: (continued)

Table 8.--AMT Income Tax Computation for Second City Bank

	Regular	AMT	Recomputed AMT for exclusion items
Regular taxable income	\$518,199	\$ 518,199	\$ 518,199
Adjustment/preference items			
Depreciation	--	175,000	
Tax-exempt private activity bond interest	--	550,000	550,000
Appreciated property charitables deduction	--	<u>212,296</u>	<u>212,296</u>
AMTI before BIA		1,455,495	1,280,495
BIA			
50 percent x (\$3,256,974 - \$1,455,495)	--	900,740	--
Regular taxable income	<u>\$518,199</u>		
AMTI		<u>\$2,356,235</u>	<u>1,280,495</u>
Regular tax (34 percent)	\$176,188	--	--
Gross AMT (20 percent)	--	\$ 471,247	\$ 256,099
AMT (minimum tax)	<u>295,059</u>	--	<u>79,911</u> (\$256,099
Total tax liability	\$471,247	<u>471,247</u>	<u> </u> -176,188)
AMT credit carryforward (AMT of \$295,059-recomputed AMT of \$79,911)	\$215,148		

QUESTION 2: (continued)

This calculation may be verified by the alternative formula. The AMT credit carryforward is the lesser of: the total of deferral preferences times the AMT rate of 20 percent; or the actual AMT (minimum tax).

The AMT (minimum tax) is \$295,059. The deferral preferences of \$1,075,740 (\$175,000 of adjusted depreciation plus \$900,740 for the BIA) times 20 percent equals \$215,148, the lesser amount and the AMT credit.

QUESTION 3: Third City Bank

Third City Bank is incorrect. The NOLs cannot offset more than 90 percent of AMTI, consequently only \$9,450,000 of the \$11,633,000 AMT NOLs are permitted. As exemplified, the bank incurs a tentative AMT of \$210,000 for 1989.

AMTI before NOL	\$10,500,000
Maximum AMT allowable (90 percent x \$10,500,000)	<u>-9,450,000</u>
AMTI	1,050,000
AMT rate	x 20 percent
Tentative AMT	<u>\$ 210,000</u>

QUESTION 4: Fourth City Bank

Clearly, Mr. Charles should prepare a strategy to thwart the detrimental impact of the AMT. As shown in table 9, under the most likely and pessimistic scenario the institution will be paying AMT. Only under the optimistic scenario, which has only a 25 percent probability of occurrence, will no AMT arise. A weighted average indicates an AMT bill of \$59,500:

optimistic	+	most likely	+	pessimistic
.25(\$0)	=	.50(\$52,500)	+	.25(\$133,000)=\$59,500
\$0	+	\$26,250	+	\$33,250

The data in table 10 displays the tax equivalent yields for Fourth City's municipals portfolio. Recall, beginning in 1990 the AMT situation for banks is aggravated when the excess rate jumps from 50 to 75 percent. Consequently, while so called tax-free securities were being taxed at a 10 percent (20 percent AMT x 50 percent excess) rate, in 1990 and after banks have to pay a 15 percent (20 percent AMT x 75 percent excess) rate on municipals. The 7.2 municipal yielding a 7.65 tax equivalent rate in an AMT situation is a better investment than the low 7 percent Treasuries on the market.

The very low 4.4 municipals only yield 4.68 in a tax equivalent AMT portfolio. As current Treasury rates indicate, there are much better investments on the market. Fourth City would be wise to sell the securities, invest elsewhere, and lessen the AMT bill.

Fourth City should be advised to hold on to the mid rate 6.5 municipals, at least until Mr. Charles has determined that the municipals can all be placed in higher yielding instruments. These municipals with a 6.91 tax equivalent rate in an AMT situation are very close to the low 7 percent Treasuries on the market.

Mr. Charles did not divulge the dollar composition of the municipal portfolio which makes it much more difficult to determine the

effect of each security on the AMT situation. Clearly, however, the 4.4 municipals are extremely low and based on the limited information should be sold.

Table 9.--Fourth City's Tax Bill, 1991

	Optimistic	Most Likely	Pessimistic
Book income	\$3,000,000	\$2,525,000	\$1,950,000
Tax-exempt income	-1,400,000	1,400,000	-1,400,000
Taxable income	<u>1,600,000</u>	<u>1,125,000</u>	<u>550,000</u>
Regular tax (34 percent)	<u>\$ 544,000</u>	<u>\$ 382,500</u>	<u>\$ 187,000</u>
Book income	\$3,000,000	\$2,525,000	\$1,950,000
Tentative AMTI	-1,600,000	-1,125,000	550,000
Excess	<u>1,400,000</u>	<u>1,400,000</u>	<u>1,400,000</u>
ACE (75 percent of excess)	1,050,000	1,050,000	1,050,000
Tentative AMTI	<u>1,600,000</u>	<u>1,125,000</u>	<u>550,000</u>
AMTI	<u>2,650,000</u>	<u>2,175,000</u>	<u>1,600,000</u>
Tentative AMT (20 percent)	<u>\$ 530,000</u>	<u>\$ 435,000</u>	<u>\$ 320,000</u>
AMT (minimum tax) to be paid (Tentative AMT less regular tax)	<u>\$ None</u>	<u>\$ 52,500</u>	<u>\$ 133,000</u>

Table 10.--Fourth City's Tax Equivalent Yields for Municipal Securities, 1991

Tax-free yield		Tax equivalent yield 20 percent bracket	(20% X 75%) Subject to AMT at 15 percent
4.4 percent	$\left[\frac{.044}{1-.2} = \right]$	5.5 percent	$ [.055 (1-.15)=]$ 4.68 percent
6.5		8.13	6.91
7.2		9.0	7.65

Note: Calculations assume municipal securities do not carry an interest expense deduction.

CHAPTER 6

STRATEGIC AUDIT: CNB BANCSHARES, INC.

Citizens National Bank, at \$1.3 billion in assets, is Evansville, Indiana's second largest banking institution. Mr. H. Lee Cooper, the bank's Chairman and Chief Executive Officer, is keenly aware of the intensely competitive situation in the banking industry and the Evansville community in particular.

Mr. Cooper believes that by hiring you as an independent consultant, as an outsider you may be able to pinpoint trouble areas that his own staff has not identified. Last year, Cooper requested the in-staff work management department prepare a performance evaluation of each banking department, and was disappointed by the lack of constructive suggestions.

You are commissioned to perform a financial ratio analysis on the bank as well as produce a listing of specific recommendations to heighten the overall performance of the institution. Specifically,

- (1) Analyze CNB's financial position to evaluate the bank's current condition, future opportunities, and how it compares to other banking institutions of similar size.
- (2) Examine CNB's management and internal organization, relevant issues in the banking industry, and societal factors affecting the industry. Given these conditions, discuss how CNB should plan for the future.

Business Background

CNB Bancshares, Inc. (CNB) is a regional interstate bank holding company, serving portions of Indiana, Illinois, and Kentucky through 7 subsidiary banks, 31 banking locations and 705 employees. CNB's lead bank is Citizens National, located in Evansville, Indiana.

Evansville, population 136,885, is an industrial community commonly referred to as "plastics country" because of the large number of plastic firms operating in the area. The city is located in southwestern Indiana, bordering the Ohio River, just five miles from Kentucky and thirty miles from Illinois.

In 1984 Indiana passed a regional reciprocal interstate banking pact. The Indiana regional reciprocal law stated that bank holding companies from Illinois, Kentucky, Michigan and Ohio could acquire its banks and bank holding companies if these states reciprocated. Recently, the Indiana law was extended to include the states of Iowa, Missouri, Pennsylvania, Tennessee, Virginia, West Virginia and Wisconsin.¹ Indiana initiates national reciprocity beginning July 1, 1992.

As shown in table 1, the company has acquired six banks in the immediate Indiana and Kentucky area since the passage of the legislation. All current subsidiary banks are within sixty miles of lead bank Citizens National. An additional acquisition, Shively Bancshares

¹Iowa has no interstate banking legislation. Missouri has a regional reciprocal pact which does not include Indiana. Virginia and Pennsylvania have regional reciprocal pacts which do not include Indiana, but national reciprocal banking begins March 4, 1990. Wisconsin and Tennessee do permit regional reciprocal banking with Indiana while West Virginia allows national reciprocal banking.

Corporation, located just outside Louisville, Kentucky, is pending. Louisville has a population of 750,000, and is slightly over one-hundred miles from Evansville.

The community of Evansville is served by three strong national banks, all have operated in the city for over a century, including Citizens National which originated in 1874. National City Bank, which began operations in 1850, is the smallest in asset size of \$480 million. The management of National City is highly conservative and has pursued a reflective acquisition strategy, with three subsidiary banks. Old National Bank, dating from 1834, is the city's largest at \$2.1 billion in assets. It is also the most aggressive in acquisition growth with thirteen subsidiary banks. The holding company for Old National was an instrumental force in lobbying for passage of the Indiana interstate banking legislation.

CNB is centered between the banks on both acquisitions and asset size. In 1988 CNB reached a record level of assets of \$1.287 billion. Deposits topped \$1,043 billion while loans and net income were \$718 million and \$13 million, respectively. CNB's return on assets of 1.09 percent was among the best in its peer group.

CNB's corporate mission is to provide a complete line of banking services for its customers. The following brief description in CNB's recent Investment Profile overviews its strategy formulation:

CNB's strategy is to achieve growth by acquisition and by increasing the market share of its subsidiary banks. Consistent increases in earnings have been achieved through an emphasis on loan quality, above average fee revenue and strict

control of overhead expenses. CNB has no foreign loans in keeping with a policy of direct leading activity to markets from which deposits are drawn. CNB's goals are to deliver unparalleled service to customers and superior return to shareholders.²

²CNB Bancshares, Inc. Investment Profile (Evansville, Indiana: Citizens National Bank, 1989).

Table 1.--CNB Corporate Organization

	Offices	Assets (Millions)
Lead Bank:		
The Citizens National Bank of Evansville, Indiana, Established in 1874. Holding company formed in 1984.	12	\$849
Banks acquired:		
1986 Posey County National Bank, Mt. Vernon, Indiana (Posey Bank)	3	70
Peoples Bank & Trust Company, Madisonville, Kentucky (Peoples Bank)	7	120
1987 Farmers National Bank, Princeton, Indiana (Farmers Bank)	1	64
Wabash Valley Bank, Vincennes, Indiana Name later changed to Citizens Bank of Vincennes	3	30
1988 Haubstadt State Bank, Haubstadt, Indiana	1	44
Farmers Bank & Trust Company, Wadesville, Indiana (Wadesville Bank)	4	114
1989 Bank of St. Helens, Shively, Kentucky (Pending)	1	40
Other subsidiaries:		
Citizens Information Systems, Inc., data processing subsidiary, serving over thirty banks and numerous other businesses.		
Citizens Investment Company, Inc., leasing subsidiary.		
Services provided:		
Commercial and retail banking, electronic funds transfer networking, trust services, discount brokerage, mortgage lending and servicing, cash management services, and data processing services.		

Source: CNB Bancshares, Inc. Investment Profile (Evansville, Indiana:
Citizens National Bank, 1989).

Strategic Managers

Board of Directors

As shown in table 2, the Board of Directors of CNB is composed of sixteen people--six inside and ten outside directors. The directors are divided into three classes, as nearly equal in number as possible, with all directors serving three-year terms. Each year at the annual meeting a new class of directors is elected.

The average age of a director is fifty-five. He has been on the board of CNB (or Citizens National prior to forming the CNB holding company in 1984) since 1979. Together the directors own 2.89 percent of CNB. The bank is a publicly traded company on the NASDAQ over-the-counter market, listed under CNBE.

Most outside directors head major businesses in the Evansville area, which are strong customers of the bank. Citizens National representatives hold four inside director seats: Lee Cooper, Chairman of the Board and Chief Executive of CNB and Citizens National; Bill Vieth, President of CNB and Citizens National; Dave Knapp, Executive Vice President, Secretary and Chief Financial Officer of CNB and Citizens National; and R. J. Brunton, retired Chairman of the Board of CNB and Citizens National. The remaining two inside directors represent executive management from subsidiary banks, Peoples Bank and Posey Bank.

Traditionally, the board holds ten regular meetings a year. Outside directors receive a payment of \$4,500 per year for their services plus \$300 per directors' meeting attended. An additional small fee for participating in committee meetings is awarded.

A review of CNB annual report information would suggest that the board has active participation in strategic management. Board members are involved in the review and implementation of key bank decisions. Bank directors establish and administer an equitable salary and benefits program for officers of CNB. Additionally, they make recommendations on the specific salaries of certain executive officers of the bank. Bank directors are responsible for monitoring the accounting, auditing and financial practices of CNB and its subsidiaries. They are also involved in the commercial loan division of the bank, with certain board members meeting regularly with loan officers to review loan applications.

Each of the seven subsidiary banks has its own board of directors. Additionally, each institution retains at least one officer from CNB on its board.

Top Management

The executive management structure with Cooper in first position, Vieth in second, and Knapp as third, has been in place since 1986. As previously mentioned: Cooper is Chairman of the Board and Chief Executive of CNB and Citizens National, Vieth is President of CNB and Citizens National, and Knapp is Executive Vice President, Secretary and Chief Financial Officer of CNB and Citizens National. The 1988 executive compensation for these three officers is listed in table 3.

The year 1986 was one of major change for the bank, with the retirement of both number one man, R. J. Brunton, and number two man, Robert Hargrave.³ Brunton was the Chairman of the Board of CNB and

³Mr. Brunton now serves on the Board of Directors of CNB and Posey Bank while Mr. Hargrave is a board member of Citizens National.

Citizens National and Chief Executive of Citizens National. Hargrave functioned as President and Chief Executive of CNB and Vice Chairman of the Board of Citizens National. Together, this well-respected entrenched management team had run the banking institution for years.

The new executive group is an aggressive young management team, highly skilled in the banking business. Cooper is just fifty years old and has worked for Citizens National for twenty years. Prior to the management succession, Cooper was in the number three position at the bank as Vice President of CNB and President and Chief Administrative Officer of Citizens National. Vieth, forty-seven years old, has worked at the bank for twenty-three years. He was formerly the Executive Vice President of the Lending Department of Citizens National. Knapp, forty-nine years old, was functioning as the Secretary of CNB and Executive Vice President and Chief Financial Officer of Citizens National.

Executive management has a positive working relationship with the Board of Directors as well as management in lead bank, Citizens National. Each of the acquired banks has its own executive management structure and have been permitted to function with relative autonomy.

The institution's three executive officers plus two other officers have obtained golden parachute contracts from CNB in the event of change of control of the organization. The employment agreement with CNB provides for a three-year term commencing upon the effective date of any future change of control of CNB. "If during the term of the agreement, or the one year period prior thereto, the officer's employment is

terminated by the Company (other than for cause) or if the officer voluntarily leaves the employ of the Company during the term, the agreement provides for a payment to the officer of an amount equal to a maximum of three times the officer's annual authorized base salary."⁴

⁴CNB Bancshares, Inc. Notice of Annual Meeting and Proxy Statement (Evansville, Indiana: Citizens National Bank, 23 March 1989), 6.

Table 2.--CNB Board of Directors

<u>CLASS I</u>			
(Term to Expire 1992)			
<u>Name</u>	<u>Principal Occupation(s) for Past 5 Years</u>	<u>Shares of Company Stock Beneficially Owned as of December 31, 1988</u>	
		<u>Number</u>	<u>Percent</u>
William C. Ayer, 69 Director of Company since 1986	Chairman of the Board, The Peoples Bank	11,850	.18%
David L. Knapp, 49 Director of Company since 1986	Executive Officer of The Citizens Bank, currently Executive Vice President, Secretary, and Chief Financial Officer of the Company and the Citizens Bank.	6,662	.10%
Jerry A. Lamb, 54 Director of Company since 1983 (Citizens National since 1976)	Industrialist; Prior to January, 1985, President of Indiana Tube Corp. (manufacturer of refrigeration tubing).	21,413	.33%
Burkley F. McCarthy, 58 Director of Company since 1983 (Citizens National since 1966)	President, Fendrich Industries, Industries, Inc. (diversified manufacturer).	9,240	.14%
Thomas W. Traylor, 49 Director of Company since 1983 (Citizens National since 1977)	President, Traylor Bros., Inc. (underground and marine construction).	8,682	.13%

Table 2.--Continued

<u>CLASS II</u>				
<u>(Term Expiring 1990)</u>				
<u>Name</u>	<u>Principal Occupation(s)</u> <u>for Past 5 Years</u>	<u>Shares of</u> <u>Company Stock</u> <u>Beneficially</u> <u>Owned as of</u> <u>December 31, 1988</u>		
		<u>Number</u>	<u>Percent</u>	
August Brogno, 53 Director of Company since 1984	Vice President-Manufacturing, Whirlpool Appliance Group, Whirlpool Corporation.	1,602	.02%	
R. J. Brunton, 68 ^a Director of Company since 1983 (Citizens National since 1964)	Retired; Prior to February, 1986, Chairman of the Board and of the Company and The Citizens Bank.	16,000	.24%	
Walter R. Brunton, 37 ^a Director of Company since 1986	President and Chief Executive Officer, The Posey Bank.	1,765	.03%	
H. Lee Cooper, 50 Director of Company since 1983 (Citizens National since 1978)	Executive Officer of the Company and The Citizens Bank; Currently, Chairman of the Board and Chief Executive Officer of the Company and The Citizens Bank.	19,360	.29%	
John D. Engelbrecht, 37 Director of Company since 1983 (Citizens National since 1980)	President, South Central Communications Corporation.	17,738	.27%	

^aR.J. Brunton and Walter R. Brunton are father and son.

Table 2.--Continued

<u>CLASS III</u> (Term Expiring 1991)		Shares of Company Stock Beneficially Owned as of <u>December 31, 1988</u>	
<u>Name</u>	<u>Principal Occupation(s)</u> <u>for Past 5 Years</u>	<u>Number</u>	<u>Percent</u>
Ronald C. Coleman, 56 Director of Company since 1983 (Citizens National since 1975)	Retired; Formerly, Manager, Warrick Operations, Aluminum Company of America.	2,050	.03%
Wendell L. Dixon, 65 Director of Company since 1983 (Citizens National since 1973)	Retired; Formerly, Chairman and Chief Executive Officer, CrediThrift Financial, Inc. Mr. Dixon also serves as a director of American General Corp.	2,808	.04%
Paul C. Fletchall, 70 ^b Director of Company since 1988	President, Poseyville Telephone Co. Mr. Fletchall also serves as a director of The Wadesville Bank, and President and Chief Executive Officer of Posey Bancorporation.	29,236	.44%
Robert L. Koch, II, 50 Director of Company since 1983	President, George Koch Sons, Inc. (manufacturing). Mr. Koch also serves as a director of Southern Indiana Gas & Electric Co. and Bindley Western Industries.	20,802	.32%
William E. Vieth, 47 Director of Company since 1985	Executive Officer of the Company and The Citizens Bank; Currently President of the Company and The Citizens Bank.	15,863	.24%
Norman P. Wagner, 65 Director of Company since 1983 (Citizens National since 1979)	Chairman, President and Chief Executive Officer. Southern Indiana Gas & Electric Co.	4,012	.06%

Source: CNB Bancshares, Inc. Notice of Annual Meeting and Proxy Statement (Evansville, Indiana: Citizens National Bank, 23 March 1989), 2-4 and CNB Bancshares, Inc. Notice of Annual Meeting and Proxy Statement (Evansville, Indiana: Citizens National Bank, 14 May 1985), 2-4.

Table 2.--Continued

^bMr. Paul C. Fletchall was elected as a Class III director by the Board of Directors at its July, 1988 meeting, in accordance with the Agreement and Plan of Merger between the Company and Posey Bancorporation (Posey), which was previously the parent company of The Wadesville Bank. That Agreement provided that a representative of Posey would serve as an additional member of the Company's Board after the effective date of the merger and at least until the 1991 Annual Meeting of Shareholders. As of the date of the 1989 Annual Meeting, Mr. Fletchall will resign, having reached the mandatory retirement age of 70 for Company directors. The Board of Directors of the Company intends to appoint a successor representative of Posey to serve the unexpired portion of Mr. Fletchall's term. The successor shall be chosen from their current directors who were also serving as directors at the time of the merger.

<u>Beneficial Owners</u>	<u>Number</u>	<u>Percent</u>
All Directors as a Group	189,083	2.86%

Table 3.-- Executive Compensation

<u>Individual</u>	<u>Capacities in Which Served</u>	<u>1988 Cash Salaries and Fees</u>
H. Lee Cooper	Chairman of the Board and Chief Executive Officer of the Company and The Citizens Bank.	\$ 177,925
William E. Vieth	President of the Company and The Citizens Bank	137,700
David L. Knapp	Executive Vice President, Secretary and Chief Financial Officer of the Company and The Citizens Bank.	110,235

Source: CNB Bancshares, Inc. Notice of Annual Meeting and Proxy Statement (Evansville, Indiana: Citizens National Bank, 23 March 1989), 6.

Note: The cash compensation table does not include any personal benefit from automobiles and/or club memberships or insurance benefits which are provided for certain officers, including those named above. The amount of such benefits for the fiscal year ended December 31, 1988 did not exceed the lesser of \$25,000 or 10 percent of the compensation reported for each person or for the group as a whole.

Societal Factors Affecting the Banking Industry

Aging of Population

Due to better health practices, nutrition and medication the lifespan of Americans is increasing. As our population ages, the banking industry has an opportunity to provide products and services for older adults. Individuals of retirement age often require the safety and protection of income in products offered by banks. Investments such as bank certificates of deposit(CDs), which are insured by the FDIC, are a much more stable investment than the stock or bond market.

CNB has targeted the banking business of individuals fifty-five and older by offering the Citizens 55+ Advantage Account. This account offers participants free personal checks plus a variety of banking product discounts.

Economic Outlook

When inflationary pressures are low, banks are extending loans and engaging in the host of other activities profitable to the industry. Federal Reserve Chairman, Alan Greenspan, has been committed to reconciling the objectives of economic expansion with the need to keep inflation under control. On July 21, 1989, Greenspan testified in his biannual review of monetary policy before Congress. He implied that the economy is headed for a moderate slowdown of economic growth, declining inflation and interest rates, with the risk of a recession not likely.

Wall Street Journal reporter, Alan Murray reviewed Greenspan's testimony:

The Fed chairman's comments were a far cry from his testimony at the beginning of the year, when he warned of the dangers of

excessive growth and emphasized the risk of inflation still "remains high--clearly above our objective" he said "the balance of risk may have shifted somewhat away from greater inflation."

The Fed chairman refused to comment directly on plans for interest-rate policy in the coming weeks. But his testimony made it clear that the Fed is poised for further rate reductions.⁵

The Federal Reserve Board and the regional Fed presidents collectively predict a slowdown in real GNP growth from forecasted 2.5 percent in 1989 to 1.5 to 2.0 percent in 1990.⁶ The prime rate in mid-July 1989 lies at 10.5 to 11 percent. This combined forecast of a slowdown in economic growth coupled with possible interest rate reductions provides a reasonable outlook for the banking industry.

Although the national economy certainly will affect a bank's performance, the strength of a bank's regional economy is of utmost concern. Indeed, in the 1988 annual report, "Message to Shareholders," Cooper and Vieth explain that CNB has continued "to operate within an environment of regional economic stability that has sufficient diversification to resist downturns and area-wide recession."⁷ In an article in the Evansville Press following Greenspan's projection for a moderate downturn, Cooper said he "expected Evansville to survive the expected downturn in the economy without a recession. Nationally, consumer spending hatened but the bank's manufacturing customers

⁵ Alan Murray, "Greenspan Predicts Economy Will Slow, Says There's Risk of Substantial Downturn," The Wall Street Journal, 21 July 1989, sec. A:2(E).

⁶ Ibid.

⁷ CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988), 6.

haven't felt as much of a downturn as expected and the bank's retailers report business has remained strong."⁸

The continued economic strength of the southwestern-Indiana region is highlighted by the strengthening of its transportation network. The east-west Lloyd Expressway, running through the city of Evansville, was completed in 1988. Work on the I-164 highway connector is near completion. A new \$25 million airport terminal and accompanying ramps at Evansville Regional Airport was opened in January, 1989. The new, modernized transportation facility is a vast improvement over Evansville's small outdated terminal. A sophisticated highway system and airport will encourage industrial development and economic growth, a situation favorable for CNB.

Technological Advancements

Technological achievements over the last two decades have made it possible for banking institutions to offer a number of new services: automatic teller machines (ATMs), automatic wire transfer of funds, and automatic deposits and debits. Such technology offers banks an opportunity to provide customers more efficient service, and if managed effectively to control costs. For example, ATMs and automatic deposits and debits used for transactions are more cost-effective than using the teller window.

CNB has implemented the new technology available to banks. Additionally, since joining the PLUS, Inc. interchange ATM system

⁸Mel Runge, "CNB Nets 5.5% Gain in Recent Quarter," Evansville Press, 20 July 1989, 16.

in 1985, customers have been able to access their checking accounts nationwide.

Tax Reform

The Tax Reform Act of 1986 dealt a major blow to the banking industry. Historically, banks have been a major holder of municipal securities. The impetus for banks to purchase municipal securities has been their federal tax-free income and special deductions for the interest expense on money borrowed to purchase or "carry" municipals.

Under the new rules, banks can no longer deduct interest expense for municipal issues acquired after August 7, 1986 except for qualified issues from "small issuers" not issuing more than \$10 million of bonds in one year. The act further mandates that interest on private activity bonds issued after August 7, 1986 be treated as a tax preference for alternative minimum tax (AMT) purposes. Once the AMT applies to a bank, the institution is in a 20 percent marginal tax bracket and any additional supposedly tax-free securities (regardless of when the municipal was or will be purchased) will be taxed at 10 percent, one half the marginal rate.⁹

These new restrictions have caused all banking institutions to begin divesting of municipals. Banks now have the challenge of seeking the high pre-tax reform returns of municipals elsewhere in the investment market. A review of CNB's financial statement indicates that its tax exempt portfolio has declined significantly from 1987 to 1988.

⁹John T. Lee and Marie Bussing-Burks, "The Impact of Tax Reform on Commercial Banks Municipal Investment Holdings" (New Orleans: Southwestern Society of Economists, 10 March 1989), 1-2, photocopied.

Relevant Factors Within the Banking Industry

New Banking Entrants

The threat of new national or state banking entrants in the Evansville area is minimal. The region is served by three national banks, four savings banks, three savings and loan associations, and sixteen credit unions. One of the many requirements to obtain a national or state bank charter is to show a need in the community. It is doubtful that any need could be shown in a city with a population of 136,885, served by so many financial institutions.

Rivalry Among Competing Banking Institutions

Traditionally, there has been a long standing competition with the two largest and most aggressive banks, CNB and Old National, for customers. Prior to 1984, there was a limited customer base of Evansville and surrounding counties for which the banks were competing. CNB, although a consistently high performing bank, always trailed Old National in assets and deposit base. Now that Indiana banks can purchase banks in certain states, CNB has the opportunity to move into new areas which offer expansion and growth potential.

New Products

The passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 called for a number of changes in the banking industry, namely the six year phase out of interest rate ceilings on time deposits. By April 1986, all ceilings were lifted and banks were permitted to pay market rates on deposits, leveling the playing field between banks and other financial services firms.

CNB offers a wide variety of new CDs. For example, in 1988 the bank introduced the Step-Up Rate CD which offers a rate increase every six months.

New Service

Investment banking may be in the future for the banking industry. The Glass-Steagall Act of 1933 prohibited banks from engaging in the underwriting and dealing of corporate securities. The year 1988 began a major push by the banking industry for the reform of Glass-Steagall, arguing that the public would benefit from lower costs due to more bidders competing to underwrite issues. While bankers are still pressing they have not yet been successful in amending Glass-Steagall.

It has been argued by James D. McLaughlin, the American Banker's Association (ABA) director of Agency Relations, Trust and Securities that "philosophically, Glass-Steagall is already dead. The fight is over who will sign the death certificate and when."¹⁰ For the first time, in 1988 select banks in effect bypassed Glass-Steagall by petitioning to the Federal Reserve for underwriting powers. Under the Bank Holding Company Act applications by several large New York banks were approved by the Fed and upheld by the federal courts. No underwriting of corporate equities will be approved until the Fed evaluates the banks' performance in the debt market. Those institutions permitted to underwrite debt have a tremendous opportunity because historically it has been a very profitable business.

¹⁰"Life after FSLIC?" ABA Banking Journal 81, no. 1 (January 1989): 27.

Although amendment of Glass-Steagall or Fed permission to underwrite in a small mid-western community are both circumspect, investment banking may be an opportunity for CNB to explore in the future.

Trade Association

The ABA trade association is a tremendous force in the banking industry. When the insolvency of the FSLIC became apparent, ABA was the first major trade association to develop specific recommendations on resolving the crises. The recommendations, largely stressing the importance of tough capital guidelines for thrift institutions, became a major factor of the Bush bailout plan. The ABA also successfully fought off any proposals to allow thrifts to merge FDIC and FSLIC funds which, needless to say, would have been a tremendous threat to CNB and all banking institutions. ABA strongly maintains that the FDIC shouldn't be responsible for picking up any portion of the staggering FSLIC bill.

Foreign Governments and Businesses

Foreign governments and businesses have defaulted on many loans to U.S. banks in recent years. This has been a great problem for the banking industry as a whole; however, CNB had the excellent foresight of making it a policy to extend no foreign loans.

Legislation

Recent legislation suggests a trend toward nationwide banking. Currently, forty-four states have passed some form of interstate banking legislation. Nationwide interstate banking is permitted by fourteen states. Additionally, another fourteen states have passed trigger

dates, effective through 1992, for national reciprocal banking. It appears probable that nationwide banking will expand even further in the 1990s.

Nationwide banking presents an opportunity for banking institutions. If acquisitions are skillfully chosen, economies of scale and scope may be reached through lower-cost services and expanded product lines. The threat, however, of unfriendly takeovers becomes more severe as states increasingly expand their interstate banking boundaries.

CNB has both seized the opportunity for increased acquisitions and attempted to protect itself from an unfriendly takeover attempt. The bank had authorized the issuance of a preferred stock with numerous provisions to help fend off an unfriendly offer.

CNB's Financial Structure

At year end 1983, prior to any acquisitions, Citizens National was CNB's only bank with 11 banking offices and 405 employees. It was a \$615 million dollar bank with \$481 million in deposits, \$326 million in loans and \$4.7 million in net income.

Stock Information

The overwhelming growth and excellent performance CNB has experienced from 1984 to 1988 has accrued to stockholders, as indicated in table 4. A stockholder with one-hundred shares of CNB on January 1, 1984, held an investment with a market value of \$4,050. The same shares, adjusted upward for stock splits, had a market value of \$10,395 on December 31, 1988. The increase in market value of \$6,345, combined

with the dividends received of \$1,627, netted the shareholder a five year time-weighted return of 25.4 percent.

The CNB shareholders are invited to participate in a dividend reinvestment and stock purchase plan. Stockholders are allowed to reinvest dividends and purchase \$20,000 of additional shares of common stock, all without the payment of any brokerage commission or fees. In 1988, 46,056 shares were issued in the plan, providing CNB with \$938,000 in funds.

In 1985 stockholders voted to give the bank authorization to issue two-million of no par value preferred stock, sometimes called "blank check preferred." The board has a "blank check" to allow a variety of special provisions for the shares prior to issuance. They may approve one or more series, fix the voting powers, preferences and other special rights of each series. Although currently unissued, the rights of these shares could have an anti-takeover effect as explained in the following passage:

. . . the Board of Directors could, by resolution passed before any shares of a particular series of Preferred stock are issued, give the shares of that series a right to vote as a class on any proposed merger or other business combination involving the Company and another corporation. In such a case, the affirmative vote of the required percentage of the outstanding shares of that series of Preferred Stock would be required before the merger or business combination could be accomplished, regardless of the outcome of the vote of the holders of the Common Stock of the Company or the ability of the shareholders, voting as a whole, to satisfy any special voting requirements such as those set forth in Article X of the Company's Articles of Incorporation regarding certain business combination transactions. Further, the Board could require a percentage vote by the Preferred Stock, or a particular series of Preferred, that is higher than the sixty-six and two-thirds percentage vote required by Indiana law to approve any such transaction, or could provide that the shares of Preferred Stock would be automatically convertible into one share (or more) of the

common stock of any successor to the Company after a merger between the Company and the successor.

The Board of Directors would have the power . . . to issue a series of Preferred Stock bearing such special voting or conversion rights to a selected, "friendly" shareholder or group of shareholders in instances where an unfriendly takeover of the Company was threatened, and thereby may be able to defeat or frustrate the takeover. As a result, potential offerors for the Company's stock may be discouraged from seeking to acquire the Company at all. The anti-takeover effect of the Preferred Stock is somewhat diminished by the existence of the preemptive rights possessed by holders of Common Stock, which may require that any Preferred Stock offered for sale, especially voting Preferred, first be offered to existing holders of Common Stock on a pro rata basis. Nevertheless, shareholders should bear in mind that the Preferred Stock Amendment may have the effect of discouraging purchasers from attempting to acquire control of the Company, and from paying the premium prices for shares that often accompany such takeover attempts.

¹¹CNB Bancshares, Inc. Notice of Special Meeting of Shareholders (Evansville, Indiana: Citizens National Bank, 6 September 1985), 10.

Table 4.--Total Return to CNB Shareholders, 1984-1988

CNB Bancshares, Inc. (and Citizens National Bank) prior to 1984 has paid dividends continuously for over 50 years. In addition, stock dividends have been paid in eight of the last ten years. The table below highlights how these dividends have benefited shareholders.

Year	Stock Dividends and Splits	Shares Owned	Market Value of Shares Held
1984	January 1, purchased shares at \$40.50	100.00	\$ 4,050.00
	1 for 8 Stock Dividend	112.50	
1985	2 for 1 Stock Split	225.00	
1986	2 for 1 Stock Split	450.00	
1987	1 for 10 Stock Dividend	495.00	
1988	1 for 20 Stock Dividend	519.75	
	December 31, value of \$20.00 per share		\$10,395.00

Source: CNB Bancshares, Inc. Investment Profile (Evansville, Indiana: Citizens National Bank, 1989).

Note: The increase in market value of \$6,345, combined with dividends received of \$1,627, provided the shareholder with an average 5 year time-weighted return of 25.4%. This return was computed without regard to the reinvestment of cash dividends received. CNB has a Dividend Reinvestment and Stock Purchase Plan through which shareholders may purchase additional stock.

Financial Statement Discussion

In addition to lead bank Citizens National, CNB has acquired six banks during the 1986 to 1988 period. Select financial highlights are exhibited in table 5. These statements include the combined financial data of all subsidiary banks for years 1984 to 1988, regardless of the year banks were actually purchased. The consolidated institution would have grown from a \$914 million asset base in 1984 to the \$1.287 billion base in 1988. The bank would have experienced yearly growth in each of the key financial figures: assets, loans, deposits, equity, net interest income and net income. Bank analysts commonly view an ROA of 1.0 percent and an ROE of 10 percent as strong for a bank. The bank had an ROA above 1.0 percent every year except 1984 when it barely missed at .99 percent. ROE was quite high every year, fluctuating in the 12 to 14 percent range.

The bulk of earlier financial information has not been restated for pooling of interests to include all acquisitions; therefore, not readily comparable for trends. The remaining financial discussion is centered upon years 1987 and 1988, for which all data has been restated for pooling of interests.

Table 6 lists the CNB balance sheet for year end 1988 and 1987. CNB and industry peer balance sheet data, as a percentage of assets, is displayed in table 8. CNB's industry peer consists of the average financial information of the 118 banking institutions in the St. Louis Federal Reserve district, with assets between \$1 to \$3 billion. Peer balance sheet data appears in table 7.

Several important points emerge in table 6. The asset base grew 5.64 percent from \$1.218 billion in 1987 to \$1.287 billion in 1988. The tax-exempt investment decline of 12.69 percent is reflective of tax reform restrictions severely diminishing the incentive for banks to hold such securities. While interest bearing deposits in other banks have fallen drastically at 65.97 percent and bankers acceptances' and term Fed funds have likewise declined to 55.96 percent, these year end figures are somewhat deceiving. Average balances for interest bearing deposits in other banks actually increased 5.70 percent. Average balances for bankers' acceptances and term Fed funds for 1987 was \$15.046 million and \$12.140 million for 1988, a more moderate 19.31 percent decline. The purchase of other banks bankers' acceptances and the lending of Fed funds are utilized in CNB's asset/liability management program to match certain short-term liabilities; consequently, such balances will vary from year to year.

Viewing table 8, the balance sheet percentage of asset analysis appears strikingly similar for CNB and its industry peer. CNB does, however, hold a considerably higher percentage of assets in Fed funds sold. The bank does a large business in packaging Fed funds from its correspondent banks and selling them in larger markets.

CNB's income statement for 1987 and 1988 is provided in table 9 with peer income data in table 10.. Net income for CNB rose a profitable 8.25 percent, from \$12.011 million in 1987 to \$13.022 million in 1988. The 90.41 percent increase in 1988 income tax expense reflects higher pre-tax income which offset the benefits of the corporate tax rate reduction of 40 percent in 1987 to 34 percent in 1988. Furthermore,

following with the reduction of the tax-exempt portfolio the amount of interest income derived from tax-exempts fell 11.32 percent.

Table 11 lists the income statement as a percentage of total interest income for both CNB and the peer. Net income is a higher percentage of interest income for the industry peer.

Table 5.-- CNB Financial Highlights

	1984	1985	1986	1987	1988
Key year-end figures (in thousands)					
Total assets	\$914,840	\$983,669	\$1,152,496	\$1,218,594	\$1,287,331
Total loans	503,009	530,092	603,443	675,727	718,556
Total deposits	744,434	800,470	948,619	995,824	1,043,110
Total equity	64,874	72,072	91,241	101,055	107,427
Net int. inc. (FTE)	32,501	33,963	39,983	42,947	43,673
Net income	8,437	9,809	10,721	12,011	13,002
Key financial ratios (based on averages)					
Return on assets	0.99%	1.09%	1.05%	1.06%	1.09%
Return on equity	12.79	14.39	13.21	12.45	12.51

Source: Adapted from CNB Bancshares, Inc. Investment Profile
(Evansville, Indiana: Citizens National Bank, 1989).

Table 6.-- CNB Bancshares Consolidated Balance Sheet
(In Thousands Except for Share Data)

Assets	December 31,		Percent change
	1988	1987	
Cash and due from banks	\$ 74,310	\$ 66,634	11.52
Federal funds sold	145,225	129,800	11.88
Total cash and cash equivalents	219,535	196,434	11.76
Interest bearing deposits in other banks	5,499	16,159	-65.97
Investment securities:			
Taxable	217,562	192,180	13.21
Tax exempt	85,394	97,804	-12.69
Total inv. securities (market value, \$298,199 and \$288,953)	302,956	289,984	4.47
Commercial loans	291,928	252,467	15.63
Tax exempt loans	56,579	63,096	-10.33
Real estate loans	213,933	201,476	6.18
Consumer loans	140,710	123,704	13.75
Bankers' acceptances and term Federal funds	15,406	34,984	-55.96
Total loans	718,556	675,727	6.34
Less: Allowance for loan losses	9,235	8,520	8.39
Net Loans	709,321	667,207	6.31
Premises and equipment	26,496	25,774	2.80
Other real estate owned	2,548	1,593	59.95
Interest receivable	12,999	12,415	4.70
Other assets	7,977	9,028	-11.64
Total assets	\$1,287,331	\$1,218,594	5.64
Liabilities			
Deposits:			
Non-interest bearing	\$ 157,645	\$168,360	-6.36
Interest bearing	885,465	827,464	7.01
Total deposits	1,043,110	995,824	4.75
Securities sold under repurchase agreements	71,067	55,627	27.76
Federal funds purchased	19,291	26,800	-28.02
U. S. Treasury demand notes	13,348	8,214	62.50
Long-term debt	21,494	21,709	- .99
Interest payable	8,180	5,803	40.96
Other liabilities	3,414	3,562	- 4.15
Total liabilities	1,179,904	1,117,539	5.58

Table 6.--Continued

Shareholders' Equity			
Preferred stock, no par or stated value			
Shares authorized and unissued: 2,000,000			
Common stock, \$1 stated value			
Shares authorized: 15,000,000			
Shares issued: 6,582,327 in 88 &			
6,337,876 in 87	6,582	6,338	3.85
Capital surplus	60,359	54,390	10.97
Retained earnings	40,486	40,327	.39
Total shareholders' equity	<u>107,427</u>	<u>101,055</u>	<u>6.31</u>
Tot. Liab. & shareholder's equity	\$1,287,331	\$1,218,594	5.64
Dividends declared	\$.82	\$.76	
Stock price			
Low	\$18.25	\$19.00	
High	\$24.00	\$22.00	

Source: CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988), 27.

Table 7.--Banking Institutions of St. Louis Federal Reserve District
Average Consolidated Balance Sheet
(In Thousands)

Assets	December 31,		Percent change
	1988	1987	
Cash and due from banks	\$115,298	\$131,730	-12.47
Federal funds sold	65,800	48,000	37.08
Total cash and cash equivalents	181,098	179,730	.76
Interest bearing deposits in other banks	7,398	14,685	-49.62
Investment securities:			
Taxable	244,045	181,049	34.80
Tax exempt	120,739	122,153	- 1.16
Total investment securities (market value \$368,574 and \$307,436)	364,784	303,202	20.31
Total loans	880,720	748,874	17.61
Less: Allowance for loan losses	12,475	11,703	6.60
Net loans	868,245	737,171	17.78
Premises and equipment	12,198	9,859	23.72
Other real estate owned	2,180	1,619	34.65
Other assets	81,056	75,485	7.38
Total assets	\$1,516,959	\$1,321,751	14.77
Liabilities			
Deposits:			
Non-interest bearing	\$ 253,983	\$ 278,957	- 8.95
Interest bearing	954,253	787,537	21.17
Total Deposits	1,208,236	1,066,494	13.29
Fed funds purchased and securities sold under repo agreements	153,885	130,108	18.27
Long-term debt	6,372	2,750	131.71
Other liabilities	38,565	26,143	47.52
Total liabilities	1,407,058	1,225,495	14.82
Shareholders' Equity			
Common stock	17,655	16,019	10.21
Capital surplus	33,571	16,566	102.65
Retained earnings	58,675	63,671	- 7.85
Total shareholders' equity	109,901	96,256	14.18
Total liabilities and share- holders' equity	\$1,516,959	\$1,321,751	14.77

Source: Bank Holding Company Performance Report (Washington, D.C.:
Federal Deposit Insurance Corporation, 1988), 5-6.

Note: Data represents the 118 banking institutions in the St. Louis
district with assets between \$1 and \$3 billion.

Table 8.-- CNB Bancshares and Industry Peer Balance Sheet as a Percentage of Assets

Assets	December 31, 1988		December 31, 1987	
	CNB	Peer	CNB	Peer
Cash and due from banks	5.77%	7.60%	5.47%	9.97%
Federal funds sold	11.28	4.34	10.65	3.63
Total cash & cash equiv.	17.05	11.94	16.12	13.60
Int. bear. dep. in other banks	.43	.49	1.33	1.11
Investment securities:				
Taxable	16.90	16.09	15.77	13.70
Tax exempt	6.63	7.96	8.03	9.24
Tot. invest. securities	23.53	24.05	23.80	22.94
Total loans	55.82	58.06	55.45	56.66
Less: Allow. for loan losses	.72	.82	.70	.89
Net loans	55.10	57.24	54.75	55.77
Premises & equipment	2.06	.80	2.12	.75
Other real estate owned	.20	.14	1.02	.12
Other assets	1.63	5.34	.74	5.71
Total assets	100.00	100.00	100.00	100.00
Liabilities				
Deposits:				
Non-interest bearing	12.25	16.74	13.82	21.11
Interest bearing	68.78	62.91	67.90	59.58
Total deposits	81.03	79.65	81.72	80.69
Fed funds purchased & sec. sold under repo agreements	7.02	10.15	6.77	9.84
Long-term debt	1.67	.42	1.78	.21
Other liabilities	1.94	2.54	1.44	1.98
Total liabilities	91.66	92.76	91.71	92.72
Shareholders' Equity				
Common stock	.51	1.16	.52	1.21
Capital surplus	4.69	2.21	4.46	1.25
Retained earnings	3.14	3.87	3.31	4.82
Total shareholder's equity	8.34	7.24	8.29	7.28
Total liabilities & shareholder's equity	100.00	100.00	100.00	100.00

Source: Adapted from information provided in the Bank Holding Company Performance Report (Washington, D.C.: Federal Deposit Insurance Corporation, 1988), 5-6 and CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988), 27.

Table 9.-- CNB Bancshares Consolidated Statement of Income
(In Thousands)

Interest Income	Year Ended December 31,		Percent change
	1988	1987	
Loans, including fees:			
Taxable	\$ 65,260	\$ 56,692	15.11
Tax exempt	4,535	4,588	- 1.16
Investment securities:			
Taxable	15,900	14,923	6.55
Tax exempt	6,618	7,463	-11.32
Federal funds sold	7,135	6,258	14.01
Int. bearing dep. in other banks	981	993	- 1.21
Total interest income	100,429	90,917	10.46
Interest Expense			
Deposits	52,782	47,925	10.13
Short-term borrowings	7,368	5,733	28.52
Long-term debt	1,982	1,991	- .45
Total interest expense	62,132	55,649	11.65
Net Interest Income	38,297	35,268	8.59
Provision for loan losses	2,544	2,169	17.29
Net Interest Income After Provision for Loan Losses	35,753	33,099	8.02
Non-Interest Income			
Data processing fees	2,690	2,552	5.41
Trust fees	2,425	2,358	2.84
Service charges on dep. accounts	2,759	2,488	10.89
Income on sale of mortgage loans	132	397	-66.75
Securities gains	471	570	-17.37
Other	2,979	2,477	20.27
Total non-interest income	11,456	10,842	5.66
Non-Interest Expense			
Salaries & Employee benefits	16,193	15,674	3.31
Equipment expense	2,529	2,383	6.13
Net occupancy expense	2,267	1,986	14.15
Taxes other than income	1,175	1,120	4.91
Other	9,979	9,683	3.06
Total non-interest expense	32,143	30,846	4.20
Income Before Income Tax	15,066	13,095	15.05
Income tax	2,064	1,084	90.41
Net Income	\$ 13,002	\$ 12,011	8.25

Source: CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988), 28.

Table 10.--Banking Institutions of St. Louis Federal Reserve District
Average Consolidated Statement of Income
(In Thousands)

	Year Ended December 31, 1988	1987	Percent change
Interest Income			
Loans, including fees:			
Taxable	\$68,606	\$56,689	21.02
Tax Exempt	2,638	2,688	- 1.86
Investment securities:			
Taxable	12,092	9,964	21.36
Tax exempt	11,077	12,931	-14.34
Federal funds sold	4,954	4,731	4.71
Interest bearing deposits in other banks	521	561	- 7.13
Total interest income	99,888	87,564	14.07
Interest Expense			
Deposits	33,480	26,394	26.85
Short-term borrowings	8,571	7,471	14.72
Long-term debt	10,229	8,123	25.93
Total interest expense	52,280	41,988	24.51
Net Interest Income	47,608	45,576	4.46
Provision for loan losses	4,184	3,169	32.03
Net Interest Income After Provision for Loan Losses	43,424	42,407	2.40
Non-Interest Income			
Securities gains (losses)	-4	15	-126.67
Other	22,240	21,764	2.19
Total non-interest income	22,236	21,779	2.10
Non-Interest Expense			
Taxes other than income	5,092	7,539	- 32.46
Other	41,264	39,827	3.61
Total non-interest expense	46,356	47,366	- 2.13
Income Before Income Tax	19,304	16,820	14.77
Income tax	4,342	3,815	13.81
Net Income	\$14,962	\$13,005	15.05

Source: Bank Holding Company Performance Report (Washington, D.C.:
Federal Deposit Insurance Corporation), 2.

Note: Data represents the 118 banking institutions in the St. Louis
district with assets between \$1 and \$3 billion.

Table 11.--CNB Bancshares and Industry Peer Income Statement as a Percent of Total Interest Income

	December 31, 1988		December 31, 1987	
	CNB	Peer	CNB	Peer
Interest Income	100.00%	100.00%	100.00%	100.00%
less: Int. expense	61.87	52.34	61.21	47.95
Net Interest Income	38.13	47.66	38.79	52.05
less: Provision for loan losses	2.53	4.18	2.39	3.62
plus: Non-int. income	11.41	22.26	11.93	24.87
less: Non-int. exp.	32.01	46.41	33.93	54.09
Income Before Income Tax	15.00	19.33	14.40	19.21
less: Income tax	2.05	4.35	1.19	4.36
Net income	12.95	14.98	13.21	14.85

Source: Adapted from information provided in the Bank Holding Company Performance Report (Washington, D.C.: Federal Deposit Insurance Corporation, 1988), 2 and CNB Bancshares Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988), 28.

CNB's Internal Organization

Corporate Structure

Through the seven subsidiary banks "CNB is engaged in commercial and retail banking, mortgage lending and servicing, trust services, electronic funds transfer networking, discount brokerage services and cash management services for corporate accounts and other banks. Citizens Information Systems, Inc., a wholly owned subsidiary of Citizens National Bank, provides data processing services to banks and other businesses in Indiana, Illinois, and Kentucky."¹² Citizens Investment Company, Inc., a leasing subsidiary, has just been formed.

¹²CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988), 49.

Trust Services

Estate planning, trust administration and a variety of retirement related services are offered by Citizen National's Trust Department. The Investment Division is headed by a Chartered Financial Analyst and the officer staff includes attorneys, officers with business degrees and an experienced farm manager with an agriculture degree.

The Trust Department earned \$2.4 million in commission fees for 1988, an increase of 2.8 percent from the prior year. Trust fee income is subject to market conditions, based primarily on the market value of assets under management. This figure reached a total of \$551 million in 1988.

Electronic Funds Transfer Networking

CNB's emphasis on electronic delivery systems resulted in Super Susie ATM cardholders having access to machines all through Kentucky and southern Indiana by 1982. In 1985 CNB's membering in the PLUS ATM interchange system allowed customers to have nationwide access to their checking accounts. In 1988 in an innovative move CNB placed ATM machines in four popular convenience stores, the first retail stores in Evansville to offer this service.

Discount Brokerage

As permitted under regulation, CNB offers a discount brokerage service with no investment advice given. Customers can save up to 70 percent on fees as compared to a conventional brokerage.

Cash Management

The cash management service provides businesses with rapid processing and collection of checks, lockbox capabilities and wire

transfers to allow faster access to funds. Excess funds are invested daily by the Cash Management Department with banks in the Fed funds market and corporate customers favoring short-term repurchase agreements.

Citizens Information Systems (CIS)

CIS provides a full range of data processing services to over thirty banks and area businesses. The subsidiary not only works outside Citizens National, but services each new CNB bank for which revenue is not generated. Despite CNB's growing number of acquisitions, data processing fees increased 54 percent to \$2.7 million in 1988.

Loans

CNB's Commercial Loan Department is active in extending adjustable rate loans responsive to interest rates and variable costs of funding. The \$303 million 1988 commercial loan balance represents an increase of 15.63 percent over the 1987 level.

Real estate mortgage loans totaled \$214 million in 1988, rising 6.18 percent from 1987. Approximately \$11 million of residential real estate loans originated by CNB were sold in the secondary market during 1988.

Consumer loans increased from \$124 million to \$141 million between 1987 and 1988. Strong growth was experienced in installment loans for purchases of automobiles and other consumer wares, credit card loans and home equity lines of credit. This overwhelming growth was somewhat offset by a decline in student loan balances.

Organizational Reporting

The structure of CNB is based on function. Each of the heads of the main divisions of lead bank Citizens National--Corporate, Community

and Government Relations, Loan and Deposit Services, Correspondent Banking and Trust Services--is ultimately responsible for reporting to the Cooper, Vieth and Knapp executive committee (see fig. 1). The bank is still small enough that much of the overall bank strategy can be effectively centralized by the executive committee. The heads of each of the major divisions in Citizens National is very active in the decision making for their department.

Each of the six subsidiary banks report to CNB's Senior Vice President for Affiliate Banks, Marvin Huff. Huff reports to the three executive officers for CNB. The newly acquired banks were purchased for excellent performance and operation and have largely been permitted to function autonomously, without much interference from officers at Citizens National.

The CIS subsidiary has its own executive board. It functions largely autonomously, reporting to the CNB executive committee.

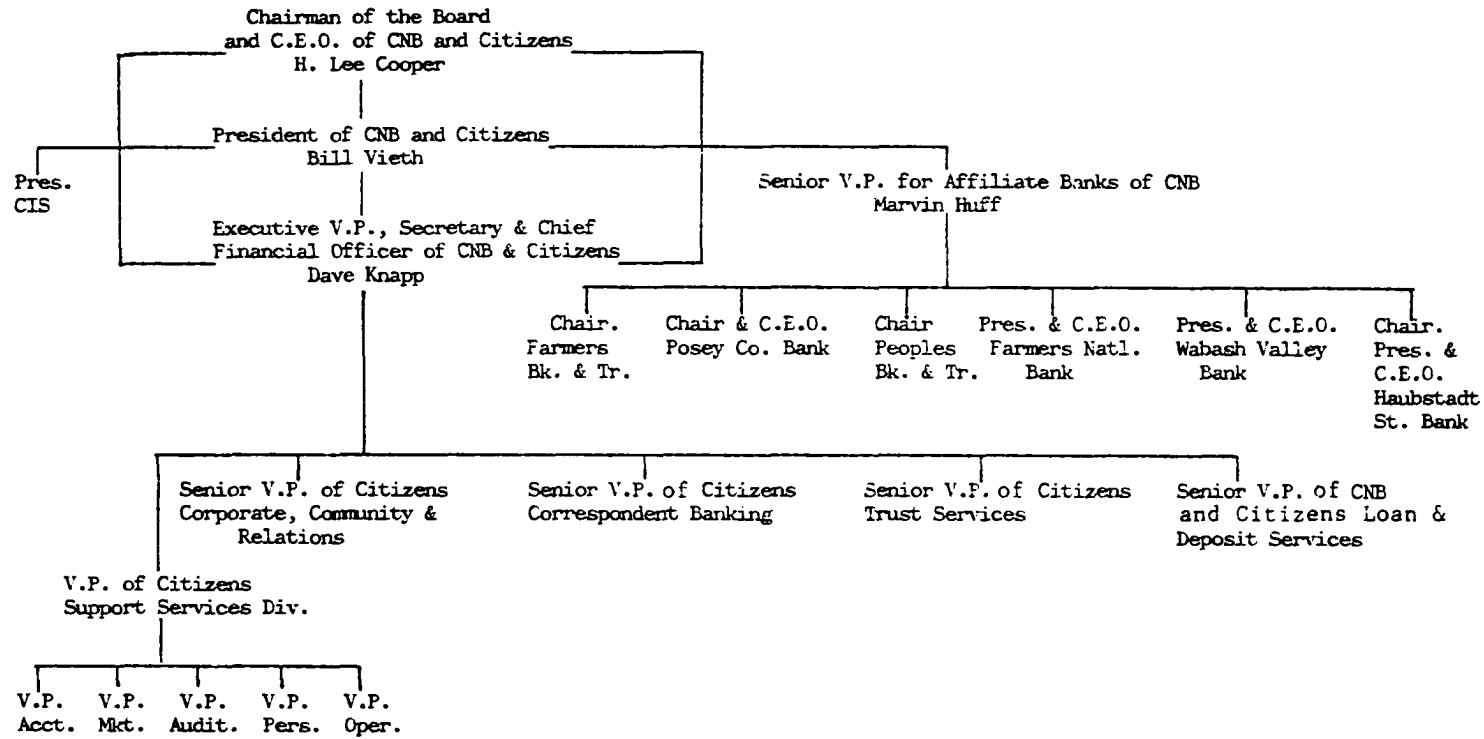
Corporate Resources

Marketing

As of 1988, the slogan "Leading the Way," which reflects the banks aggressive leadership and banking capability, became CNB's theme in a multi-media campaign on television, radio and print advertisements. Cooper and Vieth commented, "Response to the campaign in 1988 was impressive, both in terms of community acceptance and in building our customer base."¹³

¹³Ibid., 9.

Fig. 1. CNB Organizational Chart



Seminars

In an effort to support the Evansville business community, Citizens National supported a series of business success seminars. Those seminars occurred one night a week over an eight week period. Several hundred business people attended the meetings which covered such topics as planning, marketing and management. Additionally, over two-hundred people attended seminars sponsored by the Citizens National Trust Department on women's financial needs and the legal system.

Customer Service

All Citizens National Bank offices extend banking hours Monday through Thursday, 9:00 a.m. to 4:00 p.m. Citizens National branch offices extend Friday hours from 9:00 a.m. to 8:00 p.m. The downtown main office of Citizens National is opened Friday from 9:00 a.m. to 4:00 p.m. with the drive through opened until 6:00 p.m. Following the norm of banking institutions in Evansville, Citizens extends no Saturday hours of operation.

Innovative Products

In response to the competitive atmosphere of banking institutions, CNB introduced three new products in 1988: Young Citizens Account, Citizens 55+ Advantage Account and the Step-Up Rate CD.

The Young Citizens Account is available for individuals twenty-two or under. It will allow CNB to target young customers that will hopefully remain with the bank a lifetime. The first fifty checks are free and participants may write up to twelve checks each month with no service charge.

Through a cross-selling strategy, Citizens 55+ Advantage Account will hopefully attract all accompanying financial business of the fifty-five plus group. It provides free checks, money orders, cashier's checks, traveller's checks and notary service at no charge. The interest bearing checking account has no service charge as long as a daily balance of \$1,500 or more is maintained. If the balance falls below this amount, the fee is just \$8 per month. A 20 percent discount is granted on safe deposit rentals. If members are sixty-two or over they receive a Visa or Mastercard with no annual fee.

The Step-Up Rate CD offers customers a rate guaranteed to increase every six months during the CD's term.

Corporate Training Institute

In order to help prepare employees to deliver high quality service, the Corporate Training Institute was formed in 1987. CNB is committed to providing excellence in service toward the most important element of its success--the customers. Virtually every CNB employee attends the Institute seminars on customer relations and communications topics.

Employees

The Citizens Incentive Savings Plan was introduced in 1985. All CNB employees who have completed one year of service are eligible to participate. At the discretion of the Board of Directors, the bank may match a percentage of employee contributions and may make an additional contribution based on earnings performance. For 1988 the matching percentage was set at 40 percent, subject to a ceiling of 5 percent of each employee's base salary. A total expense of \$190,000 was incurred for the savings plan in 1988.

Employee dress is both conservative and professional. Professional conduct while working is a must, especially for those who have contact with customers.

Bank employees, as a whole, are very dedicated to the success of CNB. Occasionally, however, as happens in the banking industry as well as other industries, an employee proves painfully disloyal. Such a situation recently arose at CNB where an ex-bank employee is under investigation for an alleged theft of customer and bank funds. Following is the June 21, 1989 story printed in the Evansville Press:

A former Citizens National Bank employee is under investigation by the FBI for allegedly taking more than \$37,000 from a customer's account and from the bank, the man's attorney has confirmed.

No criminal charges have been filed against Michael L. Reynolds of Evansville, but a civil suit filed against him by the bank claims Reynolds took \$20,475 from a customer's account on Sept. 16, 1988. The suit also claims Reynolds wrote \$16,621 in cashier's checks to himself from the Eastland Mall branch.

Reynolds, who was an assistant branch manager, was fired from his job last month, bank officials said.

The suit filed in Vanderburgh Superior Court says the bank reimbursed the customer's account for the reported loss plus \$806 in interest and recovered \$1,012 after Citizens froze Reynolds' account at the bank.

Under state statute, the bank could recover three times the amount reported to have been taken.

Reynolds' attorney, Glenn Grampp, confirmed the FBI and the U.S. attorney's office were investigating the former bank employee. No criminal charges have been filed, but Grampp said he expected them to be filed.

No hearing date has been set on the civil suit.¹⁴

¹⁴"Ex-bank Employee Accused of Taking More Than \$37,000," Evansville Press, 21 June 1989, 1.

REFERENCES

- Amel, Dean F., and Michael J. Jacowski, "Trends in Banking Structure Since the Mid-1970s." Federal Reserve Bulletin 75, no. 3 (March 1989): 120-133.
- Bank Holding Company Performance Report. Washington, D.C.: Federal Deposit Insurance Corporation, 1988.
- Citizens Bank Annual Report. Evansville, Indiana: Citizens National Bank, 1983.
- Citizens Bank Leader. Evansville, Indiana: Citizens National Bank, July 1989.
- Cleland, George. "FSLIC Has Priority, but Its Not the Only Issue." ABA Banking Journal 81, no. 7 (July 1989): 13.
- CNB Bancshares, Inc. Annual Report. Evansville, Indiana: Citizens National Bank; 1984, 1985, 1986, 1987, 1988.
- CNB Bancshares, Inc. Dividend Reinvestment and Stock Purchase Plan Prospectus. Evansville, Indiana: Citizens National Bank, 16 May 1985.
- CNB Bancshares, Inc. Investment Profile. Evansville, Indiana: Citizens National Bank, 1989.
- CNB Bancshares, Inc. Notice of Annual Meeting and Proxy Statement. Evansville, Indiana: Citizens National Bank; 14 May 1985, 13 March 1989.
- CNB Bancshares, Inc. Notice of Annual Meeting of Shareholders. Evansville, Indiana: Citizens National Bank, 26 March 1987.
- CNB Bancshares, Inc. Notice of Special Meeting of Shareholders. Evansville, Indiana: Citizens National Bank, 6 September 1985.
- Derk, James. "Former Citizens Bank Official Sued Over Missing Funds." Evansville Courier, 21 June 1989, 1.
- "Domestic Financial Statistics." Federal Reserve Bulletin 75, no. 7 (July 1989): A(18) and A(27).
- "Ex-bank Employee Accused of Taking More Than \$37,000." Evansville Press, 21 June 1989, 1.
- From Evansville's First to Evansville's Largest. Evansville, Indiana: Old National Bank, 1984.

- Graddy, Duane B., Austin H. Spencer and William H. Brunsen. Commercial Banking: Financial Services Industry. Reston, Virginia: Prentice-Hall, 1985.
- Harding, Bruce W. "The Five-Year Outlook for Interstate Banking." The Bankers Magazine. (January-February 1988): 25-30.
- "Life after FSLIC?" ABA Banking Journal 81, no. 1 (January 1989): 25-27.
- "Interstate Banking: Business as Usual." ABA Banking Journal 78, no. 12 (December 1986): 29-32.
- Kroeger, Mark. "City Ready Home Renewal Plan." Evansville Courier, 29 June 1989, 17.
- Lee, John T., and Marie Bussing-Burks. "The Impact of Tax Reform on Commercial Banks Municipal Investment Holdings." New Orleans: Southwestern Society of Economists, 10 March 1989. Photocopied.
- Miller, William D. "Emerging Patterns on Mergers." ABA Banking Journal 80, no. 10 (October 1988): 27-30.
- Murray, Alan, "Greenspan Predicts Economy Will Slow, Says There's Risk of Substantial Downturn." The Wall Street Journal, 21 July 1989, sec. A:2(E).
- "The National City Bank, Evansville." Hoosier Banker, February 1963, 86.
- "Old National Bank Evansville." Hoosier Banker, February 1963, 88.
- Runge, Mel. "CNB Bancshares Nets 5.5% Gain in Recent Quarter." Evansville Press, 20 July 1989, 16.
- Sease, Douglas R. "Greenspan's Remarks Send Stock Gyration." The Wall Street Journal, 21 July 1989, sec. C:1(E).
- Sheshunoff, Alex. "Banks Climb Back in the Saddle." ABA Banking Journal 81, no. 7 (July 1989): 31-37.
- Thomas, Paulette. "As S & L Bailout Plan Draws Nearer Passage, Flaws Become Clear." The Wall Street Journal, 21 July 1989, sec. A:1(E).

INSTRUCTOR ANSWER UNIT

Question 1: Financial Ratio Analysis

A total of ten categories of major financial ratios for 1987 and 1988 for both CNB and peer data are listed in table 12 with mathematical computation exhibited in table 13. If the students are already adequately skilled in ratio computation, the instructor may permit students to utilize a computer disc (a copy is on hand in the Economics and Finance Department) which calculates the ratios in table 13. The financial data of tables 6 through 11 is also exhibited on the disc, which is operational under the Quattro spreadsheet. Use of the disc allows students to spend their time concentrating on the significance and implications of the ratios for CNB. Comments follow on the most pertinent ratios in each section and CNB's overall performance for select categories.

Profitability Ratios

Measures of profitability are the most inclusive indicator of a bank's performance. They measure the effectiveness of a bank in generating income. CNB's year end profitability ratios are roughly similar to the peer group.

CNB's profitability is strong for both years, with each of the ratios based on averages showing improvement from 1987 to 1988. Significantly above a 10.0 percent ROE benchmark for the banking industry, CNB's ratio rose from 12.45 to 12.51 percent. CNB also surpassed the 1.0 percent ROA benchmark with an increase from 1.06 to 1.09 percent. Additionally, asset utilization rose from 9.0 to 9.39 times, the net interest margin increased from 3.44 to 3.51 percent, and the interest spread strengthened from 2.54 to 2.59 percent. The net

income margin measuring net income to total income fell slightly from 11.80 to 11.62, due to a higher percentage of income paid out in taxes in 1988.

Liquidity Ratios

Liquidity management is essential for a banking institution to be able to meet depositor withdrawal needs as well as loan demands of customers. On all measures CNB ranks high.

Compared to the industry peer for both 1987 and 1988, CNB held a larger portion of its assets in cash, cash equivalents and deposits in other banks--the most liquid grouping. A large component of this grouping represents the Fed funds sold for correspondent bank, an operation which places CNB in an excellent position to meet its liquidity needs.

The liquidity measurements of highly interest-sensitive money to fund assets are also strong. CNB's liability ratios of time deposits over \$100,000, and Fed funds purchased and securities sold under repos are below industry averages for both years. Because the ratios are low, CNB is considered liquid with a high degree of borrowing capacity.

Financial Structure Ratios

On the ratios which examine how well a bank will be able to finance its assets CNB is in a superior position to the peer. The equity multiplier and debt to equity ratio indicate that CNB has the higher equity stance with the peer more leveraged. Additionally, the equity to total assets less highly liquid assets ratio, indicates that CNB also has the higher equity position to cover risk assets.

The peer, however, has a slightly higher ability than CNB to meet all its interest charges.

Credit Risk Ratios

The success of CNB's policy of no foreign loans and direct lending to the regional market from which its deposits are drawn, can be seen in its risk ratios. The net loan charge-off ratio shows that the percentage of the total amount of loans charged off less any recoveries was lower for CNB than its peer. Furthermore, while the industry charge-offs rose from 1987 to 1988, CNB's position actually improved in 1988.

Composition of Investments

Both CNB and its peer reduced proportionate holdings of investments in tax-exempt obligations while increasing U.S. Treasury and Federal agencies amounts. In 1987 the industry peer had a large 40.29 percent of investments in tax-exempts, but reduced 7.19 percent in 1988.

CNB had 34.21 percent of investment securities in tax-exempts in 1987, and dropped 5.69 percent in 1988. The disinvestment of tax-exempts is an excellent strategy because due to tax reform restrictions on the investments, higher returns can be found in the taxable market.

Composition of Loans

For both 1987 and 1988, CNB's composition of total loans was led by commercial loans, followed by: real estate loans, consumer loans, tax-exempt loans, and bankers' acceptances and term Fed funds. CNB's tax-exempt loan volume declined in 1988 as the benefits for making such loans were dampened by tax reform. CNB does have a slightly higher percentage of commercial loans than its industry peer as the bank is

located in a thriving industrial community. The composition of a loan portfolio is highly dependent on the area in which a bank is operating.

Historically, consumer and real estate loans have yielded the highest rates for CNB. Commercial loans appear at the lower extreme for yield return. In 1988 consumer loans yielded 11.7 percent, real estate loans 11.19 percent, tax-exempt loans 11.02 percent, commercial loans 10.14 percent and bankers' acceptances and term Fed funds 7.59 percent.

Yield on earning Assets

On total loan income CNB yielded a slightly higher rate than its peer each year. In 1987 CNB's yield of 9.07 percent was 1.14 percent higher than the peer, and in 1988 a yield of 9.71 was 1.62 percent above the industry peer,

CNB did earn considerably less than the peer on Fed funds sold income. In 1987 the bank reaped only 4.82 percent, with its peer 50.4 percent higher. CNB earned just 4.91 percent in 1988, with its peer 2.62 percent over. The Fed funds sold is not intended to be a major funding source for CNB but a service provided to its correspondent banks.

For both years CNB scored higher on yield for taxable securities while its peer earned higher rates on tax-exempts. It is most likely that the industry peer is holding older tax-exempt securities which still permit the interest expense deduction and consequently, can produce these strong yields. This situation is to CNB's praise because any older tax-exempts will soon mature and banks must be able to find high returns in the taxable market.

Average Interest Cost of Liabilities

CNB was able to pay out less interest than the peer on deposits in 1987 and 1988, CDs and other time instruments in 1988, and Fed funds purchased and securities sold under repo agreements in 1987 and 1988.

Percent of Non-Interest Income

From 1987 to 1988, service charges as a percentage of total non-interest income increased only slightly from 22.95 to 24.08 percent.

The peer group service charges rose from 24.58 to a much larger 31.90 percent. Although CNB's service charges on deposit accounts rose, fees associated with mortgage loans sold to investors fell due to a drop in real estate closings.

Trust fee income as a percentage of non-interest income was considerably higher for CNB. This is not surprising noting the strength of the CNB trust department coupled by the possibility that not all banks included in the average results have a trust department.

Percent of Non-Interest Expense

CNB paid out slightly over 50 percent of its non-interest expense to salaries and employee benefits, compared to approximately 45 percent by its industry peer. CNB's Employee Savings Plan contributed to a slightly higher expense.

Table 12.--CNB Bancshares and Industry Peer Financial Highlights

PROFITABILITY RATIOS	1988		1987	
	CNB	Peer	CNB	Peer
Return on equity (based on averages)	12.10% 12.51%	13.61%	11.89% 12.45%	13.51%
Return on assets (based on averages)	1.01% 1.09%	.99%	.99% 1.06%	.98%
Asset utilization (based on averages)	8.69x 9.39x	8.05x	8.35x 9.00x	8.27x
Net profit margin	11.62%	12.25%	11.80%	11.89%
Net interest margin (based on averages)	3.29% 3.51%	3.64%	3.20% 3.44%	4.13%
Interest spread (based on averages)	2.56% 2.59%	3.12%	2.38% 2.54%	3.50%
LIQUIDITY RATIOS				
<u>Investment securities</u> Total assets	23.53%	24.05%	23.80%	22.94%
<u>Cash+cash equiv.+dep. in banks</u> Total assets	17.48%	12.43%	17.45%	14.71%
<u>Net loans</u> Total assets	55.10%	57.24%	54.75%	55.77%
<u>Market value of securities</u> Book value of securities	98.43%	101.04%	99.64%	101.40%
<u>Time deposits over \$100,000</u> Total liabilities	11.64%	15.82%	10.17%	13.27%
<u>Fed funds pur. + sec. sold repos.</u> Total liabilities	7.66%	10.94%	7.38%	10.62%
FINANCIAL STRUCTURE RATIOS				
Equity multiplier	11.98x	13.80x	12.06x	13.73x
<u>Total debt</u> Total equity	10.98x	12.80x	11.06x	12.73x

Table 12.--Continued

	1988		1987	
	CNB	Peer	CNB	Peer
<u>Total equity</u> T. assets-(cash and equiv+dep. in banks + Treas.)	11.37%	10.10%	11.44%	10.16%
Times interest earned	1.24x	1.37x	1.24x	1.40x
<u>CREDIT RISK RATIOS</u>				
<u>Net loan chargeoffs</u> Total loans	.25%	.41%	.33%	.32%
<u>Allowance for loan losses</u> Net loans	1.30%	1.44%	1.28%	1.59%
<u>Loan recoveries</u> Total loans	.05%	.10%	.06%	.12%
<u>Provision for loan losses</u> Net loans	.36%	.48%	.33%	.43%
<u>COMPOSITION OF INVESTMENTS</u>				
<u>U.S. Treasury & Federal agencies</u> Total investments	67.86%	65.96%	62.49%	59.23%
<u>State and Municipal</u> Total investments	28.52%	33.10%	34.21%	40.29%
<u>Other securities</u> Total investments	3.62%	.94%	3.30%	.48%
<u>COMPOSITION OF LOANS</u>				
<u>Commercial loans</u> Total loans	40.63%	32.85%	37.36%	34.91%
<u>Tax exempt loans</u> Total loans	7.87%	0.00%	9.34%	0.00%
<u>Real estate loans</u> Total loans	29.77%	30.19%	29.82%	26.94%
<u>Consumer Loans</u> Total loans	19.58%	30.06%	18.31%	25.42%

Table 12.--Continued

	1988		1987	
	CNB	Peer	CNB	Peer
<u>Bankers' accept. & term</u>				
<u>Fed funds</u>	2.15%	.48%	5.17%	2.10%
Total loans				
<u>Other loans</u>	0.00%	6.42%	0.00%	10.63%
Total loans				
<u>YIELD ON EARNING ASSETS</u>				
Taxable securities	7.31%	4.95%	7.77%	5.50%
Tax exempt securities	7.75%	9.17%	7.63%	10.59%
Fed funds sold	4.91%	7.53%	4.82%	9.86%
Loan income	9.71%	8.09%	9.07%	7.93%
<u>AVERAGE COST OF LIABILITIES</u>				
Interest bearing deposits	5.26%	6.50%	5.18%	6.36%
Certificates of dep. & other time	7.20%	7.48%	6.89%	6.71%
Fed funds purchased and securities sold under repo agreements	7.12%	7.24%	6.21%	6.89%
<u>PERCENT OF NON-INTEREST INCOME</u>				
<u>Trust fees</u>	21.17%	15.03%	21.75%	12.31%
Total non-interest income				
<u>Service charges</u>	24.08%	31.90%	22.95%	24.58%
Total non-interest income				
<u>Securities gains (loss)</u>	4.11%	-.01%	5.26%	.07%
Total non-interest income				
<u>Other non-interest income</u>	50.64%	53.08%	50.05%	63.04%
Total non-interest income				
<u>PERCENT OF NON-INTEREST EXPENSE</u>				
<u>Salaries and employee benefits</u>	50.38%	45.49%	50.81%	44.55%
Total non-interest expense				

Table 12.--Continued

	1988		1987	
	CNB	Peer	CNB	Peer
<u>Net occupancy expense</u>	7.05%	13.96%	6.44%	12.79%
<u>Total non-interest expense</u>				
<u>Taxes other than income</u>	3.66%	10.98%	3.63%	15.92%
<u>Total non-interest expense</u>				
<u>Other expense</u>	38.91%	29.57%	39.12%	26.74%
<u>Total non-interest expense</u>				

Source: Adapted from information provided in the Bank Holding Company Performance Report (Washington, D.C.: Federal Deposit Insurance Corporation, 1988) and CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988).

Table 13.--CNB Bancshares and Industry Peer Financial Ratio Analysis Computation

		1988		1987	
		CNB	Peer	CNB	Peer
PROFITABILITY RATIOS					
Return on Equity	$\frac{\text{Net income}}{\text{Total equity}}$	$\frac{13,002}{107,427} = 12.10\%$	$\frac{14,962}{109,901} = 13.61\%$	$\frac{12,011}{101,055} = 11.89\%$	$\frac{13,005}{96,256} = 13.51\%$
Return on Assets	$\frac{\text{Net income}}{\text{Total assets}}$	$\frac{13,002}{1,287,331} = 1.01\%$	$\frac{14,962}{1,516,959} = .99\%$	$\frac{12,011}{1,218,594} = .99\%$	$\frac{13,005}{1,321,751} = .98\%$
Asset Utilization	$\frac{\text{Total income}}{\text{Total assets}}$	$\frac{111,885}{1,287,331} = 8.69x$	$\frac{122,124}{1,516,959} = 8.05x$	$\frac{101,759}{1,218,594} = 8.35x$	$\frac{109,343}{1,321,751} = 8.27x$
Net Profit Margin	$\frac{\text{Net income}}{\text{Total income}}$	$\frac{13,002}{111,885} = 11.62\%$	$\frac{14,962}{122,124} = 12.25\%$	$\frac{2,011}{101,759} = 11.80\%$	$\frac{13,005}{109,343} = 11.89\%$
Net Interest Margin	$\frac{\text{Tot. int. inc.} - \text{int. expense}}{\text{Earning assets}}$	$\frac{100,429 - 62,132}{1,163,001} = 3.29\%$	$\frac{99,888 - 52,280}{1,306,227} = 3.64\%$	$\frac{90,917 - 55,649}{1,103,150} = 3.20\%$	$\frac{87,564 - 41,988}{1,103,058} = 4.13\%$
Interest Spread	$\frac{\text{Interest Inc.} - \text{Int. exp.}}{\text{Earn assets Int. bearing liab.}}$	$\frac{100,429 - 62,132}{1,163,001} = 8.64\%$	$\frac{99,888 - 52,280}{1,306,227} = 7.65\%$	$\frac{90,917 - 55,649}{1,103,150} = 8.24\%$	$\frac{87,564 - 41,988}{1,103,058} = 7.94\%$
		$8.64\% - 6.08\% = 2.56\%$	$7.65\% - 4.53\% = 3.12\%$	$8.24\% - 5.86\% = 2.38\%$	$7.94\% - 4.44\% = 3.50\%$
LIQUIDITY RATIOS					
	$\frac{\text{Investment securities}}{\text{Total assets}}$	$\frac{302,956}{1,287,331} = 23.53\%$	$\frac{364,784}{1,516,959} = 24.05\%$	$\frac{289,984}{1,218,594} = 23.80\%$	$\frac{303,202}{1,321,751} = 22.94\%$
	$\frac{\text{Cash \& cash equiv. + dep. in banks}}{\text{Total assets}}$	$\frac{225,034}{1,287,331} = 17.48\%$	$\frac{188,496}{1,516,959} = 12.43\%$	$\frac{212,593}{1,218,594} = 17.45\%$	$\frac{194,415}{1,321,751} = 14.71\%$
	$\frac{\text{Net loans}}{\text{Total assets}}$	$\frac{709,321}{1,287,331} = 55.10\%$	$\frac{868,245}{1,516,959} = 57.24\%$	$\frac{667,207}{1,218,594} = 54.75\%$	$\frac{737,171}{1,321,751} = 55.77\%$
	$\frac{\text{Market value of securities}}{\text{Book value of securities}}$	$\frac{298,199}{302,956} = 98.43\%$	$\frac{368,574}{304,784} = 101.04\%$	$\frac{288,953}{289,984} = 99.64\%$	$\frac{307,436}{303,202} = 101.40\%$
	$\frac{\text{Time deposits over \$100,000}}{\text{Total liabilities}}$	$\frac{137,311}{1,179,904} = 11.64\%$	$\frac{222,542}{1,407,058} = 15.82\%$	$\frac{113,629}{1,117,539} = 10.17\%$	$\frac{162,614}{1,225,495} = 13.27\%$

Table 13.--Continued

	1988		1987	
	CNB	Peer	CNB	Peer
<u>Fed funds purchased + sec. sold repos</u>	<u>90,358=7.06%</u>	<u>153,885=10.94%</u>	<u>82,427=7.35%</u>	<u>130,108=10.62%</u>
<u>Total liabilities</u>	<u>1,179,904</u>	<u>1,407,058</u>	<u>1,117,539</u>	<u>1,225,495</u>
FINANCIAL STRUCTURE RATIOS				
<u>Equity Multiplier</u>	<u>1.287,331=11.98x</u>	<u>1.516,959=13.80x</u>	<u>1,218,594=12.06x</u>	<u>1,321,751=13.73x</u>
<u>Total assets</u>	<u>107,427</u>	<u>109,901</u>	<u>101,055</u>	<u>96,256</u>
<u>Total equity</u>	<u>1.179,904=10.98%</u>	<u>1.407,058=12.80%</u>	<u>1.117,539=11.06%</u>	<u>1.225,495=12.73%</u>
<u>Total debt</u>	<u>107,427</u>	<u>109,901</u>	<u>101,055</u>	<u>96,256</u>
<u>Total equity</u>	<u>1,287,331-</u>	<u>1,516,959-</u>	<u>1,218,594-</u>	<u>1,321,751-</u>
<u>Total assets-(cash & equiv.+dep.</u>	<u>(225,034+117,297)</u>	<u>(188,496+240,599)</u>	<u>(212,593+122,649)</u>	<u>(194,415+179,600)</u>
<u>in banks + Treas.</u>	<u>11.37%</u>	<u>10.10%</u>	<u>11.44%</u>	<u>10.16%</u>
<u>Times Interest Earned</u>	<u>15,066+62.132=1.24x</u>	<u>19,304+52.280=1.37x</u>	<u>13,005+55.649=1.24x</u>	<u>16,820+41.986=1.40x</u>
<u>Earnings before taxes + int. exp.</u>	<u>62,132</u>	<u>52,280</u>	<u>55,649</u>	<u>41,988</u>
<u>Total interest expense</u>				
CREDIT RISK RATIOS				
<u>Net loan chargeoffs</u>	<u>1,829=.25%</u>	<u>3,576=.41%</u>	<u>2,255=.33%</u>	<u>2,424=.32%</u>
<u>Total loans</u>	<u>718,556</u>	<u>880,720</u>	<u>675,727</u>	<u>748,874</u>
<u>Allowance for loan losses</u>	<u>9,235=1.30%</u>	<u>12,475=1.44%</u>	<u>8,520=1.28%</u>	<u>11,703=1.59%</u>
<u>Net loans</u>	<u>709,321</u>	<u>868,245</u>	<u>667,207</u>	<u>737,171</u>
<u>Loan recoveries</u>	<u>357=.05%</u>	<u>916=.10%</u>	<u>407=.06%</u>	<u>876=.12%</u>
<u>Total loans</u>	<u>718,556</u>	<u>880,720</u>	<u>675,727</u>	<u>748,874</u>
<u>Provision for loan losses</u>	<u>2,544=.36%</u>	<u>4,184=.48%</u>	<u>2,160=.33%</u>	<u>3,160=.43%</u>
<u>Net loans</u>	<u>709,321</u>	<u>868,245</u>	<u>667,207</u>	<u>737,171</u>
COMPOSITION OF INVESTMENTS				
<u>U.S. Treasury+Fed. agencies</u>	<u>117,297+88,205=67.86%</u>	<u>240,590+65.96%</u>	<u>122,649+58.557=62.49%</u>	<u>179,600=59.23%</u>
<u>Total investments</u>	<u>302,956</u>	<u>364,784</u>	<u>289,984</u>	<u>303,202</u>

Table 13. Continued

	1988		1987	
	CNB	Peer	CNB	Peer
<u>State and municipal</u>				
<u>Total investments</u>	$\frac{86,397}{302,956} = 28.52\%$	$\frac{120,739}{364,784} = 33.10\%$	$\frac{99,209}{289,984} = 34.21\%$	$\frac{122,153}{303,202} = 40.29\%$
<u>Other securities</u>				
<u>Total investments</u>	$\frac{10,967}{302,956} = 3.62\%$	$\frac{3,446}{364,784} = .94\%$	$\frac{9,569}{289,984} = 3.30\%$	$\frac{1,449}{303,202} = .48\%$
COMPOSITION OF LOANS				
<u>Commercial loans</u>				
<u>Total loans</u>	$\frac{291,018}{718,556} = 40.63\%$	$\frac{289,355}{880,720} = 32.85\%$	$\frac{252,467}{675,727} = 37.36\%$	$\frac{261,448}{748,874} = 34.91\%$
<u>Tax exempt loans</u>				
<u>Total loans</u>	$\frac{56,579}{718,556} = 7.87\%$	0.00%	$\frac{63,096}{675,727} = 9.34\%$	0.00%
<u>Real estate loans</u>				
<u>Total loans</u>	$\frac{213,933}{718,556} = 29.77\%$	$\frac{265,898}{880,720} = 30.19\%$	$\frac{201,476}{675,727} = 29.82\%$	$\frac{201,724}{748,874} = 26.94\%$
<u>Consumer loans</u>				
<u>Total loans</u>	$\frac{140,710}{718,556} = 19.58\%$	$\frac{264,715}{880,720} = 30.06\%$	$\frac{123,704}{675,727} = 18.31\%$	$\frac{190,372}{748,874} = 25.42\%$
<u>Bankers' accept. & term Fed. funds</u>				
<u>Total loans</u>	$\frac{15,406}{718,556} = 2.15\%$	$\frac{4,241}{880,720} = .48\%$	$\frac{34,984}{675,727} = 5.17\%$	$\frac{15,715}{748,874} = 2.10\%$
<u>Other loans</u>	0.00%	$\frac{56,511}{880,720} = 6.42\%$	0.00%	$\frac{79,615}{748,874} = 10.63\%$
YIELD ON EARNING ASSETS				
<u>Taxable inv. security income</u>				
<u>Taxable securities</u>	$\frac{15,900}{217,562} = 7.31\%$	$\frac{12,092}{244,045} = 4.95\%$	$\frac{14,923}{192,180} = 7.77\%$	$\frac{9,964}{181,049} = 5.50\%$
<u>Tax exempt investment sec. income</u>				
<u>Tax exempt securities</u>	$\frac{6,618}{85,394} = 7.75\%$	$\frac{11,077}{120,739} = 9.17\%$	$\frac{7,463}{97,804} = 7.63\%$	$\frac{12,931}{122,153} = 10.59\%$
<u>Fed. funds sold income</u>				
<u>Fed. funds sold</u>	$\frac{7,135}{145,225} = 4.91\%$	$\frac{4,954}{65,800} = 7.53\%$	$\frac{6,258}{129,800} = 4.82\%$	$\frac{4,731}{48,000} = 9.86\%$
<u>Loan income</u>				
<u>Total loans</u>	$\frac{69,795}{718,556} = 9.71\%$	$\frac{71,244}{880,720} = 8.09\%$	$\frac{61,280}{675,727} = 9.07\%$	$\frac{59,377}{748,874} = 7.93\%$

Table 13.--Continued

	1988		1987	
	CNB	Peer	CNB	Peer
AVERAGE INTEREST COST OF LIABILITIES				
Interest bearing deposits	5.26%	6.50%	5.18%	6.36%
Certificates of deposit & other time	7.20%	7.48%	6.89%	6.71%
Fed. funds purchased and securities sold under repo agreement	7.12%	7.24%	6.21%	6.89%
PERCENT OF NON-INTEREST INCOME				
<u>Trust fees</u>	2.425=21.17%	3.343=15.03%	2.358=21.75%	2.682=12.31%
Total non-interest income	11,456	22,236	10,842	21,779
<u>Service charges</u>	2,759=24.08%	7,094=31.90%	2,488=22.95%	5,353=24.58%
Total non-interest income	11,456	22,236	10,842	21,779
<u>Securities gains (loss)</u>	471= 4.11%	-4= -.01%	570= 5.26%	15= .07%
Total non-interest income	11,456	22,236	10,842	21,779
<u>Other non-interest income</u>	5,801=50.64%	11,803=53.08%	5,426=50.05%	13,729=63.04%
Total non-interest income	11,456	22,236	10,842	21,779
PERCENT OF NON-INTEREST EXPENSE				
<u>Salaries and employee benefits</u>	16,193=50.38%	21,086=45.49%	15,674=50.81%	21,105=44.55%
Total non-interest expense	32,143	46,356	30,846	47,366
<u>Net occupancy expense</u>	2,267= 7.05%	6,473=13.96%	1,986= 6.44%	6,056=12.79%
Total non-interest expense	32,143	46,356	30,846	47,366
<u>Taxes other than income</u>	1,175= 3.66%	5,092=10.98%	1,120= 3.63%	7,539=15.92%
Total non-interest expense	32,143	46,356	30,846	47,366
<u>Other expense</u>	12,508=38.91%	13,705=29.57%	12,066=39.12%	12,666=26.74%
Total non-interest expense	32,143	46,356	30,846	47,366

Source: Adapted from information provided in the Bank Holding Company Performance Report (Washington, D.C.: Federal Deposit Insurance Corporation, 1988) and CNB Bancshares, Inc. Annual Report (Evansville, Indiana: Citizens National Bank, 1988).

Question 2: Recommendations

CNB is a superior performing banking institution with numerous strengths. Some of its most positive internal attributes include: an excellent, dedicated executive management team; a well-functioning organizational structure; an experienced, active Board of Directors; innovative financial products; an anti-takeover strategy utilizing "blank check" preferred stock, a long held policy of no foreign loans; a superior electronic funds transfer network; and an in-house data processing service. CNB banks are located in an area of regional economic stability where interstate banking laws have permitted the acquisition of strong subsidiary banks.

Students may devise a variety of recommendations intended to heighten the performance of CNB. Following is a listing of possible actions:

1. Open select branches on Saturday from 9:00 a.m. to 1:00 p.m..

Citizens National East Side branch, which is located by two shopping centers and has numerous corporate customers, and Citizens National Eastland Mall branch, next to the city's main mall with a new growing business population, are recommended for Saturday morning banking hours. Because no banking institution in Evansville opens for Saturday operations, CNB would have a tremendous opportunity to capture new corporate business as well as a portion of customers from Old National and National City banks, each having a branch in the area. Many businesses do not like to use the night depository and will hold all transactions until Monday.

Additionally, many individual customers simply do not or do not like to use ATM machines. Saturday hours would prove very useful for these people who often have a full time job during the week and can't get to the bank. Others with non-traditional work weeks, such as Tuesday to Saturday, may find it convenient to have access to a bank during employment hours.

2. Bank offices in grocery stores.

Small bank offices, with two tellers, in popular grocery stores would allow CNB to capture new customers and provide an excellent service for current customers. No banking institution in the Evansville area has implemented this innovative service. Grocery stores are an excellent site for a bank office because the family shopper will visit the grocery at least weekly. Convenience is a service customers will increasingly demand in the 1990s.

3. Place heads of all subsidiary banks on CNB Board of Directors.

The chairman and/or president of each subsidiary bank should hold a seat on the CNB board. Currently, Citizens National, plus Peoples Bank and Posey Bank which were acquired in 1986, are represented on the board. The four remaining banks which were purchased during 1987 and 1988 lack a representative. Each bank needs to participate in the free flowing exchange of ideas in order to benefit itself and subsequently the entire organization.

4. Analyze the cost effectiveness of the correspondent Fed funds business.

In 1988 CNB only earned 4.91 percent in Fed funds sold income, compared to the industry average of 7.53 percent. CNB stated the

selling of Fed funds was not intended as a major source of income but a service provided to its correspondent banks. Viewing the ratios, it would suggest CNB is returning a large portion of the original Fed funds sold income to correspondent accounts. The other business provided to CNB by correspondents may more than compensate for the Fed funds business; however, the Fed funds income is so low an analysis of the return on correspondent business is warranted. The bank may then choose to give the correspondents less margin on the Fed funds, thus increasing its income.

5. Develop a strategic plan for underwriting corporate securities.

CNB may eventually be able to engage in investment banking activities through the amendment of Glass-Steagall or through Fed approval. Underwriting corporate securities can be a very profitable business and CNB may be able to obtain a stronghold on the market through advanced planning on the organization of an investment banking subsidiary. Application for Fed approval should immediately be analyzed.

6. Due to the alleged ex-employee theft CNB should implement an informal, unwritten policy of three years of service before obtaining an assistant branch manager position.

Characteristically, CNB assistant branch managers are young well-educated individuals, many of whom have joined the bank directly from college. They begin work as a customer service representative floating among the various branches to learn the business. When an assistant manager position becomes available, a customer service

representative is placed in that position. Usually, the new assistant manager has spent one to two years in various branches.

An assistant manager is in a position of authority and has access to a great deal of money. CNB should consider an informal, unwritten policy of requiring an individual to have a minimum of three years with the bank before being appointed to an assistant manager position. This time frame may allow management to become familiar with the personality traits of the customer service representative, as well as to thoroughly evaluate his or her work performance before placing the individual in such a responsible position.

7. Restrict acquisition growth to the Indiana, Kentucky and Illinois area.

Although Indiana interstate banking laws provide opportunities for acquisitions in numerous states and nationwide banking in 1992, it is recommended that CNB restrict its acquisition growth to the states of Indiana, Kentucky and Illinois for the foreseeable future.

The primary cause of an unsuccessful bank acquisition is poorly planned integration. Being too dispersed geographically is also a cause of acquisition failure.¹⁵ By maintaining planned acquisition growth in the same geographic proximity of the tri-state region, CNB will be able to oversee subsidiary bank activity. CNB can reach economies of scale through such activities as running centralized check proofs as they operate now in the Citizens National main office. Economies of scope

¹⁵William D. Miller, "Emerging Patterns on Mergers," ABA Banking Journal 80, no. 10(October 1988): 30.

can also be obtained through a wider variety of bank services for each institution.

Indiana and Kentucky permit the largest opportunities for growth and expansion because they allow countywide branch offices. Illinois only allows unit branching; however, an acquisition into that state would still be profitable with a strong single institution.

CHAPTER 7

THE IMPACT OF TAX REFORM ON COMMERCIAL BANKS' MUNICIPAL INVESTMENT HOLDINGS

MTN Bancshares, Inc. is a \$1.7 billion multi-bank holding company. As portfolio manager of MTB you are in charge of the investment holdings of the \$1.1 billion lead bank, Mid-Tennessee National. Additional responsibilities include fielding questions and preparing a weekly investment advice letter for the portfolio managers of MTN's four subsidiary banks: Northern National Bank of Tennessee, Southern National Bank of Tennessee, Western National Bank of Tennessee, and Eastern National Bank of Tennessee.

The new rules of tax reform have drastically curtailed a banks incentive to hold municipal securities. The MTN banks, along with other banking institutions, are adjusting to the rulings against the long treasured tax-free security.

The investment managers of the subsidiary banks request your expert advice on specific aspects of the rulings. Before responding, review the tax reform summary, which may aid in your assessment.

Introduction

Management of the commercial bank portfolio is impacted not only by economic and interest rate changes but regulatory and tax alterations as well. An astute bank investment officer must react to such changes with needed portfolio adjustments that will maximize return while managing risk.

The Tax Reform Act of 1986 (the Act) presented such an occasion for bank investment officers. Among the provisions of the Act affecting commercial banks are its treatment of municipal securities, a long-time favored investment vehicle for banks. The impetus for banks to purchase municipal securities has been exemption for federal income taxes and special deductions for the interest expense on money borrowed to purchase or "carry" municipals.

Under the new rules, banks can no longer deduct interest expense for municipal issues acquired after August 7, 1986, except for qualified issues from "small issuers" not issuing more than \$10 million of bonds in one year. The Act further mandates that interest on private activity bonds (bonds issued by quasi-public agencies such as sewage authorities and public utilities) issued after August 7, 1986 be treated as a tax preference for alternative minimum tax (AMT) purposes. Once the AMT applies to a bank, the institution is in a 20 percent marginal tax bracket and any additional supposedly tax-free securities (regardless of the purchase date of the municipal) will be taxed at 15 percent. These new restrictions have caused virtually all bank investment officers to reappraise their portfolio holdings and strategies.

The purpose of this overview is twofold: to examine the new rules of the game with respect to bank municipal holdings, and to gather information through a survey of Tennessee banking institutions concerning the effects of these changes on portfolio management.

Repeal of Interest Expense Deduction

In recent years Congress has enacted tax legislation to prevent banks from deducting, without limit, the interest expense deemed

allocable to tax-exempt bonds. Beginning with the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA), banks were no longer permitted to deduct the full amount of interest expense incurred in purchasing or carrying municipals. Under TEFRA, an 85 percent deduction was allowed. Later the deduction was lowered to 80 percent in 1984 under the Deficit Reduction Act. The Tax Reform Act of 1986 eliminated the remaining 80 percent municipal interest expense deduction.

Section 902 of the 1986 Tax Act¹ denies commercial banks (and other financial institutions) any deduction for the interest expense incurred in purchasing or carrying tax-exempt bonds which were acquired after August 7, 1986. This ruling became effective for taxable years ending after December 31, 1986.

There are several exceptions "grandfathered" under this ruling. Municipals acquired by banking institutions from January 1, 1983 to August 7, 1986 will still be permitted the 80 percent deduction. The 85 percent deduction remains for municipals acquired during 1982, while the 100 percent interest deduction for such bonds purchased before 1982 continues intact. Written commitments to purchase or repurchase bonds entered into on or before September 25, 1985 are treated as obligations acquired prior to August 8, 1986, and allowed the 80 percent deduction.

The Act further provides for a permanent small issuer exception to the repeal of interest expense deductions. "Bank qualified" small issues will remain subject to the 80 percent deduction rule. To qualify

¹Prentice-Hall's Explanation of the Tax Reform Act of 1986. Bulletin 42 Extra (Englewood Cliffs, N.J.: Prentice Hall, 1986).

a bond must be for public purpose² (not a private activity bond) or a 501(c)(3) organization³ (such as charitable or educational) purpose. Additionally, such bonds must be issued by an entity which reasonably expects to issue no more than \$10 million of tax-exempt obligations (as stated in the bond issue) in one calendar year.

The following examples illustrate the advantage of the 80 percent interest expense deduction (20 percent disallowance) versus the new ruling for a 100 percent disallowance.

(1) First State Bank has the following financial data for the year:

Total average assets = \$100 million
 Total interest expense = \$6 million
 Municipal portfolio consists of all securities purchased
 between January 1, 1983 and August 7, 1986 = \$25 million
 Tax rate = 34 percent

First State's dollar amount of interest expense disallowed and its negative impact on after tax earnings would be computed as follows:

$\frac{\$25 \text{ mil}}{\$100 \text{ mil}} \times \$6 \text{ mil} \times 20 \text{ percent} = \$300,000$ interest expense disallowed

$\$300,000$ non-deductible interest expense \times 34 percent = \$102,000 increased taxes

(2) Second State Bank has the following financial data for the year:

Total average assets = \$100 million
 Total interest expense = \$6 million
 Municipal portfolio consists of all securities purchased after
 August 7, 1986 and nonqualified = \$25 million
 Tax rate = 34 percent

²A public purpose bond is a security issued strictly for a public use, such as a school or highway bond.

³Federal Taxes 1986. Vol. 5 19,000-21,169, Code sections 401-506 (Paramas, N.J.: Prentice-Hall Information Services, 1987).

Second State's dollar amount of interest expense disallowed and its negative impact on after tax earnings would be computed as follows:

$\frac{\$25 \text{ mil}}{\$100 \text{ mil}} \times \$6 \text{ mil} \times 100 \text{ percent} = \$1.5 \text{ million interest expense disallowed}$

$\$1.5 \text{ million non-deductible interest expense} \times 34 \text{ percent} = \$510,000 \text{ increased taxes}$

Because no interest expense deduction is permitted on nonqualified municipals purchased after August 7, 1986, Second State has a much higher tax burden than First State, which holds older 80 percent issues.

Imposition of Alternative Minimum Tax

As of tax year 1987, the add-on-minimum tax was replaced by the corporate alternative minimum tax. Under Section 711 of the Tax Reform Act of 1986⁴ interest on private activity bonds issued after August 7, 1986 is treated as a tax preference item for AMT purposes.⁵ There are fifteen different kinds of such private activity AMT issues including "bonds financing mass commuting facilities, facilities to furnish water (other than irrigation), sewage disposal facilities, solid waste disposal facilities and qualified multi-family residential projects."⁶ For year end 1987, AMT bonds accounted for \$14 billion of the \$723.7 billion outstanding municipals.

⁴Prentice-Hall's Explanation of the Tax Reform Act of 1986.

⁵A bank which incurs interest expense to purchasing or carry activity bond, and that is denied a deduction for such expense for regular tax purposes, is permitted the deduction for minimum tax purposes where the interest is included in alternative minimum taxable income.

⁶Prentice-Hall's Explanation of the Tax Reform Act of 1986.

Interest on bonds issued on behalf of qualified 501 (c)(3) organizations and interest on bonds refundings pre-1986 issues are not categorized as preferences.

Section 701 of the Act⁷ details the computation of the AMT. The alternative minimum tax will only be paid if the sum exceeds the regular income tax.

The AMT is computed by totaling regular taxable income and tax preferences for the year,⁸ less an exemption. The exemption amount is \$40,000, less 25 percent of the excess of alternative minimum taxable income over \$150,000.⁹ The resulting amount is multiplied by the 20 percent AMT tax rate.

In addition to a bond interest being counted as a 100 percent preference if it is of the AMT variety, Section 720 of the Act, Business Untaxed Reported Profits¹⁰, mandates that in transition years 1987, 1988 and 1989, one half of book income not already included in the minimum tax base is a preference item. Corporate book income is the net income shown on financial statements, including such items as tax-exempt

⁷Ibid.

⁸Additional preferences, heavily affecting banking institutions, not discussed in this paper include the excess of the bad debt deduction over an amount computed under the experience method and accelerated depreciation on real and personal property.

⁹This exemption disappears altogether when minimum taxable income exceeds \$310,000.

\$310,000 - \$150,000 = \$160,000 excess
\$ 40,000 exemption - 25 percent x \$160,000 = \$0 exemption

¹⁰Prentice-Hall's Explanation of the Tax Reform Act of 1986.

income. Section 720 applies regardless of when municipal bonds were or will be purchased. Beginning in 1990, an earnings and profit approach called adjusted current earnings will be used to determine this preference. The preference rate will then increase from 50 to 75 percent.

The following tables 1, 2, and 3 illustrate how the AMT may affect a banking institution's tax position. The simplified examples assume tax-exempt income as the only preference (with no AMT issues) and the 1990 tax rate of 34 percent for incomes over \$335,000.

It can be shown that the AMT applies when tax-free income equals a minimum of 48.3 percent of book income. This case is shown in table 2 where Second National Bank carries book income of \$1,000,000 for the year with \$482,759 in tax-exempt income. Accordingly, regular income tax and the alternative minimum tax for Second National are equal at \$175,862.

Table 1 displays a tax situation for First National Bank which assumes a sizable proportion of tax-exempt income. Tax exempt income equals \$650,000 with book income at \$1,000,000. First National is subject to the higher alternative minimum tax of \$167,500 versus the regular income tax of \$119,000.

Another possibility presented in table 3 posits a scenario where tax-exempt income totals \$300,000 with book income of \$1,000,000. The alternative minimum tax of \$185,000 is of no significance to Third National which is subject to the higher regular income tax of \$238,000.

As seen in these three cases, not all banking institutions will be subject to the AMT. Only those generating a high percentage of tax-free

income to book income (48.3 percent and above) will be affected by the new AMT. Once the AMT kicks in, the banking institution assumes a 20 percent marginal tax; additional taxable income would be taxed at 20 percent with municipal income taxed at half this rate. Hence, supposedly tax-free securities would be taxed at a 15 percent (20 percent AMT x 75 percent excess) rate.

Table 1.--First National Bank Tax Bill

Book income is \$1,000,000 with \$650,000 in tax-exempt income	
Regular Taxable Income	\$350,000
	x .34 = \$119,000 regular income tax
Alternative Minimum Taxable Income	\$350,000
	75 percent of excess book income over minimum tax base:
+ 75 percent (\$1,000,000-\$350,000)	<u>\$487,500</u>
Adjusted Alternative Minimum Taxable Income	\$837,500
	x .20 = \$167,500 alternative minimum tax

First National Bank is subject to the alternative minimum tax of \$167,500.

Table 2.--Second National Bank Tax Bill

Book income is \$1,000,000 with \$482,759 in tax-exempt income

Regular Taxable Income	\$517,241	
	x .34 =	\$175,862 regular income tax
Alternative Minimum Taxable Income	\$517,241	
75 percent of excess book income over minimum tax base:		
+ 75 percent (\$1,000,000 - \$517,241)	<u>\$362,069</u>	
Alternative Alternative Minimum Taxable Income	\$879,310	
	x .20 =	\$175,862 alternative minimum tax

Second National Bank is subject to tax of \$175,862.
The regular income tax and the alternative minimum tax are equal.

Table 3.--Third National Bank Tax Bill

Book income is \$1,000,000 with \$300,000 in tax-exempt income

Regular Taxable Income	\$700,000	
	x .34 =	\$238,000 regular income tax
Alternative Minimum Taxable Income	\$700,000	
75 percent of excess book income over minimum tax base:		
+ 75(\$1,000,000 - \$700,000)	<u>\$225,000</u>	
Adjusted Alternative Minimum Taxable Income	\$925,000	
	x .20 =	\$185,000 alternative minimum tax

Third National Bank is subject to the regular income tax of \$238,000.
It is not affected by the alternative minimum tax.

Municipal Yields

By lowering the marginal tax rates and eliminating the 80 percent interest expense deduction, the 1986 Tax Act has eliminated the impetus for banking institutions to purchase nonqualified municipals. Current tax equivalent yields on nonqualified municipals are too low to be attractive investments. Representative municipal yields, based upon February 14, 1989 quotes, are illustrated in table 4, "Tax Equivalent Yields for Municipal Bonds Versus Treasuries." As seen in Column 2, post-tax reform (assuming a 34 percent tax rate), Treasury securities are yielding a higher return than tax adjusted nonqualified municipals. The five year Treasury generates a 200 basis point spread over the five year municipal, while the ten year Treasury note is 153 basis points above an equivalent term municipal.

Column 1 (using current nonqualified municipal rates) reveals the fact that the pre-tax reform yields on municipals based upon the higher pre-reform 46 percent maximum tax rate and a 20 percent disallowance (80 percent deduction) would make municipals attractive, yielding higher tax equivalent yields than Treasuries.

Under the current rate structure, "bank-qualified" small issues yield a slightly higher return than Treasuries. The five year "bank-qualified" municipal supports a twenty-four basis point spread over the five year Treasury rate, while the ten year "bank-qualified" municipal yields a seventy-one basis point spread over the ten year Treasury.

Mike Heflin, Manager of the Financial Services Group for First Tennessee bank (\$5 billion assets) summarized the banking industry's position on municipal bonds, "Banks simply aren't buying municipals if

they are not 'bank-qualified'. The problem is that the market in 'bank-qualified' issues is very small and the securities are difficult to find." Indeed, estimates indicate that the "bank-qualified" small issues market is only 5 percent of new security issues.¹¹

¹¹Thomas S. Buckmeyer, "Credit Market Comment" (Atlanta: Smith, Barney, Harris Upham & Company, 1 January 1988) 11, photocopied.

Table 4.--Tax Equivalent Yields for Municipal Bonds Versus Treasuries

	(1) Pre-Tax Reform (20% disallowance/ 46% tax rate/ assume a 6.75% muni rate)	(2) Post-Tax Reform (100% disallowance/ 34% tax rate/ 6.75% nonqual. muni rate)	(3) Post-Tax Reform (20% disallowance/ 34% tax rate/ 6.60% qualified municipal)
5 year municipal	11.48%	7.14%	9.38%
5 year T. note	9.14%	9.14%	9.14%
	assume a 7.0% muni rate	7.0% nonqualified municipal rate	6.85% qualified municipal
10 year municipal	11.94%	7.52%	9.76%
10 year T. note	9.05%	9.05%	9.05%

Municipal yield calculated as follows:

$$\frac{\text{Municipal rate} - (\% \text{ disallowance}) (\text{average cost of funds}) (\text{tax rate})}{1 - \text{tax rate}}$$

Tax Equivalent yields assume 6.0 percent cost of funds (which will vary among banks), no alternative minimum tax, and no state tax.

Sources: Municipal calculation equation from "A Farewell to Municipals and Other Tax Effects," ABA Banking Journal 79, no. 2 (February 1987):35. Treasury rates from "Key Interest Rates," The Wall Street Journal, 14 February 1989, sec. C:20(E).

Note: Municipal security rates based upon A rated obligations coming to market February 14, 1989. Rates provided by David Z. Barnett, Vice President, Sovran Bank, Nashville.

The Trend of Municipals in the Bank Portfolio

The municipal bond market has experienced an upheaval since the passage of the 1986 Tax Reform Act. Not only has municipal issuance been curtailed due to the Act, but banking institutions have continued to reduce the percentage of municipal holdings. Furthermore, as the Act constricted both the size and profitability of the municipal business,

number one ranked Salomon Brothers led an industry-wide retrenchment, withdrawing from the municipal securities business in mid-October 1987. Since that time over a dozen investment banking firms and commercial banks have either eliminated or cutback their municipal securities business.

The level of municipal placements totaled \$214 billion in 1985, declined gradually to only \$114 billion in 1989. Much of the reduction in offerings has been attributed to the new rules from the 1986 Tax Reform Act. Not only did banks lose much of their incentive to purchase municipals; on the supply side the issuance of private-purpose debt was restricted and the definition of public-purpose bonds was narrowed (that is, 90 percent of the issue must now be for public use to keep its tax-exempt status).¹²

As shown in table 5, "Holders of Outstanding Municipal Securities," banks have traditionally been large-scale purchasers of municipal bonds, holding 35 percent of the market in 1985. Due to changes in the tax laws, banks have been disinvesting in municipals and reducing their share of holdings in outstanding securities. Banks have gone from holding 30 percent of the market in 1986 to a substantially lower 17 percent in quarter 1-1990.

¹²"State and Local Government Finance in the Current Expansion," Federal Reserve Bulletin 74, no. 2 (February 1988):87-88.

Table 5.--Holders of Outstanding Municipal Securities
(In Billions)

Year	Total	Households	Mutual Funds	Money Mkt. Funds	Commer. Banks	P & C Insurance	Other
1980	\$350.3	\$ 88.3	\$ 4.4	\$ 1.9	\$149.2	\$ 80.5	\$26.0
1981	373.7	99.8	5.1	4.2	154.2	83.9	26.5
1982	417.9	120.2	8.0	13.2	158.5	87.0	31.1
1983	469.0	155.1	13.4	16.8	163.2	86.7	33.8
1984	520.0	181.1	19.1	23.8	174.2	84.7	37.1
1985	655.5	219.2	33.5	36.3	231.3	88.2	47.0
1986	679.1	195.7	65.3	63.8	202.8	103.9	47.6
1987	713.2	238.2	70.7	61.4	173.7	127.8	41.4
1988	759.8	282.0	78.7	65.7	151.2	140.7	41.5
1989	785.2	298.8	93.6	69.4	133.9	149.5	40.0
1990: Q1	792.1	292.3	97.4	77.1	132.9	151.3	41.1

Source: Federal Reserve Flow of Funds cited in "Trends in the Holdings of Municipal Securities" (New York: Public Securities Association, First Quarter 1990), photocopied.

The Impact of Tax Reform on Tennessee Banks' Municipal Holdings

Further evidence on the expected decline of municipals in the bank portfolio was gathered through a questionnaire survey.¹³ The survey instrument was mailed in January 1989 to the 168 Tennessee commercial banking institutions with assets of at least \$25 billion. A total of fifty-five banks (33 percent response rate) responded. The results of the survey are presented in table 6.

Prior to the tax reform changes in 1985, the average municipal share of the investment portfolio was 34 percent. As the impact of tax reform was phased in, holdings of municipals declined as follows: 32

¹³This survey was prepared with Dr. John T. Lee, Professor of Finance, Middle Tennessee State University, Murfreesboro, Tennessee.

percent of their portfolio in 1986; down to 28 percent in 1987; and 25 percent in 1988.

Since the interest disallowance, the overwhelming majority of banks, 85 percent, have not purchased any municipals which were not "bank-qualified". The CEO of a \$38 million bank explains the lack of interest in municipals, "At this time tax free equivalent yields do not meet taxable yields." Of the small group of banks, 15 percent, that continue to purchase municipals which were not "bank-qualified", two explanations were largely cited: (1) a few securities purchased were taxable municipals with comparable yields, and (2) acquisitions were done to support a local municipality such that yield was not the sole factor considered.

Mr. Heflin, of First Tennessee, explains the advantage of taxable municipals:

Taxable municipal bonds are one of the most significant new products developed in response to the Tax Reform Act of 1986. Interest on these bonds is taxable because the issuer has purposely structured the financing to fail one or more of the Tax Bill restrictions, such as a volume cap or using more than 10% of the bond proceeds for a private entity [taxable municipals do not qualify for interest expense deductions]. It is important to note that these restrictions apply to even general obligation bonds. As a result, you will find that these securities generally have the same investment characteristics as the tax-free municipal bonds many of you purchased before, except they are now at higher taxable yields.¹⁴

Whereas only a few banks have continued to purchase securities to support their local municipalities at the cost of a lower than available return elsewhere, two-thirds of those responding continued to provide

¹⁴Mike Heflin, "Taxable Municipals" (Memphis: First Tennessee Financial Services Group, 17 October 1986), photocopied.

some support of local needs through direct loans instead of buying their debt.

Sixty-seven percent of the survey participants report purchases of "bank-qualified" issues since tax reform, citing sufficient tax-equivalent yields. Pointing to the difficulty of locating such issues, those obtained were largely local Tennessee issues. Institutions who had not entered the "bank-qualified" market mentioned that the issues weren't available or that their bank was in an AMT situation and the yields were not high enough to compensate.

Jennifer Fain, Assistant Investment Officer for the \$2.6 billion Third National Bank of Nashville comments, "banks will continue to purchase Bank Qualified municipal bonds. Banks still need tax exempt income, however, the banks will have to consider the AMT possibility to decide if municipals make sense to buy."¹⁵

While the survey found that only 38 percent of banks have thus far been subject to the AMT, an overwhelming 75 percent anticipate the AMT to be a consideration in future planning. Further, a total of 17 percent have specifically liquidated municipal securities because of the AMT. The CEO of a \$71 million bank commented, "We intend to hold the bank's investment in municipals just at the level at which AMT is triggered. This may dictate buying or selling tax exempt municipals."

The AMT has particularly affected the municipal holdings of First Tennessee Bank. Immediately after the passage of the Act, Mr. Heflin

¹⁵Jennifer Fain, Third National Bank, Nashville, Tennessee. Written Interview, October. 1987.

urged First Tennessee investment officers to sell off any low yielding municipals. Given their low tax equivalent yield in an AMT situation, a yield of 6 percent or less was considered a poor investment. Mr. Heflin sees more profitable alternatives in the investment market.¹⁶

For those retargeting funds traditionally flowing to municipals, a number of different investment vehicles are popular. The first choice for retargeting was the U.S. Treasury bill followed by mortgage-backed securities. The mortgage-backed instruments carry much higher yields than Treasuries; however, they still do not match the majority of municipal yields prior to tax reform. As of February 14, 1989, a newly issued thirty year Government National Mortgage Association backed security yielded 10.47 percent¹⁷ versus a 9.09 percent thirty year Treasury bond,¹⁸ a spread advantage of 138 points.

Spread advantages over Treasuries also exist for government agency issues, the third most popular instrument for retargeting funds. As of February 14, 1989, a five year Federal Home Loan Bank issue yielded 9.60 percent¹⁹ versus a 9.18 percent comparable term Treasury note,²⁰ a spread advantage of 42 points.

¹⁶Mike Heflin, First Tennessee Bank, Memphis, Tennessee. Written Interview, August 1988.

¹⁷"Bond Market Data Bank," The Wall Street Journal, 15 February 1989, sec. C:14(E).

¹⁸"Treasury Bonds, Notes, and Bills," The Wall Street Journal, 15 February 1989, sec. C:13(E).

¹⁹"Government Agency Issues," The Wall Street Journal, 15 February 1989, sec. C:13(E).

²⁰"Treasury Bonds, Notes, and Bills," The Wall Street Journal, 15 February 1989, sec. C:13(E).

Ranking next among the choices of bankers who rechanneled funds away from municipals were loans, followed by investing in collateralized mortgage obligations (CMOs). CMOs are mortgage-backed obligations that are corporate securities. They have a ten to fifteen year stated maturity, with a three year average life and a five year expected pay out. For February 14, 1989, a newly issued five year CMO carried a 102 point spread over a comparable maturity Treasury while a seasoned five year CMO was 98 points above a Treasury.²¹ Other choices for retargeting include corporate bonds, certificates of deposit, and bankers' acceptances of institutions, respectively.

The large majority of respondents felt that the banking industry industry as a whole will no longer continue purchasing municipals in any measureable degree. Most banks were interested in purchasing "bank-qualified" issues; however, if the bank was in an AMT situation the yields would have to be sufficient to compensate.

Table 6.--Survey on the Impact of Tax Reform on Bank Municipal Holdings

I. Classification	
a. _____ Bank Name	d. Affiliated with a multi-bank building company? Yes <u>43%</u> No. <u>57%</u>
b. _____ Location	If yes, e. _____ Name
c. <u>average-\$329 million</u> Bank Asset Size	f. <u>average - \$5.6 billion</u> Holding Co. Asset size
g. Are portfolio decisions made at the holding company level? Yes <u>25%</u> No <u>75%</u>	

²¹ "Bond Market Data Bank," The Wall Street Journal, 15 February 1989, sec. C:14(E).

Table 6.--Continued

II. Impact on Portfolio

1. Since the 100 percent interest expense disallowance became effective, has your bank purchased any "bank-qualified" municipals for your investment portfolio?
Yes 67% No 75%
Please explain.
2. Since the interest disallowance, has your bank purchased any municipals which were not "bank-qualified"? (Do banks buy municipals for anything other than yield?)
Yes 15% No 85%
What reason(s) led to this decision?
3. Has your bank made any loans to municipal entities instead of buying their securities? (small issues may be done as loans)
Yes 66% No 32% Unsure 2%
4. a. Has your bank been subject to the Alternative Minimum Tax (AMT)?
Yes 38% No 57% Unsure 5%
b. Do you anticipate the AMT to be a consideration in future planning?
Yes 75% No 21% Unsure 4%
c. Have you specifically liquidated any of your municipal securities because of the AMT?
Yes 17% No 83%
Please explain:
5. Using your bank's balance sheets for 1985, 1986, 1987 and 1988, approximately what percentage of tax exempts were held in your investment portfolio?
1985 34% 1986 32% 1987 28% 1988 25%
6. If the percentage of municipal holdings has been reduced, what specific investment securities were chosen to absorb these funds?

<u>34%</u>	U. S. Treasury Securities	<u>7%</u>	Collateralized Mortgage
<u>29%</u>	Mortgage-Backed Securities		Obligations
<u>5%</u>	Corporate Bonds	<u>0%</u>	Asset-Backed Securities
		<u>25%</u>	Other(s), please specify
			(Govt. Agencies 13%,
			loans 8%, CDs 3%, Bankers'
			Acceptances 1%)
7. Given the new tax treatment of municipals, in your opinion, are there any circumstances under which your bank would purchase municipals?
8. Please feel free to make any comments or suggestions.

Thank you for your cooperation. Please return in enclosed envelope.

Conclusion

The Tax Reform Act of 1986 states that banks can no longer deduct interest expense for municipal issues acquired after August 7, 1986 except for qualified issues from "small issuers" not issuing more than \$10 million of bonds in one year. Additionally, some banks would be subjected to the AMT because of municipal holdings. Where a banking institution is subject to the AMT, once the AMT applies the bank is in a 20 percent marginal tax bracket with municipal income being taxed at an effective 15 percent tax rate.

Currently, with the prevailing tax equivalent yields on alternative bank investments, nonqualified issues are not attractive, a situation not likely to change unless the market or tax environment changes dramatically. Much of the reduced demand by banks has been offset by individual purchases; consequently, municipalities haven't been forced to offer the higher yields necessary to attract banks under the new rules.

In summary, although banks will continue to purchase the relatively scarce "bank-qualified" issues and may in some instances support local municipalities by holding investments under market yield, they will no longer be the major holder that they have been historically. The investment officer now has the challenge of seeking the high pre-tax reform returns of municipals elsewhere in the investment market.

Questions

1. The portfolio manager of Northern National Bank of Tennessee has located a public-purpose municipal security, which was part of a

\$9.5 million issue. The portfolio manager is very enthused because he maintains the security will have a much higher tax equivalent yield because he believes it is a "bank qualified" municipal. He requests your verification.

2. Eastern National Bank of Tennessee submits the following financial data for the year, desiring an interest expense disallowance summary:

Total average assets = \$17,500,000

Total interest expense = \$1,050,000

25 percent of Eastern National's assets consist of nonqualified municipal securities acquired after August 7, 1986 and an additional 25 percent consist of municipals acquired between January 1, 1983 and August 7, 1986

3. The portfolio manager at Southern National Bank of Tennessee claims that in 1989 the institution carried a high 53 percent of tax-free income to book income and was not affected by the AMT. Consequently, the manager maintains that in 1990 if he is able to maintain approximately the same ratio, the institution will again avoid the AMT. Comment (assume in both years the bank was under the 34 percent regular tax rate).
4. (a) Western National Bank of Tennessee has sold municipals to the point where it is not subjected to the AMT. The institution has a 6.25 percent cost of funds and is in the 34 percent tax bracket. Based upon such information, which one of the following securities would you recommend the portfolio manager purchase:

-- a five year 7.15 percent nonqualified municipal

-- a five year 5.65 percent qualified municipal

-- a five year 7.94 Treasury note.

(b) Would your recommendation change if the bank is able to drop its cost of funds to 5.75 percent, as optimistically anticipated?

5. Prepare an investment advice letter for the subsidiary banks on what you perceive to be one of the most profitable instruments in which to retarget traditional municipal funds. Current security rates may be obtained from an investment publication, such as The Wall Street Journal.

References

- Baldo, Anthony. "Municipal Bombs." Financial World, 5 April 1988, 114-117.
- "Bank Investment in Mini's Plumets." ABA Banking Journal 79, no. 10 (October 1987):219.
- Bank Investments and Funds Management. Washington, D. C.: American Bankers Association, 1987.
- Bates, John C. Jr. "Changes Made in Tax-Exempt Bond Area by 1986 Act Usher in New Era in Public Finance." The Journal of Taxation 66, no. 2 (February 1987):72-77.
- Beauchaine, Alan, and Reilly, Raymond R. "Managing a Bank's Investment Portfolio." Bankers Monthly Magazine, 15 December 1984, 10-13.
- Bench, Joseph. "The Secular Case for Buying Bonds." Bankers Monthly Magazine, 15 August 1984, 4.
- "Bond Market Data Bank." The Wall Street Journal, 15 February 1989, sec. C:14(E).
- Brod, Alan J., and Rogers, William A. "Tax Exempts: After the Act." Bankers Monthly, 104, no. 2 (February 1987):10.
- Buckmeyer, Thomas S. "Credit Market Comment." Atlanta: Smith, Barney, Harris, Upham & Company, 1 January 1988, 11. Photocopied.
- Cofield, Glenn. "Year-End Tax Planning for Financial Institutions/The First Year Under the New Tax Law." First Tennessee Financial Services Group, 21 September 1987. Photocopied.
- "Congress Comes Under Fire for Municipal Bond Massacre." Insight, 21 December 1987, 42-43.
- Crowder, Jr., L. Ollen. Dominion Bank, Nashville, Tennessee. Written Interview, October 1987.
- Fain, Jennifer. Third National Bank, Nashville, Tennessee. Written Interview, October 1987.
- "A Farewell to Municipals and Other Tax Effects." ABA Banking Journal 79, no. 2 (February 1987):35-36.
- Federal Taxes 1986. Vol. 5 19,000-21,169, Code sections 401-506. Paramas, NJ: Prentice Hall Information Services, 1986.
- Federal Taxes 1987. Vol. 5 19,000-21,169, Code sections 401-506. Paramas, NJ: Prentice Hall Information Services, 1987.

"Federalism's Funeral." The Wall Street Journal, 27 April 1988, 26(E).

"Floating Rate CMOs." Memphis: First Tennessee Financial Services Group, 10 March 1987. Photocopied.

Galante, Steven P. "Low-Cost Financing Dwindles as Industrial Bonds Disappear." The Wall Street Journal, 20 October 1986, 29(E).

Gelfand, Matthew D., and Hanweck, Gerald A. "The Effects of Tax Reform on Banks." The Bankers Magazine 169, no. 1 (January-February 1986): 59-66.

General Explanation of the Tax Reform Act of 1986. Bulletin 20 Extra. Englewood Cliffs, NJ: Prentice Hall Inc., 11 May 1987.

"Government Agency Issues." The Wall Street Journal, 15 February 1989, sec. C:13(E).

Haugh, James W. "Accounting for Alternative Minimum Tax: Part 1." Magazine of Bank Administration 64, no. 2 (February 1988):6-8.

_____. "Accounting for Alternative Minimum Tax: Part 2." Magazine of Bank Administration 64, no. 3 (March 1988):8.

_____. "Accounting for the Alternative Minimum Tax: Part 3." Magazine of Bank Administration 64, no. 4 (April 1988):8.

_____. "The Impact of Tax Reform on Banks." Magazine of Bank Administration 62, no. 11 (November 1986):8.

Heflin, Mike. "Coping with the Alternative Minimum Tax." Memphis: First Tennessee Financial Services Group, 21 September 1986. Photocopied.

_____. "Effects of the Senate Tax Bill on Tax-Exempt Securities for Financial Institutions." Memphis: First Tennessee Financial Services Group, 12 May 1986. Photocopied.

_____. First Tennessee Bank, Memphis, Tennessee. Written Interview, October 1987 and August 1988.

_____. "Qualified Muni Bonds for Banks Analysis of Yields and Returns." Memphis: First Tennessee Financial Services Group, 13 July 1987. Photocopied.

_____. "Short Supply Props Up Muni Prices." Memphis: First Tennessee Financial Services Group, 3 September 1987. Photocopied.

_____. "Taxable Municipals." Memphis: First Tennessee Financial Services Group, 17 October 1986. Photocopied.

- Hempel, George H. "Basic Ingredients of Commercial Banks' Investment Policies." The Bankers Magazine 155 (Autumn 1972):50-59.
- "It's Open Season on Tax-Exempt Bonds." Business Week, 2 May 1988, 38-40.
- "Key Interest Rates." The Wall Street Journal, 23 August 1988, 31(E).
- "Mortgage-Backed Securities Come to the Fore." ABA Banking Journal 79, no.2 (February 1987):31-32.
- "Municipal Credit Quality Waned in '87, S & P Says." The Wall Street Journal, 14 January 1988, 41(E).
- "Munis Face the Squeeze." The Banker (September 1987):125-126.
- Neubig, Thomas S., and Martin A. Sullivan. "The Implications of Tax Reform for Bank Holdings of Tax-Exempt Securities." National Tax Journal 40 (September 1987):403-418.
- "New Security Issues." Federal Reserve Bulletin 76, no. 6 (June 1990):A(34).
- Peers, Alexandria. "Alternative Tax Municipal Bond's Seen Attractive." The Wall Street Journal, 11 February 1988, 33(E).
- _____. "How Municipal Bonds Went from Cash Cow to a White Elephant." The Wall Street Journal, 4 December 1987, 1(E).
- _____. "Municipal Bond Industry Has Difficult Year as Field Shrinks." The Wall Street Journal, 4 January 1988, sec. B:8(E).
- _____. "Pinch in Muni Bonds Strains Industry Ties." The Wall Street Journal, 22 January 1988, 45(E).
- _____. "Push for Fuller Disclosure by Issuers of Municipals Is Discussed by Analysts." The Wall Street Journal, 25 April 1988, 37(E).
- _____. "States, Cities Struggle to Keep Tax-Exempt Bonds Alive." The Wall Street Journal, 8 March 1988, 14(E).
- Peterson, John E. "Examining the Impacts of the 1986 Tax Reform Act on the Municipal Securities Market." National Tax Journal 40 (September 1987):393-402.
- Prentice-Hall's Explanation of the Tax Reform Act of 1986. Bulletin 42 Extra. Englewood Cliffs, NJ: Prentice Hall, 1986.
- Proctor, Allen J., and Rappaport, Julie N. "Federal Tax Reform and the Regional Character of the Municipal Bond Market." Federal Reserve Bank of New York Quarterly Review (Autumn 1985):6-15.

- Rogers, Harold E. "Impact of Tax Reform Legislation on Traditional Municipal Finance Practices: Review of Alternative Financing Proposals." Municipal Finance Journal (Summer 1986):195-206.
- Sease, Douglas R., and Tom Herman. "High Court Decision on Bonds Causes Prices to Fall Briefly." The Wall Street Journal, 21 April 1988, 3(E).
- Simpson Robert S. "Municipal Bonds and the New Tax Bill." Credit and Financial Management 89, no. 3 (March 1987):12.
- "Some Municipals Likely to be Taxed, Lawyer Says," The Wall Street Journal, 8 June 1988, 11(E).
- Spain, Catherine. "The Case Against a Minimum Income Tax on Tax-Exempt Interest, or, Mrs. Dodge -- Where Are You?" Government Finance Review 1, no. 5 (December 1985):36-37.
- "State and Local Government Finance in the Current Expansion." Federal Reserve Bulletin 74, no. 2 (February 1988):79-88.
- "Tax Bill Could be Bitter for Banks." ABA Banking Journal 78, no. 5 (May 1986):32-34.
- "Tax Law Deals a Blow to Bond Banks." The Wall Street Journal, 19 May 1987, 31(E).
- "Tax Reform Reduces Shelter Appeal of Municipal Bonds." Savings Institutions (July 1987):134-135.
- "Treasury Bonds, Notes, and Bills." The Wall Street Journal, 15 February 1989, sec. C:13(E).
- "Trends in the Holdings of Municipal Securities." New York: Public Securities Association, First Quarter 1990. Photocopied.
- Urnikis, Marian S. "What it Means for Your Bank." ABA Banking Journal 78, no. 11 (November 1986):56.
- Weatherington, Richard. "Banks Take a Hit From Tax Reform." Bankers Monthly 103, no. 10 (October 1986):27.
- Weberman, Ben. "Okay, the Alternative Minimum Tax is Bad News for the Tax-Exempt Market. But its Not All That Tough on Everyone." Forbes, 1 December 1986, 249.
- Wermiel, Stephen. "Supreme Court Rules Congress Is Free to Tax Interest on State, Local Bonds," The Wall Street Journal, 21 April 1988, 3(E).

INSTRUCTOR ANSWER UNIT

QUESTION 3: Southern National Bank of Tennessee

In transition years 1987, 1988 and 1989, 50 percent of book income not already included in the minimum tax base is a preference item. The situation becomes aggravated for 1990 and years after when the preference rate rises from 50 to 75 percent.

Not all banking institutions will be subject to the AMT. Only those generating a high percentage of tax-free income to book income will be affected: (1) 58.3 percent and above for transition years 1987, 1988, and 1989 and (2) 48.3 percent and above for 1990 and years after.

Table 7 illustrates that at 53 percent of tax-free income to book income, Southern National simply pays the regular tax in year 1989. When the excess rate rises to 75 percent in 1990, the banking institution will be subjected to the AMT, as exhibited in table 8.

Table 7.--Southern National Bank of Tennessee Tax Bill, 1989

Book income is \$10,000,000 with \$5,300,000 in tax-exempt income	
Regular Taxable Income	\$4,700,000
	x .34 = \$1,598,000 regular income tax
Alternative Minimum Taxable Income	\$4,700,000
50 percent of excess book income over minimum tax base:	
+50 percent (\$10,000,000 - \$4,700,000)	<u>\$2,650,000</u>
Adjusted Alternative Minimum Taxable Income	\$7,350,000
	x .20 = \$1,470,000 alternative minimum tax

Southern National is subject to the regular income tax of \$1,598,000
It is not affected by the alternative minimum tax.

Table 8.--Southern National Bank of Tennessee Tax Bill, 1990

Book income is \$10,000,000 with \$5,300,000 in tax-exempt income.

Regular Taxable Income	\$4,700,000	
	x .34 = \$1,598,000	regular income tax

Alternative Minimum Taxable Income	\$4,700,000	
75 percent of excess book income over minimum tax base:		
+ 75 percent (\$10,000,000 - \$4,700,000)	\$3,975,000	
Adjusted Alternative Minimum Taxable Income	\$8,675,000	
	x .20 = \$1,735,000	alternative minimum tax

Southern National is subject to the alternative minimum tax of \$1,735,000.

QUESTION 4: Western National Bank of Tennessee

Tax equivalent municipal yield is calculated as follows:

$$\frac{\text{Municipal rate} - (\% \text{ disallowance})(\text{average cost of funds})(\text{tax rate})}{1 - \text{tax rate}}$$

a.

7.15 percent nonqualified	$\frac{.0715 - (1)(.0625)(.34)}{1-.34} = 7.61 \text{ percent}$
---------------------------	--

5.65 percent qualified	$\frac{.0565 - (.20)(.0625)(.34)}{1-.34} = 7.92 \text{ percent}$
------------------------	--

The 7.94 Treasury note is the recommended purchase.

b.

7.15 percent nonqualified	$\frac{.0715 - (1)(.0575)(.34)}{1-.34} = 7.87 \text{ percent}$
---------------------------	--

5.65 percent qualified	$\frac{.0565 - (.20)(.0575)(.34)}{1-.34} = 7.97 \text{ percent}$
------------------------	--

When the cost of funds falls, the tax equivalent yield on the qualified municipal rises to 7.97 percent, three basis points higher than the Treasury note. Based upon the available information, the qualified municipal is the recommended purchase.

QUESTION 5: Investment Advice Letter

Students may choose a security from numerous acceptable banking investments, such as:

- (1) U. S. Treasuries
- (2) Federal agency issues
- (3) Certificates of deposit of other commercial banks
- (4) Bankers' acceptances
- (5) Corporate bonds
- (6) Collateralized mortgage obligations
- (7) Asset-backed securities
- (8) Mortgage-backed securities

Remember, common stock is not a permissible investment for banking institutions to hold.

If funds should be retargeted, the chosen instrument yield should show a higher yield than the tax equivalent yield on current municipals.

CHAPTER 8

CONCLUSION

Each of the instructional case studies in this dissertation examined issues that have had a tremendous impact on the banking industry: increased mergers and acquisitions, hostile takeovers, tax reform, new banking products and services, and interstate merger legislation. Of course, instructors must adapt individual case materials to their particular courses. However, due to the relevance and timeliness of the cases included in this dissertation, these instructional materials could be incorporated into a graduate or undergraduate management of financial institutions course.

Whether the student is placed in the role of bank "merger and acquisition" analyst, bank consultant, or financial services manager, he or she is introduced to some of the realities encountered in the banking industry. These cases give the student practice in the decision making that may be required in a banking career; in doing so they bridge the gap between teaching theory and practical problems in banking courses.

SELECTED BIBLIOGRAPHY

- Armistead, Colin. "How Useful Are Case Studies?" Training and Development Journal 38, no. 2 (February 1984):75-77.
- Atwood, Illa W. "The Case for Case Problems." Business Education Forum 23, no. 6 (March 1969):5-8.
- Beckman, M. Dale. "Evaluating the Case Method." Educational Forum 36, no. 4 (May 1972):489-97.
- Bernhardt, Stephen A., Gary Shaw, Joel P. Bowman, and Marilyn S. Butler. "Replies to Marilyn S. Butler's Article 'A Reassessment of the Case Approach: Reinforcing Artifice in Business Writing Courses'" The Bulletin of the Association for Business Communication 49, no. 2 (June 1986):1-7.
- Butler, Marilyn S. "A Reassessment of the Case Approach: Reinforcing Artifice in Business Writing Course." The Bulletin of the Association for Business Communication 48, no. 3 (September 1985):4-7.
- Catron, Douglas M. "A Case for Cases." ABCA Bulletin 47, no. 1 (March 1984):21-25.
- Christensen, C. Roland, and Abby J. Hansen, eds. Teaching and the Case Method: Text, Cases, and Readings. Boston: President and Fellows of Harvard College, 1987.
- Cochran, Daniel S., and C. Kendrick Gibson. "Improving Communication and Problem-Solving Skills Through Behavior Modeling and the Case Approach to Learning." Journal of Business Education 60, no. 2 (November 1984):70-72.
- _____. "Putting a Square Peg into a Round Hole: Communication Models and Their Application." Journal of Business Communication 17, no. 1 (Fall 1979):27-36.
- Cornwell, Robert C. "Use the Case-Study Method." Journal of Business Education 47, no. 8 (May 1972):333-34.
- Crossley, Michael, and Graham Vulliamy. "Case-Study Research Methods and Comparative Education." Comparative Education 20, no. 2 (1984):193-207.
- Edge, Alfred G., and Dennis R. Coleman. The Guide to Case Analysis and Reporting. Honolulu: System Logistics, Inc., 1978.

- Ford, Leroy. Using the Case Study in Teaching and Training. Nashville: Broadman Press, 1969.
- Forrester, Jerry. "The Use of Case Studies in Pre-experience Business Education, Part III: The Availability of British Case Studies in Business Education." The Vocational Aspect of Education 34, no. 87 (April 1982):15-21.
- Fox, William M. "A Measure of the Effectiveness of the Case Method in Teaching Human Relations." Personnel Administration 26, no. 4 (July-August 1963):53-57.
- Gibson, C. Kendrick, and Daniel S. Cochran. "Case Writing: An Acceptable Professional Activity or an 'Exercise in Futility'?" Journal of Business Education 57, no. 8 (May 1982):308-10.
- Glenn, Allen D., Nancy A. Kozen, and Richard A. Pollak. "Teaching Economics: Research Findings from a Microcomputer/Videodisc Project." Educational Technology 24, no. 3 (March 1984):30-32.
- Gunn, Bruce. "The Self-Actualizing Case Method." Journal of Business Education 55, no 6 (March 1980):250-55.
- Henry, Mark, and David Ramsett. "The Effects of Computer-aided Instruction on Learning and Attitudes in Economic Principles Courses." Journal of Economic Education 10, no. 1 (Fall 1978):26-34.
- James, Philip. "The Study of Educational Policy Making: A Critique of the Case Study Method." Educational Administration 9, no. 3 (Spring 1981):80-89.
- Kehrberg, Kent T., and Richard A. Pollack. "Videodiscs in the Classroom: An Interactive Economics Course." Creative Computing 8, no. 1 (January 1982):98-102.
- Kenny, W. Robert, and Arden D. Grotelueschen. "Making the Case for Case Study." Journal of Curriculum Studies 16, no. 1 (January-March 1984):37-51.
- Kreps, Gary L., and Linda Costigan Lederman. "Using the Case Method in Organizational Communication Education: Developing Students' Insight, Knowledge, and Creativity through Experience-Based Learning and Systematic Debriefing." Communication Education 34, no. 4 (October 1985):358-64.
- Langdon, Danny G. "Instructional Designs for a Case Study Approach." Educational Technology 13, no. 10 (October 1973):51-54.

- Learned, E.P. "Reflections of a Case Method Teacher." In Teaching and the Case Method: Text, Cases and Readings, ed. C. Roland Christensen and Abby J. Hansen, 9-15. Boston: President and Fellows of Harvard College, 1987.
- Lundberg, Craig, and Richard Klein. "The Multi-Media Teaching Class." Improving College and University Teaching 25, no. 1 (Winter 1977):43-46.
- Mancuso, Louis C. "A Comparison of Lecture, Case Study, and Lecture-Computer Simulation Teaching Methodologies in Broadcast Economics." The Southern Journal of Educational Research 10, no. 1 (Winter 1976):1-12.
- Maunder, Peter. "The Case Study Approach in Bridging Actuality with Theory." Economics, 13, no. 58 (Summer 1977):49-55.
- Merriam, Sharan B. "The Case Study in Educational Research: A Review of Selected Literature." The Journal of Educational Thought 19, no. 3 (December 1985):204-17.
- Okoroafo, Sam C. "A Marketing Approach Evaluating Teaching Methods in Business Courses." Journal of Education for Business 64, no. 5 (February 1989):223-28.
- Oldham, Margaret, and Jerry Forrester. "The Use of Case Studies in Pre-experience Business Education: Part 1-The Case Method." The Vocational Aspect of Education 33, no. 85 (August 1981):27-29.
- _____. "The Use of Case Studies in Pre-experience Business Education, Part II-Using Case Studies Effectively." The Vocational Aspect of Education 33, no. 86 (December 1981):67-71.
- Paget, Neil "Using Case Methods Effectively." Journal of Education for Business 63, no. 4 (January 1988):175-180.
- Post, Gerald V. "Microcomputers in Teaching Economics." Journal of Economic Education 16, no. 4 (Fall 1985):309-12.
- Romm, Tsilia, and Sophia Mahler. "A Three Dimensional Model for Using Case Studies in the Academic Classroom." Higher Education 15, no. 6 (1986):677-96.
- Ronstadt, Robert. The Art of Case Analysis: A Guide to the Diagnosis of Business Situations. 2nd ed. Dover: Lord Publishing, 1980.
- Schlacter, John L., and Lonnie L. Ostrom. "Use of the 'Case Method.'" Journal of Business Education 50, no. 4 (January 1975):163-64.
- Schroeder, Hal, and Pat Fitzgerald. "Peer Evaluation in Case Analysis." Journal of Business Education 60, no. 2 (November 1984):73-77.

- Shaw, K.E. "Understanding the Curriculum: The Approach Through Case Studies." Journal of Curriculum Studies 10, no. 1 (January-March 1978):1-17.
- Solem, Allen R. "Human Relations Training: Comparison of Case Study and Role Playing." Personnel Administration 23, no. 5 (September-October 1960):29-37.
- Soroko, Mary P. "Student Learning Styles--A Teaching Consideration in Principles of Accounting Course." Journal of Education for Business 64, no. 6 (March 1988):248-50.
- Towl, Andrew R. To Study Administration by Cases. Boston: President and Fellows of Harvard College, 1969.
- Vaugh, Ronald L., and Robert Motley. "Case-Study Approach in Business Education." Business Education Forum 24, no. 4 (January 1970):6-8.
- Walker, Rob. "Three Good Reasons for not Doing Case Studies in Curriculum Research." Journal of Curriculum Studies 15, no. 2 (1983):155-65.
- Watson, Charles E. "The Case-Study Method and Learning Effectiveness." College Student Journal 9, no. 2 (April-May 1975):109-16.