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BANK M&A: Is There a Pulse?

Plan ahead. Start early. Expect pain.

Big banks are not only too big to fail. They also appear to be too big to merge. What does this mean in 2015 for financial institutions M&A? Can the sector as a whole find its pulse after flat-lining for the past six years? Since the crash of 2008, banks have been subjected to new regulations that have rapidly increased in complexity and effect in direct proportion to the size of the companies in question. What's more, rules that have long been in place have not only been expanded but are also being enforced more rigorously than ever. "The Federal Reserve has made it clear that they are not interested in further acquisitions by the very largest U.S. banks," says H. Rodgin Cohen, senior chairman of Sullivan & Cromwell and one of the world's leading experts on financial institutions. "They may let pass tiny deals for this group of banks," Mr. Cohen says, "but that is all. The regulators do not want the biggest banks to get bigger. Another issue for all transactions is the record of widespread violations of regulatory and legal requirements."

From 2008 through to the present, there have been a mere 18 bank deals worth more than $1 billion. This includes Royal Bank of Canada's recently announced plan to buy Los Angeles-based City National Corp. for $5.4 billion From 2000 to 2007, there were 65 such deals. "Since the financial crisis," says Lee Meyerson, head of Simpson, Thacher & Bartlett's Mergers and Acquisitions and its Financial Institutions Practices, "bank mergers have represented only one to two percent of U.S. merger volume. Last

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Lee Meyerson
Simpson Thacher

David Ingels
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year, which was a banner year for U.S. M&A generally, bank mergers were an even lower percentage of the total."

Because the regulatory system imposes ever stricter rules on banks based on their size, growth is penalized. "There certainly will be reluctance among some banks to cross the $50 billion asset threshold because the regulatory burdens increase dramatically as you do so," explains David Ingles, a partner at the Financial Institutions Group of Skadden, Arps, Slate, Meagher & Flom. "Community banks are relatively unimpeded. But many of the largest banks in the U.S. have been more focused recently on stress testing, capital planning and the various other additional regulatory requirements after Dodd-Frank, and less focused on M&A."

No bank deal is a more frightening example of the perils of purchasing than M&T Bank Corp.'s proposed acquisition of Hudson City Bancorp, valued at over $3.8 billion. With Sullivan & Cromwell representing Hudson City and Wachtell Lipton advising M&T, the two sides announced their deal in August of 2012 and have been enmeshed in regulatory delays ever since as M&T has endures pointed investigations of internal mechanisms to control potential money-laundering. In December, the two sides agreed to yet another new deadline, April 30, 2015, after which either will be allowed to back out of the deal. This means that M&T and Hudson have waited 30 months so far for approval, the longest review of a bank deal since the financial crisis. "The M&T transaction stands out as one that has caused a lot concern for other would-be buyers and sellers out there in the market," says Skadden's Mr. Ingles. "There is the perception, right or wrong, that your transaction could simply be delayed indefinitely." All this comes at a high cost, Simpson's Mr. Meyerson points out. There have been reports that M&T has spent over 200 million dollars on enhanced compliance just to address the Fed issues that came up in the Hudson City application. "The order of magnitude of spending is staggering," says Mr. Meyerson.

It has never been easy to do financial institutions M&A because its regulatory system is marbled with state and federal statutes and agencies, including the Board of Governors of the Federal Reserve System, the FTC and the Justice Department, federal laws such as the Community Reinvestment Act of 1978 (the CRA), state banking departments, the Office of the Comptroller of the Currency, and state insurance departments.

"In recent years," says Sullivan & Cromwell's Mr. Cohen, "the Fed has established various eligibility criteria which do not vary terribly much from the past. They are a little more stringent. If you have a three rating on the scale of one to five for your composite rating, your management rating or your compliance rating, you cannot get a deal done. You won't get approved. And if you don't have a satisfactory CRA rating, you can't get a deal done. And if you are under investigation for a significant violation, you can't get a deal approved. Now, all of that is just a modest ratcheting up of the eligibility criteria of the past. But what has changed is that so many more banks fall into one of these categories. That takes a number of banks out of the process and makes them ineligible as acquirors. Having said that, the Federal Reserve has also been clear--mostly in individual situations--that they are not opposed to consolidation by others in the industry beyond the very biggest banks. They indicate that they are open for business if you're eligible and if it's a well-conceived transaction. There is one further complicating factor. Although the average processing time remains quite quick, for larger deals it tends to be significantly longer, so the risk is that something could go wrong between the day you file and the day you close, in which case you would move from eligible to ineligible."

There are those who worry that the regulatory approach to the bank behemoths is being taken for a general distaste for any bank deal whatsoever, including substantial deals above the billion-dollar mark. Richard Kim, formerly an attorney with the Board of Governors of the Federal Reserve, is a partner at Wachtell Lipton, which has been involved in more billion-dollar-plus bank mergers since the financial crisis than any other law firm. Mr. Kim agrees with Mr. Cohen that there is no implicit ban on large bank deals. "There is a misimpression in the market that large banks--those that are below a trillion dollars--can't do deals," Mr. Kim says. "Regulators have stated to me that they think the market has misinterpreted their actions in the Hudson/M&T deal as standing for the proposition that banks with $50 billion or more in assets should not be allowed to engage in M&A. To the contrary, I believe that the intended message by the regulators in that deal was that there is a very high bar for anti-money laundering compliance, not that M&T is too big to grow. It isn't--neither is PNC nor Capital One or other similarly sized banks."

Mr. Kim is convinced that regulators want to encourage sensible deals by community banks as well as regionals and super-regionals. "It's a different story for the very largest banks," he says. "For this group, the regulators keep coming out with new rules that disincentivize size and complexity." On December 9, 2014, for example, the Federal Reserve proposed a rule designed to strengthen the capital position of giant U.S. banks. Eight U.S. banks, including Bank of America, Citigroup and JPMorgan Chase, would "be subject to a risk-based capital surcharge that is calibrated based on its systemic risk profile." However, for banks below that threshold, Mr. Kim argues, there is no animus on the part of regulators against mergers for the big banks. For these banks, as long as the deal makes sense, regulators have told him their message is: "Yes, you can grow. Yes, we will permit acquisitions."

Mid-level banks are the hope of the future. The largest banks are those with assets over $250 billion, including a group known as GSIBs, which stands for "globally systemically important banks," a form of the expression "too big to fail." The second group are those bank holding companies, or BHCs, that have between $50 billion and $250 billion in assets, followed by those with between $10 billion and $50 billion. The final category contains all other BHCs with assets below the $10 billion threshold. When Dodd-Frank was enacted, banks under $50 billion in size, were seen as innocent of any role in the financial crisis, and therefore are largely exempt from the regulatory punishment meted out to their larger compatriots. With more freedom of maneuver, it is the midsize banks--those between the $10 billion and $50 billion bookends--that dealmakers predict will be the most active acquirors and targets in 2015. Bank regulators are reporting privately that, after years of silence, they are seeing a marked increase in inquiries from CEOs about potential deals. Although an anecdotal measure, this development is seen as both significant and encouraging. "This spike in CEO inquiries is one of the most interesting recent developments," Mr. Meyerson says.

Regulators have always been the gatekeepers of bank M&A but now they are extremely well-armed. How should dealmakers deal with regulators in this age of regulation? In the not so distant past, dealmakers would typically notify the regulators on a Friday about a Monday announcement. That is no long feasible. For the larger deals, the parties consult the regulators in Washington, D.C. and at the local level over a month in advance. The motto has become plan ahead, start early, expect pain.

What does the future hold for bank M&A? "We are going from close to zero to at least some level of sustained activity," says Simpson's Mr. Meyerson. Across all economic sectors, it is the dearth of alternatives for growth that is largely driving the resurgence of M&A in 2014 and so far in 2015. This is, if anything, often more painfully true for financial institutions. "The basic economic drivers are the same as they've been for several years now," Mr. Meyerson says. "There is relatively anemic loan growth for many banks, shrinking interest margins due to Fed interest rate policies, ever-rising regulatory compliance costs, and capital requirements on the rise. It's tough for much of the industry to have significant top-line growth and, certainly once you run out of releasing loan/loss reserves and cutting expenses, it's tough to have bottom-line growth. I think for these reasons there will be an increase in activity. It won't be 2006 again, but I think it will be somewhat closer to normal--or at least the new normal."

Other forces are beginning to be stir as well. Foreign buyers on the prowl, for one thing. Banks are likely to continue to shed assets, for another, and there are private equity-owned consumer franchises that are trying to consolidate. What's more, there have been some signs of life among the giants. BB&T announced in November its agreement to buy Susquehanna Bancshares for $2.5 billion, one of the largest bank deals since the financial crisis. This comes after BB&T's announcement in September of its agreement to acquire Bank of Kentucky Financial Corp. as well as its recent acquisition of 41 Citibank branches in Texas. Skadden's Mr. Ingles, among others, is not sanguine that BB&T's moves will start an avalanche of mega-deals among the largest banks. However, as he points out, "they definitely will be watched by other banks as a sort of 'test-case' for large bank M&A going forward." There is also talk that the Fed may relax some of its regulatory grip by raising the threshold definition of a GSIB, the systemically important and rule-burdened banks, and that approvals for mergers may get easier.

On another slightly mixed note of optimism, Simpson's Mr. Meyerson says, "The banking industry as currently configured is grappling with long-term profitability issues, especially as interest rates remain ultra-low for longer than anyone expected. It is hard to see how that changes, at least over the near term. Consolidation is inevitable."

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