Bank Director

Breakout I: Getting a Deal Approved

Lowell Harrison
Fenimore Kay Harrison LLP

Jonathan Hightower
Fenimore Kay Harrison LLP

Stephanie Kalahurka
Fenimore Kay Harrison LLP

#AOBA23

GETTING A DEAL APPROVED

SPEAKERS

LOWELL W. HARRISON | PARTNER, FENIMORE KAY HARRISON LLP

JONATHAN S. HIGHTOWER | PARTNER, FENIMORE KAY HARRISON LLP

STEPHANIE E. KALAHURKA | PARTNER, FENIMORE KAY HARRISON LLP

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RECENT M&A APPLICATION DATA

- **Average time to approval is taking longer**
- **Median time to approval is somewhat stable**
- **Significant increase in M&A applications receiving adverse public comments (3.4% for 2021 to 14.5% 2022:H1)**

Mergers and acquisitions	2018	2019	2020	2021	2021:H1	2022:H1
Dispositions						
Approved	190	190	144	184	81	87
Withdrawn	10	16	14	6	4	4
Percent M&A of total approved proposals	*20.5%*	*20.4%*	*18.6%*	*19.3%*	*17.5%*	*19.1%*
Processing time (days)						
Average	57	60	69	65	67	81
Median	42	43	45	45	43	48

In first half of 2022, only four proposals were withdrawn, suggesting that adverse comments may delay, but not necessarily prevent deals from being completed.

Source: Board of Governors of the Federal Reserve System, Banking Applications Activity Semiannual Report, December 2022

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STATUTORY FACTORS

- **Financial condition**
  - Current and pro forma financial condition
  - Future prospects
- **Managerial resources**
  - Competence, experience and integrity of management
  - Management's record of compliance with laws and regulations
  - Management's record of fulfilling commitments and conditions imposed by the regulators
- **Convenience and needs of the community**
  - Record of performance under CRA
  - Overall compliance record
  - Results of recent fair lending exams
- **Effect on competition and financial stability**
  - Market deposit concentrations
  - Larger systemic risks to financial stability in the US

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SAFETY & SOUNDNESS

- **Self Analysis**
  - Regulatory status (S&S, compliance, CRA)
  - Outstanding enforcement actions
  - Outstanding MRAs/MRBAs
  - Acquiring to address regulatory issues of buyer is not a solution

- **Target Analysis**
  - Develop early-stage analysis of Target
  - Regulatory status (S&S, compliance, CRA)
  - Combined risk analysis
  - Buyer ability and approach for addressing Target weakness and deficiencies

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SAFETY & SOUNDNESS (cont.)

- **Capital**
  - Funding and capital planning (cash/stock/debt)
  - Aim for conservative pro forma to demonstrate capital strength post-closing
    - Minimum 8%-9% leverage
    - Double Leverage
      - No specific regulatory limits
      - FRB considers 120% high and increases scrutiny
      - Small bank holding companies should carefully consider the requirements of the Federal Reserve Small Bank Holding Company Policy Statement
  - Asset growth consistent with pro forma capital

- **Liquidity**
  - AOCI effect on tangible capital
  - FHLB borrowing limitations

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CONSUMER COMPLIANCE ISSUES

- Most likely compliance show-stoppers are CRA and Fair Lending.
- A CRA protest will, in most cases, cause an application to be immediately removed from delegated processing, resulting in longer processing times (avg. > 100 days).

Source: Federal Reserve Board, Banking Applications Activity Semiannual Report, December 2022

	2018	2019	2020	2021	1st Half 2022
Avg. Days to Process – No CRA Protest	53	56	64	62	65
Avg. Days to Process – With CRA Protest	113	143	232	186	197

- CRA protests typically blend CRA/Fair Lending allegations, and may be used by the regulators as justification for a fair lending "fishing expedition" or to bring current an older CRA evaluation.

RESPONDING TO A CRA PROTEST

- If a CRA protest is received during the applicable application comment period:
  - Regulators will forward the protest letter to the applicant with instructions for any written response.
  - Regulatory cover will generally state that the application may (or will) be removed from delegated or expedited processing.
  - The time permitted for any response varies by regulator, but is short. Typically 8-10 business days.
  - *Ex parte* rules may be triggered, limiting communication with regulators.

Pursuant to the Board's policy on ex parte communications, Board and Federal Reserve Bank staff may not discuss substantive matters relating to an application with an applicant unless the commenter has been notified so that both the commenter and the applicant may participate. Accordingly, staff is unable to discuss this application with you by telephone.

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CONSIDERATIONS IN RESPONDING

- **To respond or not to respond?**
  A formal, written response is recommended.
- **Considerations when responding:**
  - Does the protest constitute a "substantive adverse comment?"
  - Are the allegations "substantially identical" to claims that have been reviewed within on year may be considered on delegated processing? *(See FRB SR 97-10) .*
  - Are the allegations frivolous or unsubstantiated? Are claims supported by verifiable evidence or data?
- **Applicant's response is often parroted in approval orders.** "Your word become the regulator's words," and this can be extremely powerful in connection with future responses or applications.

The Bar is Low:

*A comment is substantive unless it clearly qualifies under the delegation criteria that relate to individual customer complaints, **previously decided issues**, minority shareholder rights issues, **frivolous or unsubstantiated claims**, or issues that are not related to factors in the [applicable regulation].*

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POSSIBLE OUTCOMES

- **Application is approved on delegated processing** -- Rare outcome, and typically only happens if the adverse CRA comment is not substantive or is substantially identically to a recently considered comment.
- **Application survives prolonged "fishing expedition," and is approved**. More common. Not ideal, but applicant will be strategically well-positioned for future transactions.
- **Application is approved with non-standard conditions.** More common recently. Applicant needs to consider implications of the condition – safety and soundness, fair lending, possible need for a special purpose credit program.
- **Regulators imply that application will be denied.** Generally signals the need to withdraw the application and regroup.

BEST PRACTICES – PRE APPLICATION

- **Give appropriate attention to consumer compliance in diligence and reverse diligence.**
- **Know where your CRA weaknesses are and proactively address them.** An overall "Satisfactory" rating does not mean safety, especially if the evaluation is dated.
- **Put your best foot forward in the application itself.** Prepare and provide meaningful responses to the "convenience and needs" questions.
- **Build extra time in the application timeline, deal timeline and agreement termination provisions.** Expect delays in markets with active serial protesters.
- **Consider strategically engaging community partners support.**

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COMPETITIVE EFFECTS MATTERS

- Regulators are required to review the competitive effects of transactions subject to the Bank Merger Act, which includes purchase and assumption transactions.
- Consolidation in certain markets has given rise to a much greater risk of competitive effects issues.
- Banking regulators screen transactions using the Herfindahl-Hirschman Index (HHI), which uses deposit data to calculate pro forma market concentrations.

HHI Screening

A transaction creating an increase in the HHI of 100 points in moderately concentrated markets or of 50 points in highly concentrated markets triggers additional scrutiny.

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COMPETITIVE EFFECTS MATTERS

- The U.S. Department of Justice, which would investigate a transaction that raises antitrust concerns, uses a more nuanced analysis that disaggregates lines of business and considers a transaction's impact on various lines of business such as retail and small business lending.

- While very reasonable arguments can be made that consumers have access to a wide variety of online banking services regardless of location, the DOJ's data suggests that small businesses prefer to do business with banks that have locations within three to five miles.

- How can we address the issues?

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COMPETITIVE EFFECTS MATTERS

- Early planning is critical. A first step in transaction planning is to review a pro forma market concentration analysis to determine if any markets exceed screening guidelines.

- If so, begin a review of designated Federal Reserve markets to determine if they are current and begin review by each party of practical competitors in the relevant markets. Also consider practical matters relevant to market competition such as traffic patterns.

- If negotiations proceed, carefully negotiate a contingency plan if branch divestitures may be required.

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REGULATORS AND NONBANK BUYERS

- Given a variety of market forces, nonbank buyers such as technology companies, investor groups, and credit unions are increasingly relevant to would-be community bank sellers.

- Generally, regulatory acceptance of these nonbank buyers has improved in recent years, including last year.

- However, these transactions raise unique issues with regulators that should be anticipated and planned for.

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REGULATORS AND NONBANK BUYERS

- For technology companies and investor groups, sellers should demand an understanding of the go-forward business plan, carefully reviewing it with regulatory experts to determine if it is viable.

- Sellers should also evaluate the character and fitness of directors and executive officers to determine viability.
  - If these people have not been identified at the time an agreement is executed, due diligence is not complete.

- The impact of the business plan on the communities of the target should be addressed. The Community Reinvestment Act Plan is critical.

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REGULATORS AND NONBANK BUYERS

- For credit union transactions, state laws are the primary hurdle. However, general regulatory review standards still apply.

- Federal bank regulators must approve the transaction using the same criteria used for bank-to-bank transactions.
  - Is the credit union ready to chin the bar for a bank regulatory review? Does it have the data?

- Changes in fees, products, and services are also important. Just because a credit union is "member-driven" does not mean it will offer bank customers an acceptable level of services.

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COMMUNICATING WITH REGULATORS

- **When should you discuss a proposed transaction with your regulators?**
  As a courtesy and to maintain an ongoing dialogue and transparency with your regulators, our recommendation is to always disclose a proposed transaction prior to public announcement and possibly much earlier.

- **What are the alternatives for pre-filing communications?**
  - Seasoned acquirors will typically just pick up the phone
  - Fledgling acquirors may consider in-person pre-filing meetings to preview a potential transaction
  - Federal Reserve provides for a confidential "pre-filing" consultation process; intended to help reduce delays and discuss potentially challenging issues in advance

Interesting Statistic

The FRB "pre-filing" process is not frequently used. Only 25 pre-filing proposals were reviewed by the FRB in 2022:H1, representing only 5% of total applications filed.

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