KRIEG DEVAULT

Insights

M&A Transactions: Avoiding the 'Regulatory Penalty Box'

December 3, 2015

By: Michael J. Messaglia

As seen in the December 2015 issue of the Indiana Bankers Association's Hoosier Banker

In merger and acquisition transactions, buyers and sellers should both take care to ensure compliance with regulatory requirements prior to applying for merger approval. Failure to do so may put the acquirer in the position of having to withdraw the application.

The regulatory penalty box.

The Bank Merger Act[1] requires an analysis of the managerial resources and future prospects of the merging entities, compliance with anti-money-laundering laws, and meeting the convenience and needs of the community to be served. Although the law does not explicitly prohibit the approval of a transaction for noncompliance, in practice the regulators typically will not approve a transaction with an outstanding enforcement action or regulatory compliance issue facing the buyer. This has become known as the "regulatory penalty box," because acquirers are not allowed to participate in merger transactions until these issues have been resolved. Sellers facing noncompliance issues are not necessarily placed into the regulatory penalty box, provided that the buyer is capable of addressing the noncompliance issues without harming the buyer.

M&T and Hudson City merger.

The approval by the Board of Governors of the Federal Reserve System (Board) of the merger of M&T Bank Corp. (M&T) and Hudson City Bancorp Inc. (Hudson City) highlights the risks of noncompliance with regulatory requirements. This merger approval process was plagued by compliance issues from both M&T and Hudson City following the filing of the application, resulting in an approval process that stretched beyond three years. Further, the Board clarified in its approval order that such applications in the future will not be suspended while regulatory matters are being addressed; instead, the Board expects these applications to be withdrawn. As background, in August 2012, M&T and Hudson City entered into a merger agreement, providing that M&T would acquire Hudson City. The parties expected the transaction to close in the second quarter of 2013. M&T filed an application with the Federal Reserve Bank of New York in October 2012, seeking approval of the merger. Eventually the Board approved the merger on Sept. 30, 2015.

BSA/AML enforcement action.

During the processing of the application, a regularly scheduled examination of M&T by the Federal Reserve Bank of New York identified weaknesses in M&T's risk-management program, including its Bank Secrecy Act/anti-money laundering compliance management program. In June 2013, M&T entered into a written enforcement action with the Federal Reserve Bank of New York to address those issues. As a result in 2013,

M&T hired 285 additional employees and 151 nonstaff consultants, plus invested $60 million, to address the weaknesses.

Deceptive advertising enforcement action.

In a separate examination, the Consumer Financial Protection Bureau (CFPB) found that M&T had deceptively advertised free checking accounts. In October 2014, M&T consented to an enforcement action brought by the CFPB, resulting in $10.9 million in refunds to approximately 59,000 customers, and payment of a $200,000 civil money penalty. In addition, examinations by the Federal Reserve Bank of New York identified weaknesses in M&T's consumer compliance program.

Fair lending enforcement action.

In March 2014, the CFPB began an examination of Hudson City to determine whether it had engaged in redlining, and in March 2015 the Department of Justice paired with CFPB in a joint investigation. Both organizations determined that Hudson City had discouraged applicants in majority black and Hispanic neighborhoods in three metropolitan statistical areas (MSAs). They alleged that Hudson City had placed bank branches and loan offices outside of these neighborhoods, had excluded these neighborhoods from Hudson City's Community Reinvestment Act (CRA) assessment areas, and had focused its marketing outside of these neighborhoods. In September 2015, the CFPB announced a consent order, subject to court approval, resolving the actions against Hudson City and requiring more than $27 million inpayments toward lending initiatives in low- to moderate-income (LMI) and minority neighborhoods, plus a $5.5 million civil monetary penalty. As part of these payments, Hudson City is required to take several remedial measures and operational commitments to prevent future violations, and must encourage access to credit in these neighborhoods through several means, including opening at least two full-service branches, hiring additional staff, and developing and submitting compliance plans and policies for its employees and brokers. Hudson City's fair lending issues became the focal point of Board review in consideration of the merger application, mirroring the growing importance of CRA issues in the overall regulatory approval process, due to a significant increase in public protests over violations. Fortunately for M&T, however, it has maintained a strong CRA record with an "Outstanding" CRA rating. The Board has thus determined that the combined M&T/Hudson City organization would better address fair lending issues by following M&T's approach to serving LMI and minority neighborhoods, which focuses on community involvement, advertises affordable mortgage products in newspapers targeted to residents of LMI and minority neighborhoods, and offers government-backed mortgage products. M&T agreed to address the weaknesses identified at Hudson City. Finally, as the surviving entity, M&T will be required to fulfill the requirements of the consent order.

Order by the Board approving the merger.

In the order approving the merger, the Board noted the uniqueness of suspending the processing of the application. The Board noted that it "expects that a banking organization will resolve all material weaknesses identified by examiners before applying to engage in expansionary activity."[2] The Board specifically referenced SR Letters 14-2 and 13-7, which provide further insight into the application process. Additionally the Board noted that it "took the highly unusual step of permitting the case to pend while M&T addressed its weaknesses. The Board does not expect to take such action in future cases. Rather, in the future, if issues arise during processing of an application, the Board expects that a banking organization will withdraw its application pending resolution of any supervisory concerns." Clearly the regulatory penalty box is strong and solid. Buyers remain on notice that they must have their regulatory houses in order before embarking on acquisition transactions. Banks that are interested in selling must continue to perform reverse due diligence of buyers with respect to their regulatory compliance, including CRA. Buyers, on the other hand, must continue to be sensitive to the regulatory and CRA issues facing sellers and must develop plans to address those issues.

[1]12 U.S.C. § 1828(c)

[2]*FRB Order No. 2015-27, footnote 28*