Insights Conversations: Update on Shareholder Activism in the US Banking Industry

Skadden

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Two years ago, the U.S. banking industry was a rare exception to the trend of increased shareholder activism that was prevalent across industries. At the time, Skadden partners **Brian Christiansen**, **David Ingles**, **Sven Mickisch** and **William Sweet** predicted a rise in activism targeting banks. Here they provide an update on the topic and discuss some aspects unique to activism involving banks.

Your prediction regarding shareholder activism in the U.S. banking industry came at a time when there had been relatively little activism compared to other industries. How has that trend changed and what are activists attempting to do in U.S. banks now?

David: We certainly have seen more activist investor campaigns affecting U.S. banks, particularly in recent months. Activist efforts have focused mostly on the smaller to midsize super-community banks rather than the larger banks, such as SIFIs (systemically important financial institutions with assets of $50 billion and up), although Bank of New York Mellon is a prominent exception. One of the reasons for the distinction is that the bank M&A market has become increasingly more robust at the smaller to midsize level but remains relatively inactive at the super-regional and large-cap level, which can limit the near-term "exit" opportunities for investors acquiring stakes in larger institutions.

Sven: Apart from the largest diversified financial institutions, banks in the U.S. are pretty simple in terms of balance sheet composition and business lines — this simplicity effectively removes certain alternatives from the typical activist playbook, like proposing a spin-off or sale of "underperforming" or "noncore" business lines. So the play that we most often see from activists is agitating for a sale. Examples include Hudson Valley Holding, which merged with Sterling Bancorp in late 2014, and the recent announcement by Metro Bancorp of its pending merger with F.N.B. Bancorp. These deals also reflect how shareholder activism increasingly is affecting larger super-community banking institutions. Similarly, the most recent publicly reported activist situation in the industry — Basswood Capital's 9.2 percent stake in Astoria Financial and its request for representation on Astoria's board of directors — involves a bank with more than $15 billion in assets.

Obviously the role of senior management and the board of directors is critical when talking about shareholder activism. How has the trend in the industry impacted boards and management teams?

Bill: The level of awareness has increased markedly, and CEOs and boards are increasingly focused on activism preparedness. Boards and management teams are asking investment bankers and counsel to update them on the activism landscape, and the topic has become a regular part of the agenda for board meetings and retreats.

Sven: We are spending an increasing amount of time tracking activism situations, advising our clients about shareholder activism developments, and reviewing their corporate governance and preparedness profiles. We expect this will continue.

What is different about activism in banking versus other industries?

Brian: The bank regulatory overlay is an important and unique element affecting shareholder activism in the industry, based on the safety and soundness restrictions it places on what banks can do in terms of expense reduction and capital management as well as the limits it places on investors acquiring "control" of banking institutions.

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Banking laws generally prohibit any shareholder from acquiring control without first obtaining regulatory approval. Historically, the banking regulators generally interpreted these laws to be triggered only when a shareholder sought to acquire 10 percent or more of any class of a banking organization's voting securities or to take other actions that could constitute "control." In recent years, the Federal Reserve and other banking regulators have taken a more expansive view, finding "control" to exist at ownership levels as low as 5 percent under circumstances not typically associated with practical control. Bank regulatory considerations significantly affect the offensive and defensive tactics employed by activist investors and bank management and boards. However, where activist investors are careful to avoid the regulatory pitfalls, the Federal Reserve has avoided inserting itself into business disputes between shareholders and management.

David: As Sven mentioned, most banking institutions in the U.S. below the SIFI level have relatively simple franchises focused primarily on deposit-taking and lending, and generally are subject to a comprehensive federal regulatory scheme imposing safety and soundness, minimum capital and other regulatory requirements. So there tend to be fewer opportunities for activists to push for meaningful near-term restructurings or spin-offs or significant capital management initiatives such as a large special dividend or share repurchase plan. Historically, key activist concerns for banking institutions have been capital management, expense reduction, and lackluster profitability and growth; but these concerns frequently lead to calls for the board to seek a sale to a larger institution.

Sven: A limited number of activist investors focus on the U.S. banking industry, as compared to "generalist" activist funds. Activists that do specialize in banking are pretty well-known in the industry and have many passive positions in banking institutions across the country — as a general matter, they know the industry and the relative performance of their targets compared to the rest of the industry.

What's next for the industry with regard to activism and how should banks prepare?

David: We expect that activism will remain a driver for greater bank M&A activity for smaller and midsize banking institutions, and will become a more relevant factor for larger banking institutions as the market for M&A involving those institutions becomes more active. Continued improvement in the economy and in market valuations and trading multiples for banks should lead to increased M&A activity, which should result in even greater attention from activist investors. Accordingly, management teams and boards must assess their institution's vulnerabilities to activist investors and anticipate potential challenges. Management teams and boards that remain familiar with the relevant bank regulatory regime and their companies' governance profiles and preparedness efforts, anticipate potential issues of concern for activists, and develop detailed contingency plans will be in the best position to navigate the current environment effectively and in a manner consistent with the long-term interests of their shareholders.