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Business Opportunities for Chinese Bank Acquisitions of U.S. Banks

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U.S. Legal Developments

This past May, the Federal Reserve Board ("FRB") approved for the first time the acquisition of control of a U.S. national bank by China's largest bank, Industrial and Commercial Bank of China ("ICBC") with $2.5 trillion in assets, together with the approval of branch openings by two other Chinese Banks. The FRB determined that each of the acquiring banks is subject to comprehensive consolidated supervision ("CCS") in its home country. Although such a determination is limited to the particular applicant, it is necessarily reflective of the FRB's views of the quality of overall bank supervision by the host country in which the bank is chartered. Such a determination is a threshold that many foreign banks are unable to clear because of the absence of a strong enough bank regulatory system in their home country. In making its determination, the FRB applied the Basel Core Principles, which in its view have become "the de facto international standard for sound prudential regulation and supervision of banks." Therefore, a Chinese bank that is regulated by the Chinese Bank Regulatory Commission ("CBRC") and meets the supervisory standards of the CBRC would be treated for the most part as a U.S. domestic bank by the FRB in its consideration of an application to acquire a U.S. bank under the Bank Holding Company Act ("BHCA"). This CCS determination was a result of high level country-to-country meetings in Beijing between Chinese officials and Treasury Secretary Geithner in which the Chinese made substantial concessions to open the door to U.S. companies seeking to make investments in Chinese companies. More importantly, this meeting led to the U.S. agreeing to endeavor to act expeditiously on pending applications by Chinese banks. The FRB's approval signals an open door to Chinese acquisition of U.S. banks.

Bank Holding Company Act Approval Criteria

Foreign bank acquisitions of U.S. Banks are subject to Section 3 of the BHCA. The factors that the FRB normally applies in its consideration of BHCA approvals are generally the competitive effects of the acquisition, and the future prospects of the applicants in view of the managerial and financial resources of the acquirer and resulting entity. This latter criteria will doubtlessly require the acquirer to demonstrate that it will meet Basel III capital requirements and that the Holding Company will serve as a source of strength to the U.S. subsidiary. Therefore, a Chinese acquirer must consider whether its financial condition will meet the FRB's standards for regulatory approval.

Political Considerations

Notwithstanding the significant precedent that has been created by this FRB approval, future U.S. bank acquisitions will not be free from influence of the U.S. – China relationship as well as domestic Congressional politics. Senator Robert Casey (D.Pa.) in a letter to the FRB raised the question of whether Chinese acquisitions might undermine competition among U.S. financial services companies. He has also questioned the degree to which U.S. regulators will have sufficient access to Chinese financial data to ensure transparency.

Presumably, political sensitivity will be directly related to the size and importance of the U.S. bank. However, the FRB, among the banking regulatory agencies, is less susceptible to domestic political pressures and, without a significant deterioration in U.S. – Chinese relations, it is not likely to change policy.

Collateral Regulatory Issues

Both the SEC and the Public Accounting Oversight Board which oversee U.S. public accounting firms are challenging the transparency of auditing standards and operations of Chinese audit firms. In the FRB approval order, the FRB obtained a commitment from ICBC to provide access to such information which would allow it to continue to oversee the observance by the acquiring bank of the Basel Core Principles with a caveat that if the FRB determined its ability to obtain such information in the future was impaired it would consider a divestiture order. Notwithstanding this caveat, the FRB in a lengthy footnote to its order, addressed its confidence in the accuracy and reliability of Chinese accounting methods and practices as applied to the applicants.

National Security Review

The Committee on Foreign Investment ("CFIUS") may review certain foreign investment in U.S. businesses and deny such investment if it threatens U.S. national security. Generally, banking institutions are treated as "critical infrastructure" and are subject to review by the CFIUS, but in practice there is little evidence that the CFIUS has exercised its authority to block foreign acquisitions of U.S. banks. Unless a bank is of significant size or heavily involved in financing companies that have a direct bearing on national security, it is unlikely that such a review would be problematic.

Business Opportunities for Acquisition of U.S. Banks

The number of acquisitions of U.S. depository institutions has fallen dramatically since the beginning of the financial crisis. While initially this was caused by uncertainty as to the value of U.S. bank portfolios, the last year has seen a number of acquisitions with compelling premiums for attractive U.S. banks. Most of the 267 acquisitions since 2010 have involved smaller banks. This is no surprise as only 170 out of the approximate total of 6,600 FDIC insured banks in the U.S. have an asset size greater than $5 billion. In addition to these reasons, perhaps the most significant reason for the small number of acquisitions has been the regulatory uncertainty of the extent and manner of application of bank supervision standards under the recently passed Dodd-Frank Act.

Nonetheless, the most significant cause of the small number of acquisitions has been the lack of capacity. The traditional acquirers have not enjoyed the attractive stock multiples or access to enough capital that would support an active growth strategy that they did enjoy pre-crises. Only the largest banks enjoy trading multiples over 125 percent of tangible book value with an average price to tangible book of 140 percent for banks over $5 billion in assets.

Regionally, there have been fewer acquisitions involving Southeastern and Western banks which have been impacted negatively price-wise. Northern and Midwestern regions show greater activity. In 2011, the median one month market premiums (take out price compared to average trading price over 30 days prior) have averaged 95 percent for Mid-Atlantic and Northeastern transactions.

It is a buyers' market and bank shareholders' price expectations have declined dramatically since 2008 when price to book sale ratios in excess of 300 percent of book value were not uncommon. At the same time, the number of acquirers who have the capacity and regulatory standing to complete acquisitions is also at an historic low. In short, the inclination by banks under $5 billion to sell has seldom been higher but the number of buyers with capacity to buy is at an historic low.

Reasons Why the Current Business Environment is Ideal for U.S. Bank Acquisitions

1. Stock market activity has caused buyers to be more comfortable with their valuations and enjoy increased buying power with their stock currency;
2. Failed bank activity has declined to a low point since 2008;
3. Buyer opportunities to enhance earnings internally have diminished, making acquisitions an attractive method of enhancing scale and earnings;
4. Improving credit and capital positions will encourage opportunistic acquisitions—the market is staged for a rally;
5. Smaller institutions continue to be unable to access capital with current prices trading at a discount to tangible book;
6. Shareholder impatience for returns on their investment grows;
7. Competition from U.S. domestic acquirers is low;
8. Many of the largest U.S. banks are either too big or too weak to qualify for FRB approval;
9. Congressional preoccupation with "too big to fail" has chilled the inclination of the larger banks to make further acquisitions; and
10. Bank regulatory agencies have been resistant to private equity purchases of banks.

All of these factors demonstrate the compelling opportunities that exist for large Chinese bank acquirers that have sufficient capital to satisfy the FRB that they meet the FRB's Bank Holding Company Act standards. Unlike the rush to invest in U.S. real estate and financial service companies by Japanese banks during the height of the market, the market valuations are very attractive for buyers today offering unprecedented buying opportunities at low multiples.

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