ARTICLES

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ESG Considerations in Community Bank M&A

Services

ESG Strategy & Compliance

Financial Institutions M&A and Regulatory Compliance

Mergers & Acquisitions

The community bank segment may still be in a consolidation phase, but that dynamic slowed perceptibly in 2022. According to S&P Global, U.S. banks announced 168 acquisitions in 2022. This represented a 17.6 percent decline year over year. Deal values declined even more steeply, with just under $23 billion in announced deal value compared to more than $76 billion in 2021.

There are now approximately 4,400 community banks, less than half the number that existed in 1997. According to PCBB, amid sluggish new bank formation and steady merger activity, “the total number of community banks is likely to continue falling,” but as the divide widens between what sellers expect and what buyers are willing to pay, consummating deals in the near term could be a challenge.

To command top-of-the-market premiums, community banks eying an exit need to differentiate themselves in a manner that illustrates the value of the underlying operation. Some will struggle in this endeavor, particularly those whose operations are more interest-rate sensitive during the current tightening cycle. For instance, potential sellers with low concentrations of noninterest-bearing deposits will likely see lower deal multiples. This was a central concern that killed the proposed tie-up between First Internet Bancorp and First Century Bancorp, which fell apart in March due to a valuation dispute, according to S&P Global.

Interest-rate sensitivity or a weak loan book is not something that can be remedied quickly, or sometimes, remedied at all, but there are still some approaches community banks can take to enhance their attractiveness to potential suitors, even when their banking operations are underperforming. Chief among these is developing and implementing an Environmental, Social, and Governance (ESG) program.

ESG & Corporate Value

ESG has quickly risen to the top tier of boardroom concerns throughout corporate America, not least because of its discernable impact on valuations and capital raising. For instance, in the first quarter of 2022, ESG-themed funds accounted for 26 percent of all newly launched passive exchange-traded funds. Similarly, ESG-themed funds counted over $300 billion in assets, a more than ten-fold increase since 2011. With so much capital being funneled into ESG-friendly enterprises, it would be a dereliction of duty to ignore this emerging area of concern.

And yet, according to the Consumer Financial Protection Bureau's "Report on Diversity and Inclusion within Financial Services," published in January 2022, two-thirds of the 270 regulated entities it surveyed for information provided "no" or "low" information regarding their diversity, equity, and inclusion (DEI) policies—a key component of ESG scores. Additionally, the level of reported information tracked strongly the size and the type of financial institution. Overall, depository lenders scored higher than other financial services firms, such as mortgage lenders, automobile lenders, and payday lenders. Thirty-six of the 58 depository lenders surveyed were scored as providing a high degree of DEI information. Furthermore, larger institutions scored the highest.

The size factor is a compelling one. Banks that are actively seeking acquisitions are de facto committed to growth and are likely pondering how and when their growth strategy begins to intersect with ESG in a meaningful way; therefore, acquisition targets would do well to demonstrate their ESG bona fides in order to attract more offers and better terms from institutions that are scaling up their operations via M&A.

ESG in the Due Diligence Setting

As the CFPB report suggested, the larger the acquiror, the likelier it is that they have more robust ESG programs in place. By extension, there is a greater likelihood these institutions have integrated ESG into their pre-acquisition evaluation and due diligence processes; therefore, community banks looking to launch ESG efforts could benefit greatly from examining how ESG is evaluated in the deal context and making sure their programs account for those areas of concern. Typically, these include:

Carbon Footprint. This includes both the carbon footprint of the bank itself as well as those of its borrowers. Although difficult to measure, does the bank have a plan to reduce over time the percentage of loans made to borrowers that lack a plan to reduce its carbon footprint?

Environmental/Sustainability. Does the target track and report on its consumption of paper, plastic, water, electricity and natural gas? Does it have plans to reduce consumption of these items over time?

If so, has it achieved any specified goals to minimize its impact on the environment and to use recyclables as much as possible?
What has the community bank target done to reduce, reuse, and recycle within its own corporate offices and branch banks? For example, community banks use a significant amount of paper. Have they implemented processes leading to greater digitization thereby reducing paper consumption? Do they have a water filtration system that reduces the need for plastic water bottles? Have they purchased green appliances like refrigerators for break rooms that are energy efficient?

DE&I. Who comprises the executive and senior management of the community bank and the bank holding company? Is and to what extent is the board of directors diverse? Has the community bank or the bank holding company implemented a DE&I program? Is it complying with that program? Have there been efforts to diversify its management or its employee base? Does the bank have programs, targets, and/or systems to track hiring practices? If there is an incentive compensation plan, are awards or payouts tied to the achievement of ESG goals or targets?
Board Diversity. All operating companies listed on Nasdaq's U.S. exchange must use the Board Diversity Matrix provided by Nasdaq or a format substantially similar, to annually disclose board-level diversity data in their proxy statements, their Forms 10-K or 20-F), or on their respective websites. NASDAQ listed companies must also meet a board diversity objective or explain their reasons for not having done so in its proxy statement, information statement for its annual shareholder meeting, or on the company's website. There is a transition period for companies to meet the diversity objectives or explain why they have not done so. There are also certain states that have adopted legislation or in which legislation is pending regarding board diversity objectives applicable primarily to publicly traded companies. Knowledge of and achieving these board diversity objectives will be of great importance to publicly traded bank holding companies

Community Outreach. What opportunities is the bank creating to promote a safe and vibrant community? Is the bank doing more than the federal requirements to provide services to minority groups in their community? For example, the bank may have a program to increase community lending through tax incentives.

Hiring Practices. Community banks can implement DE&I metrics within the hiring process and use HR tracking programs to measure success over time.

"Me Too" Issues. Are there programs and resources available to bank employees addressing sexual harassment and sexual assault in the workplace? Has the bank established mechanisms whereby incident reporting is safe and effective?

Ethics. Is the bank operating ethically? Is the bank simply meeting regulatory standards, or has it implemented other ethical standards that go beyond the requirements? Does the bank take precautionary measures against predatory lending, money laundering, fraud, and other legal and ethical concerns?

The degree to which ESG concerns are vetted by acquirors naturally will vary, and as alluded to earlier, larger institutions tend to take greater interest in ESG and devote greater resources to ESG programming; however, most acquirors looking at ESG in their due diligence process will likely be sophisticated enough to sniff out so-called paper programs, that is, programs that are "all talk" or so under-resourced as to be meaningless. When looking to enhance value through ESG, community banks will need to make a serious effort that is backed by adequate resources and proper reporting mechanisms. It can be a significant expense, but one that can potentially yield significant benefits in the M&A setting.