RPIA
Global Fixed Income Experts

ESG Engagement Example
Q3 2023

BACKGROUND

In May of this year, a major, globally significant Canadian bank and a regional U.S. financial services firm jointly announced the mutually agreed termination of their merger, citing the bank's uncertainty regarding the timeline of regulatory approvals. This announcement prompted us to question the potential reasons for not receiving approval, including the correlation to the bank's deficient AML controls and the impact on its growth and capital deployment strategy.

A few days after this announcement, the Wall Street Journal reported that the Office of the Comptroller of the Currency (OCC) and the Fed's concerns stemmed from the bank's handling of unusual transactions and its timeliness of reporting suspicious activity. As a result, two lawsuits were filed against the issuer in May and June by the shareholders of the company being merged into the bank over the failed acquisition and misleading statements regarding the likelihood of regulatory approval, in addition to the failure to disclose deficient AML procedures and policies.

Additionally, Sustainalytics downgraded the outlook for the bank's Business Ethics from Category 2 to Category 3, Neutral. We felt these events and the subsequent rating change required engaging with the bank's management team to address our questions.

ENGAGEMENT FOCUS

1. AML Compliance

Disclosed that they have been on top of and responding to inquiries from regulatory authorities including U.S. Department of Justice on matters concerning the bank's AML compliance program in the U.S. and anticipates monetary and non-monetary penalties to be imposed. The size of both impacts is difficult to estimate at the time we spoke as the discussions with regulators are still ongoing.

2. Operational Risks

Litigation issues mean the bank must hold additional operational risk capital, which stays with the bank for the next 10 years as it cannot be reversed very quickly. Monetary penalty is possible and there may be additional expenses to cure any deficiencies. Impact will be longer-term, but we believe the impacts on both expenses and capital are manageable.

3. Growth Plans

Management confirmed the bank's strategy for growth in the Southeast region of the U.S. has not changed. In our view, it is a positive sign that the bank has already been using excess capital into growing that market organically through new branches in targeted cities and regions.

We also discussed the bank's recent activity in the market with a few unsecured bond issuances. Management explained that the banks is pursuing healthy growth in the U.S. and Canadian market, which requires liquidity and has driven the need for additional wholesale funding.

PROGRESS & MONITORING

In our view, the cessation of the deal works favourably for the bank's creditors from a fundamental perspective. The bank's regulatory capital levels solidly at the top of the peers. Moreover, we believe the timing is not optimal for closing this substantial U.S. regional bank deal given the current turmoil in the U.S. banking space.

We will continue to monitor the bank's plans to enhance their U.S. AML compliance program and any impact on operational risks as discussions continue between the bank and regulators. AML deficiency is of concern; however, at this time, it is important to continue engaging with the management team to understand how the team will address the issue and what the magnitude of the impact will be once discussions with regulators come to a close.

Following this engagement, given our analysis of both ESG and fundamental risk factors, we did not believe it necessary to change our position in this banking issuer as the issue was not deemed material enough to change our view on the issuer as a whole.

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