Bank Regulators Focus on Financial Stability Factor to Reevaluate Large Bank Mergers

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In 2021, banks, including regional banks, engaged in significant levels of merger activity as they sought, in large part, to gain efficiencies of scale in order to enhance offerings and thus compete with larger institutions. The total deal value for bank mergers and acquisitions in 2021 reached a 15-year high, including 13 announced deals with values above $1 billion.[1] However, greater regulatory scrutiny has slowed large bank merger activity in the first quarter of 2022, with only one deal announced with a value above $500 million.[2]

Bank regulators have recently engaged in steps to reconsider their historical review processes for mergers, citing, among other items, the financial stability factor added to the Bank Merger Act and the Bank Holding Company Act by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") as a basis for their current reform efforts.

For the Bank Merger Act, Dodd-Frank's statutory language requires that the regulator consider "the risk to the stability of the United States banking or financial system" when assessing a proposed transaction, while for deals subject to the Bank Holding Company Act, Dodd-Frank mandates that the Federal Reserve Board consider "the extent to which a proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system."[3] Regulators generally have applied these statutory requirements by considering risks with respect to the stability of the U.S. banking or financial system as a whole; for example, the Federal Reserve Board, in its order approving the merger of BB&T Corporation and SunTrust Banks, Inc., noted, "[a]n organization's size is one important indicator of the risk that the organization may pose to the U.S. banking or financial

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1 *See* Seay, Lauren, Ali Shayan Sikander & Zuhaib Gull, S&P Capital IQ, *After Topping $75B in 2021, Bank M&A Shows No Signs of Slowing Down* (Jan. 13, 2022).

2 *See* Seay, Lauren & Ali Shayan Sikander, S&P Capital IQ, *Increased Regulatory Scrutiny Puts Pause on Large Bank M&A* (Apr. 14, 2022).

3 Codified to 12 U.S.C. § 1828(c)(5) (Bank Merger Act); 12 U.S.C. § 1842(c)(7) (Bank Holding Company Act).

system. [. . .] In this case, the Board has considered measures of the combined organization's size *relative to the U.S. financial system*, including the combined organization's consolidated assets, consolidated liabilities, total leverage exposure, and U.S. deposits."[4]

The use of the financial stability factor as pretext for further reconsideration and potential revision of bank merger regulatory review processes appears inconsistent with this historical "impact on the U.S. economy" approach, and indeed may be adverse to that historical approach by inhibiting regional and superregional banks from effectively competing with the largest U.S. financial institutions.

OCC and FDIC Regulatory Activities

On April 1, 2022, Michael J. Hsu, the Acting Comptroller of the Currency, spoke before the Wharton Financial Regulation Conference regarding the resolvability of large regional banks.[5] In his speech, he points to a gap in resolvability for so-called "large regionals,"[6] which are not subject to the heightened resolvability requirements that apply to the eight U.S. global systemically important banking organizations ("U.S. GSIBs"). Expressing a concern about financial stability if a large regional needed to be resolved, Hsu suggests that large regionals be subject to resolvability requirements similar to those applicable to the U.S. GSIBs, including adopting a single-point-of-entry ("SPOE") resolution strategy, requiring sufficient bail-in-able long-term debt at the parent (so-called total loss-absorbing capacity or "TLAC"), and ensuring "separability."

Hsu acknowledges in his speech that it "made sense" that these requirements were initially placed only on GSIBs. However, because large regional banks are significantly larger and more complex than they were a decade ago, even though large regional banks do not need to be "subject to the full set of resolvability requirements for GSIBs," Hsu suggests that the aforementioned three approaches would give the government more options in order to plug "a gap in our financial stability defenses."[7]

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[4] Federal Reserve Board, FRB Order No. 2019-16, "Order Approving the Merger of Bank Holding Companies" (Nov. 19, 2019) at 55 (emphasis added).

[5] Hsu, Michael J., "Financial Stability and Large Bank Resolvability," *Wharton Financial Regulation Conference 2022*, Philadelphia, PA (Apr. 1, 2022).

[6] Although Hsu does not define "large regional," he points to four large regionals today as having total consolidated assets of greater than $500 billion.

[7] Hsu, *supra note* 5, at 6.

Hsu notes that "[m]any of the reforms needed to effectuate those changes on a permanent basis would have to be done by the Federal Reserve and FDIC and would require rulemakings." However, in the interest of time, Hsu suggests that in order to oblige large regional banks to adopt these requirements sooner, the Office of the Comptroller of the Currency ("OCC") is reviewing and contemplating an interim alternative option, which is to "condition approval of a large bank merger on actions and credible commitments to achieving SPOE, TLAC, and separability."[8] Hsu reiterated many of these points in a speech at Brookings on May 9, 2022.[9]

Hsu's speech comes on the heels of several recent developments related to bank mergers. On July 9, 2021, President Biden issued a sweeping Executive Order on Promoting Competition in the American Economy ("Executive Order") asking for the "revitalization of merger oversight" and more extensive scrutiny of bank mergers. See Debevoise In Depth here. Additionally, on March 25, 2022, citing the Executive Order, the Federal Deposit Insurance Corporation ("FDIC") published a request for information soliciting comments regarding the application of the laws, practices, rules, regulations, guidance, and statements of policy that apply to merger transactions involving one or more insured depository institution. Both Hsu and the FDIC point to their authority to regulate on issues impacting financial stability as the reason behind the suggested or contemplated changes to the agencies' approaches to bank mergers, as Dodd-Frank added financial stability as a factor in bank merger review.[10] Hsu's suggestion in his speech alluding to certain "actions and credible commitments" regarding resolution actions is one way in which the OCC could give effect to the financial stability factor in its merger review.[11] Although expressly focusing on large regionals or "superregionals," there is no numerical test cited by Hsu that would preclude regional banks engaging in material transactions from becoming subject to at least a less stringent version of this approach.

In this Debevoise In Depth, we first provide additional background on SPOE, TLAC and separability. Next we summarize additional, related developments in the bank merger space. Lastly, we summarize potential implications for large regional banks, and potentially regional banks engaging in significant transactions, in the merger context.

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8 *Id.*

9 Hsu, Michael J., "Bank Mergers and Industry Resiliency," *Remarks at Brookings*, Washington D.C. (May 9, 2022).

10 These developments may be responsible for slowing the pace of large bank M&A thus far in 2022. *See, e.g.*, Seay & Sikander, *supra* note 2.

11 *See also* Greg Baer, Bill Nelson and Paige Paridon, *Financial Stability Considerations for Bank Merger Analysis*, Bank Policy Institute (May 16, 2022) (Setting out a proposed framework with multiple factors for federal regulatory agencies to apply when assessing the change in financial stability resulting from a proposed merger).

Background on Heightened Resolvability Requirements

Hsu states in his speech that there is currently a gap in large bank resolvability between U.S. GSIBs and large regional banks. While Hsu acknowledges that it is "logical" that large regional banks are not subject to the same requirements as U.S. GSIBs around resolvability as these large regional banks are "not as big, complex, or interconnected as the GSIBs," he underscores that there needs to be more options to resolve a large regional bank and then, in apparent contradiction to his earlier statement, suggests those same heightened requirements be applicable to U.S. GSIBs.[12] Hsu asserts that with current requirements, should a large regional bank need to be resolved, the only viable option would be a purchase and assumption transaction with a GSIB, which Hsu describes as a "shotgun marriage" that would force the GSIB to become "significantly more systemic."[13] We note that Hsu seems to disregard that large regional banks must file viable insured depository institution ("IDI") resolution plans with the FDIC, and that Category II and III regional banks must still file credible section 165(d) parent company resolution plans with the FDIC and the Federal Reserve Board.

Nevertheless, Hsu identifies three approaches, each already applicable to U.S. GSIBs, that would give the government additional options to resolve a large regional bank: implementing an SPOE resolution strategy, complying with TLAC requirements and restructuring in order for business lines and/or assets to be "separable."

SPOE Resolution Strategies

SPOE has become the prevailing approach to resolving the U.S. GSIBs and is now the strategy expected from regulators. SPOE resolution strategies are designed to eliminate the need for a government bailout and to minimize the contagion caused by a banking organization's failure, thereby addressing systemic and moral hazard risk. As Hsu acknowledges, in an SPOE resolution, only the top-tier parent company would fail; all of the material subsidiaries would continue to operate and function, "thus avoiding the chaos of multiple proceedings."[14] Under this approach, losses would be imposed on shareholders and long-term creditors of the top-tier parent holding company without the need for additional taxpayer or government support. By imposing losses on long-term creditors and by requiring holding companies to recapitalize and provide liquidity support to material operating subsidiaries that conduct critical operations, the SPOE strategy also helps to minimize contagion risk to the financial system. We note that the

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[12] Hsu, *supra* note 5, at 4.

[13] *Id.* Hsu notably did not discuss regulators' ability to resolve financial institutions through the Orderly Liquidation Authority provided in Title II of Dodd-Frank.

[14] Hsu, *supra* note 5, at 4.

U.S. GSIBs have had to make significant adjustments to their business-as-usual structure and operations in order to facilitate a successful SPOE strategy, such as ensuring they issue sufficient external loss-absorbing long-term debt at the parent company, as discussed in the next sub-section on TLAC.

TLAC Requirements

The Federal Reserve Board adopted a "TLAC" rule designed to facilitate an SPOE resolution strategy. The rule requires the U.S. GSIBs to hold a minimum amount of capital and eligible long-term debt ("LTD") at the top-tier holding company and to maintain a "clean" top-tier holding company that facilitates the SPOE strategy by prohibiting or limiting the ability of the parent holding company to enter into certain financial arrangements that could impede the firm's orderly resolution. The purpose of the capital and long-term debt requirement is to ensure losses are absorbed by the parent company's shareholders and creditors and not taxpayers or the government. Hsu states that TLAC "serves as an important buffer, so that if the firm fails, private investors absorb the firm's losses and are 'bailed in' instead of taxpayers footing the bill for a bailout."[15] In order to comply with the TLAC rule, U.S. GSIBs had to make adjustments to the liabilities and other arrangements entered into by their parent holding companies.

Separability

Hsu states that to be separable, banks "must identify lines of business and/or large portfolios that can be sold quickly in stress or in receivership, and operate them so that such a sale can be effectuated quickly, ideally over a weekend. In other words, the firm must be able to be broken up." Hsu adds that "[i]n most large financial groups, this is not a given. Business lines or portfolios that seem naturally separable are often structured and operated in ways that make it quite difficult to sell them quickly for value."[16] Hsu does not acknowledge that large regional banks already focus on separability, as they must address separability in their IDI resolution plans with the FDIC, and Category II and III regional banks must present a credible resolution strategy in their section 165(d) parent company resolution plans submitted to the FDIC and the Federal Reserve Board.

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[15] *Id*. at 5.

[16] *Id*.

Additional Bank Merger Developments

The OCC's internal review of its merger approval process to potentially condition approval on actions and commitments to achieve SPOE, TLAC, and separability comes alongside actions taken by the FDIC to review its own rules, guidance, and statements of policy that apply to merger transactions. In a request for information published in the *Federal Register* on March 31, 2022 (the "RFI"), the FDIC requests comment on its existing regulatory framework governing bank merger transactions, citing, like Hsu, Dodd-Frank's financial stability factor and the increase in large banking organizations as reasons for the current reexamination of the merger framework.[17] Comments are due by May 31, 2022.

For merger transactions subject to FDIC approval, the current FDIC Statement of Policy on Bank Merger Transactions (the "FDIC Policy Statement") lists four factors that the FDIC evaluates in its review of proposed transactions: (1) competitive factors, (2) prudential factors, (3) convenience and needs factor, and (4) the anti-money laundering record. Notably, the RFI recognizes that the FDIC Policy Statement does not address Dodd-Frank's financial stability factor.

The RFI presents ten specific sets of questions for comment, including "[w]hat, if any, additional requirements or criteria should be included in the existing regulatory framework to address the financial stability risk factor included by the Dodd-Frank Act?"[18] Mirroring the concepts Hsu discussed in his speech, a different question asks, "Are there attributes of GSIB resolvability, such as a Total Loss Absorbing Capacity (TLAC) requirement, that could be put into place that would facilitate the resolution of a large insured depository institution without resorting to a merger with another large institution or a purchase and assumption transaction with another large institutions?"[19] The questions also seek to possibly re-evaluate the existing factors used by the FDIC; one set of questions focuses on the convenience and needs factor in the FDIC Policy

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[17] FDIC, *Request for Information and Comment on Rules, Regulations, Guidance, and Statements of Policy Regarding Bank Merger Transactions*, 87 Fed. Reg. 18,740 (Mar. 31, 2022). In discussing the financial stability factor, the FDIC, like Hsu, also highlights the "significant challenges" that the failure of a large bank would present to the FDIC's resolution and receivership functions, noting that "given the increased number, size, and complexity of non-GSIB large banks, however, a reconsideration by the FDIC of the framework for assessing the financial stability prong of the BMA and focused attention on the financial stability risks that could arise from a merger involving a large bank is warranted." *Id.* at 18,741.

[18] *Id.* at 18,744.

[19] *Id.*

Statement. The breadth and depth of the questions for comment underscore that the FDIC is potentially undertaking a significant revamp of its merger approval process.

Separately, in an April 6, 2022 letter, Senate Banking Committee Chairman Sherrod Brown urges the OCC and the Federal Reserve Board "to join the FDIC and review and reconsider their approach to big bank mergers."[20] Brown's comments focus on the impacts that bank consolidation has had on communities, noting that "[i]t is time for regulators to transform their approach to better protect the consumers and small businesses that bank mergers leave behind."[21] Brown asks the OCC and Federal Reserve Board to initiate a public comment process on bank merger review, as the FDIC has done.

Implications and Next Steps

Kicked off by Biden's Executive Order in July, it is clear there is a renewed focus on the regulatory framework for bank mergers. While it is uncertain what changes ultimately will be made to the standards and factors for merger approvals, large banks should be prepared for additional scrutiny during the merger application process, with potentially more requests for information or follow-up questions on submitted applications than may have been historically received. Such additional scrutiny is likely to extend the timeline for merger approvals, which should be accounted for when negotiating "drop-dead" dates and other timing considerations in a purchase agreement. It is also possible that bank regulators will begin to condition approval of large and material bank mergers on representations or commitments provided in or alongside the merger application. These representations or commitments could include requiring large regional banks to agree to changes to their organizational structure to accommodate a SPOE resolution strategy or to increase the percentage of long-term debt held at the parent entity to satisfy a minimum TLAC requirement.

The current regulatory and political scrutiny around bank mergers, and particularly the (perhaps undue) focus on the financial stability factor, may mean it will become more difficult for large and regional banks to pursue transactions on the same timeframes and with the same frequency as in recent years. As a result, regional and larger banks considering merger activity may wish to plan ahead for the issues that may be raised, so as to increase the chance of approval and shorten the time to a closing. Moreover, as regulators continue to develop proposals that could inhibit these transactions, banks

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[20] Brown, Sherrod, Letter to Chair Pro Tempore Powell and Acting Comptroller Hsu (Apr. 6, 2022).

[21] *Id.*

should engage in the review and comment process through trade groups and, if appropriate, individual comment, to respond to requests for information.

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