Bank Merger Restrictions

Cite

S. 2882/H.R. 5419; Bank Merger Review Modernization Act of 2021

Recommended Distribution

Corporate Policy, corporate Development, Policy, Legal, Government Relations

Websites

https://www.warren.senate.gov/imo/media/doc/SIL21B13.pdf

Impact Assessment

- Although chances of enactment are slim, these bills nonetheless directly influence Administration policy, regulatory review. They just complicate bank M&A, especially for the largest companies.
- The measures would also constrain the pace of BHC innovation and expansion because many M&A conditions also apply to new BHC activities requiring prior notice or application.
- The criteria by which IDI, BHC, and SLHC mergers and expansion would be considered are sweeping and include many novel issues – e.g., wages, environmental justice. These factors combined with stringent governance requirements would recalibrate U.S. banking organizations as the equivalent of public-benefit corporations if and when any decide to merge, acquire, or even expand.
- Financial and competitiveness criteria would also make M&A/transaction approval considerably less likely. This would reduce consolidation and perhaps enhance banking-sector competitiveness, but banking as a whole is likely to lose considerable strategic ground to nonbanks allowed far more freely to acquire and innovate.
- To the extent regulatory arbitrage accelerates financial disintermediation, economic growth would likely slow and financial-stability risk increase. U.S. bank offshore expansion would be more administratively complex and possibly more difficult.
- M&A proceedings would not only be made more transparent, perhaps hindering negotiations, but also subject to "citizen protest" that could make them far more difficult to consummate.
- Disclosures related to directors and senior officials could make some reluctant to work with IDIs and BHCs, reducing the industry's talent pool and hampering diversity.

Overview

Progressive Democrats in the House and Senate have introduced legislation demanding an array of new decision factors governing bank M&A transactions and new or even revised BHC activities. President Biden's executive order demanding more competitive U.S. markets includes numerous bank-related provisions,[1] but does so largely through requests of independent agencies such as the Federal Reserve to work with the Department of Justice to reduce bank consolidation and enhance community service. This legislation backs up these goals with binding requirements that dramatically alter the public-interest, financial, and competitive analyses on which M&A or BHC activities have long been assessed. Many more acquisitions, especially by or among large banks, would almost surely be rejected and the process might also become so public as to undermine the confidentiality essential to initial M&A agreement. Although almost surely aimed at instances in which a nonbank acquires an insured depository, the bill's drafting may well exempt such acquisitions even if the acquirer is a bigtech firm.

Impact

These measures aim at a fundamental rewrite of banking even though they target their most prescriptive provisions for transactions of banking companies with over $100 billion in assets or those that register at least to a minimal extent on a systemic-risk scorecard. This is sometimes done without regard to recent developments in ways that may undermine the sponsors' objectives as well as create significant strategic and systemic anomalies. For example, the bills give the CFPB a new, high-impact role judging any acquisition involving consumer financial services if the acquirer is an insured depository institution (IDI) or a depository institution holding company (DIHC) with over $100 billion in assets after the acquisition. Use of the DIHC rubric instead of BHC was likely meant to ensure that parents of industrial loan companies or other (IDIs) that are not BHCs come under the Bureau. However, many non-BHC parents have far smaller asset profiles due to their non-traditional business models. As a result, strategic acquisitions of mid-sized regional banks and/or sweeping M&A transactions in areas such as payment services housed in a bank target might be judged more leniently than less ground-breaking BHC transactions.

Although this legislation is principally aimed at M&A, it would also affect BHC applications and notices for new or revised nonbanking activities by subjecting them to most of the bill's tests and restrictions. This would have the effect – likely intended – of reducing the extent to which BHCs can organically engage in nonbanking activities, restricting their complexity but also adversely affecting income-stream diversification and overall efficiency. New limits on U.S. bank foreign direct investment would have similar effects.

As discussed in more detail below, the measures also include an array of provisions that make any IDI or BHC subject post- acquisition or expansion to an array of public-interest objectives ahead of and after any planned transactions because approval depends not only on the traditional safety-and-soundness, managerial-capability, and Community Reinvestment Act criteria, but also on many

[1] See *Client Report* **MERGER6**, July 9, 2021.

new fair-lending, employee-benefits, environmental-justice, community-service, and stringent competitiveness conditions. Indeed, the measure appears to view most, if not all, banks as public utilities governed by public-interest criteria that dictate the extent to which shareholder return is achieved. To the extent these mission-based requirements prove incompatible with successful business models, regulated finance may become a niche business while risks increase and public interests are at best minimally served outside the regulatory perimeter.

In addition to these structural changes, the measures also make procedural changes designed to make transactions far more difficult. For example, the FRB would need to stress test proposed combinations to ensure they have high capital surpluses. While these would indeed enhance solvency, they may also so threaten shareholder return as to scotch covered transactions. This would sharply reduce consolidation and perhaps risk, but also increase banking-sector inefficiency and capacity to innovate, likely exacerbating sectoral decline due to heightened regulatory arbitrage by nonbank and tech-platform competitors. To the extent this regulatory arbitrage results in unbundled products that undermine financial intermediation, economic growth – especially for under-served communities – could be adversely affected.

The measures also aim at transaction transparency. One of the rationales behind the measure is the argument that the Federal Reserve is unduly lenient to bank M&A because no transaction has been disapproved in recent memory. The industry has countered that approved transactions often differ markedly from those that might have been made because the Fed advises the terms on which deals may proceed. The measure now includes what might be called "prove-it" provisions mandating extensive and virtually immediate disclosures of any transaction pre-negotiation. Companies desiring regulatory input would thus need to make M&A offers public in concert with applications facing uncertain fates. While indisputably increasing transparency, this process also ensures early release of transaction terms and conditions that might not only be problematic to regulators, but also in the marketplace. The "lock-up" and related provisions that give shareholders transaction buffers would be far more challenging to construct, and consolidation, innovation, and expansion made considerably more difficult. The bill does include a limited exception for emergency mergers, but only when failure to consummate a deal has systemic consequences on which most of the FSOC agrees.

What's Next

S. 2882 was introduced on September 29 by Sen. Elizabeth Warren (D-MA); the House companion was dropped on the same day by Rep. Jesús "Chuy" García (D-IL). No legislative action has yet been scheduled on these measures.

However, the bills come at a time of extensive debate about bank-merger policy. This comes not only from the White House, but also the Department of Justice's bank-merger review.[2] The banking agencies are also in transition,

[2] See *Client Report* **MERGER5**, September 2, 2020.

bringing in appointees and confirmed officials more closely aligned with the goals behind these bills. Even the Fed – traditionally more insular and focused on M&A prudential impact – has felt the political heat. Many M&A and expansion transactions have thus been in lengthy limbo. This may end if Chairman Powell is confirmed to a second term, but his colleagues on the Board may nonetheless share at least some of the concerns laid out in this legislation or feel compelled to endorse them during the confirmation process.

Analysis

Many of the provisions detailed below also apply to savings-and-loan holding companies.

A. CFPB

The Bureau would need within 180 days of enactment to establish procedures for reviewing bank/DIHC acquisitions of parties resulting in a company with more than $100 billion in assets. Approval would be conditioned on consumer compliance and systems capacity necessary to ensure ongoing compliance. These rules would need to include a thirty-day comment period for such applications, with prior written approval from the CFPB essential for any lawful bank acquisition of any entity that directly or indirectly provides consumer-financial products or services.

B. Cost-Benefit Analysis

Banking agencies could not approve any IDI acquisitions unless public benefits are found to outweigh expected public cost judged by factors such as consumer-service costs, branch closings, and local economic impact. Similar standards apply to BHC merger transactions, and BHC expansion into new activities even without need of an acquisition would also be subject to this cost-benefit test.

C. CRA Performance

IDI and BHC M&A transactions could not be approved if the largest IDI in the transaction had anything less than an outstanding CRA record in two of the last three CRA reviews or its most recent evaluation. New community-benefit plans would also be required for approval, based on mandatory consultation with community groups and a public hearing if any transaction party has a substantial noncompliance or needs-improvement rating in any of its assessment areas. The bill also prescribes the content of these community-benefit reports (e.g., measurable standards). As with cost-benefit analyses, these community-benefit standards also apply to BHC applications or notices for new or revised activities.

D. Fair Lending

CRA review would also need to include statistical fair-lending analyses using HMDA data.

E. Financial-Stability Criterion

Larger IDI and BHC transactions also require assessment of the systemic risk that might result from the IDI's failure as well as the stability implications of the transaction's competitive implications. Systemic risk would be judged by Basel's standards,[3] not those of the Fed,[4] with this review mandated at a score far below those at which GSIB status applies.

F. Financial Criteria

BHC combinations with resulting assets of $100 billion would be stress tested by the Fed on a pro forma basis to assess capital resilience under adverse and seriously-adverse scenarios. Acquisition would be barred if capital adequacy is not demonstrated on a new schedule requiring BHCs with assets over $100 billion to hold more than fifty percent of the minimum ratios to be considered well-capitalized. Smaller BHC acquisitions would need to demonstrate adequate capitalization under current standards, with the measure apparently requiring stress testing for all transactions.

G. Governance

The measure also requires extensive disclosures related to directors and senior management at IDIs and BHCs over $100 billion resulting from M&A transactions. Transactions would need to be rejected if covered persons are not deemed competent or experienced or lack the "character" and integrity to perform their duties on behalf of the IDI, shareholders, or the public.

The bill's establishment of a public-service obligation for corporate officials sets precedent in this area. Similar requirements would apply to BHCs with assets over $100 billion proposing to expand their nonbank activities.

Regulatory evaluations of each individual would be made public after the transactions is approved or denied.

3 See **GSIB13**, *Financial Services Management*, July 13, 2018.

4 See **GSIB7**, *Financial Services Management*, July 23, 2015.

H. Competitive Impact

1. Overall Criteria

Regulators would also need to consider a transaction's competitive impact with regard to:

- bank product and services "clusters" and a set of products defined in the legislation;
- geographic markets;
- tighter quantitative standards (i.e., the HHI);
- the potential for "too big to fail" designation (although this status is not accorded by any U.S. agency);
- increased conflicts of interest;
- reduced product quality, including with regard to branch-office access;
- the potential for consumer-data "exploitation";
- systemic stability;
- wages and working standards;
- environmental risks; and
- any other factors selected by the agencies.

2. BHC Activities

Criteria similar to those listed above would also apply to BHC notices or applications for new and revised activities. Drafting is not always clearly specified to non-acquisition transactions although this appears to be the bill's intent.

I. Transparency

Provisions here require disclosure of the extent to which parties to an IDI or BHC acquisition have any prior discussions with the Fed, naming names and detailing any such communications. Updates no later than two days after any new regulatory contact would also be required. The IDI's CEO would also need to certify that no agreement about likely approval had been received during any of these discussions with the Fed or any other regulator. All of these disclosures and the certification would also be made public. Similar requirements also apply to BHC activity notices or applications.

J. Systemic-Risk Assessment

Transactions that might otherwise be disapproved under all of the conditions could still proceed if the FSOC by a two-thirds vote agrees that it is necessary. The bill also requires a nonbank supervised by the FRB as a SIFI to provide the Fed with prior notice of any acquisitions other than an IDI. The revised BHC approval criteria described above would then apply.

K. Foreign Acquisitions

Direct offshore investments by U.S. banking organizations would require express FRB (not Reserve Bank) consent pursuant to new rules the FRB must issue.

L. Citizen Protests

Any merger approval or disapproval by the regulatory agencies or a BHC notice to the Fed could be challenged in federal court by any U.S. citizen regardless of whether they filed a comment or otherwise participated in the transaction's review. The relevant federal court would then have to consider this challenge under expedited procedures specified in the bill. The citizen protester cannot be required to pay for these court cases and the merger or transaction could not proceed until it is resolved.

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