Federal Financial Analytics, Inc.

# MEMORANDUM

**TO:** Federal Financial Analytics Clients

**FROM:** Karen Petrou

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On Wednesday, a Senate Banking subcommittee will consider bank-merger policy, surely providing a platform for its chair, Sen. Warren's pronounced views opposing all but the smallest bank mergers and maybe not even those. Many other senators are not as adamant, but even pro-business Republicans – see J.D. Vance – think bank mergers beyond the itty-bitty are at best problematic. The politics of this debate is obvious; the substance not so much. As with many other questions, bank-merger policy is best set with a keen understanding of recent, objective research and what it actually says about concentration as it occurs outside the gaze of those fearful only of still bigger big banks.

That there is undue market power in a financialized economy that brings a raft of woes is all too clear. I thus hoped that Assistant Attorney General Kanter's remarks last month would be a meaningful update of the Department of Justice's anachronistic 1995 policy. It helped, but only a bit because Mr. Kanter focused principally on enforcement, leaving "broader" questions solely to the banking agencies.

They in turn have long promised a transparent merger policy, but it's still deal-by-deal, case-by-case, crisis-by-crisis. More than a few mid-sized banks will wither away as deliberations continue because the sheer uncertainty and delays of most bank mergers undermine their economic value, particularly at a time of high interest rates, slow or no growth, tough new rules, and withering competition.

Recent antitrust research does not substantiate easy, blanket assertions about the benefits or the evils of all forms of bank consolidation. Sometimes it's for the public good, sometimes not. Knowing which is which is what DOJ and the banking agencies keep promising. Until they do, there's a significant danger of ill-considered transactions accomplished more by dint of astute arbitrage than structural merit.

Case in point: antitrust authorities and the banking agencies generally fail to consider the extent to which any identified, adverse merger consequences could be readily corrected by banking regulators, who of course have wide dominion over the practices, products, markets, and risks at each bank and across the industry as a whole. Regulatory fixes can come in two ways: stipulations on banking organizations in areas such as new powers, CRA, and resolvability or via actions that enhance the competitiveness of banking as a whole. With a policy, banking agencies could use their power; without one, few deals get done and more banks see little future.

A study of horizontal bank mergers – i.e., when banks acquire banks – shows the impact bank regulation can have on market outcomes. As in another study, it finds that horizontal bank mergers in highly-concentrated markets generally reduce pre-merger concentration because new banks enter the market.

Or at least they did once upon a time. Now, there may still be new competition entering temporarily-consolidated markets, but it's more likely to come from the very biggest banks or nonbanks. There has been a significant drop in the number of de novo bank charters since the great financial crisis, a change even the FDIC attributes in part to post-crisis rules only recently and sort-of relaxed. Combined with the full weight of post-crisis bank rules, it has proven difficult for start-up banks planning to provide financial-intermediation to attract investors. If regulators and politicians really want more small banks close to under-served communities, research suggests that the best way to achieve this is to allow sound regional-bank consolidation that enhances midsized-bank efficiencies along with opening markets to smaller banks able to profit by highly-targeted services to specific communities.

Because so much focus in bank merger policy and politics is on horizontal deals, little attention has been paid to vertical mergers in which banks deepen market power or enter new markets via M&A. The most significant standards applicable here are the 2020 rules defining "control" when banks buy into nonbanks or nonbanks take stakes in banks. These rules were crafted in large part by Randy Quarles and allow a lot of integration without formally constituting a merger or acquisition triggering Fed, FTC, or DOJ scrutiny.

Although horizontal deals are essential to long-term regional-bank viability, it's usually easier for a larger bank to grow in scale or scope by selective nonbank acquisitions than to undertake a horizontal deal triggering a raft of reviews. It's not that these targeted deals are immune from regulatory scrutiny, but it's a lot lighter if control isn't involved and still far less onerous even if it is as long as the entity over which a bank exerts control isn't another bank. These deals may improve bank efficiency and/or technological capacity, but some could also concentrate market power. Which is which is set case by case, not via the policy essential in this critical arena.

Perversely, vertical integration is even easier if it involves a nonbank that only wants to cherry-pick the nicest bits of a regulated bank. Does this make sense in an era of draconian horizontal bank merger restrictions and rampant nonbank regulatory arbitrage? Of course not, but thus it is.

There are also significant market-power problems in the financial sector even when no bank dares breathe its name. When no entity in a merger is a bank but does a business critical to banking – think mortgage origination, servicing, and customer-platform technology – Department of Justice or FTC analyses historically and to this day look principally at concentration, not safety and soundness, let alone financial stability. This means that high-risk deals could well scoot through – as we thought in the ICE/Black Night deal, market power becomes a formidable financial-stability risk if a deal involves a firm already deemed systemic due to its gigantic clout in key derivatives markets under only limited prudential regulation. Would the FTC have thought to look if not shown the way to this high-risk door? We're told not.

Will any of this come up at the Wednesday hearing? As of this writing, the full witness list isn't published, but also as of this writing, it probably doesn't have to be for one to forecast that the session is sure to be a barrage against too-big-to-fail banks and their nearest neighbors in the super-regional fraternity. Legitimate questions can and should be raised about the deal allowing JPMorgan to buy First Republic – indeed, they have been raised. But the uppermost question is not why JPM got even bigger, but why federal regulators knew of no other way to resolve a mid-sized regional bank. There are many lessons to be learned from recent failures, but they're not about bank mergers – they're about bank regulators.