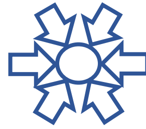
Horizontal Bank Mergers:
Critical Industry Infrastructure in Harm's Way



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- Current law and rule give the banking agencies little-used tools to prevent conflicts of interest, concentration and risk transmission from an IDI to its holding company or other investors. These should be fully deployed to provide essential market-integrity controls and limit the need to merge to compete.
- When this is done, bank-merger standards should focus on safety-and-soundness, systemic risk, and community/consumer obligations without reliance on arbitrary size or activity restraints.
- DOJ bank-merger review should focus on market-integrity and competition questions the banking agencies may not address, doing so with particular attention to the current and prospective role of nonbanks in like-kind markets.
- The FDIC's rationale for stringent merger policy rests on its self-acknowledged inability to resolve regional or larger banks. If sound mergers do not advance, weak banks will erode and even fail, leaving communities far worse off and the FDIC at greater risk than if it were able to do the job with which Congress has charged it.

Thank you, President Schmid, for convening a conference opened to such good effect earlier today by Governor Bowman. I am glad to join a discussion of bank-merger policy that could not be more timely given evolving policy from all of the banking agencies and antitrust authorities combined with the powerful profit squeeze many banks are experiencing.

The first question to which I'll turn this afternoon is akin to the one soon to be asked at Passover seders: why are banks different from all other firms? All other U.S. private ventures are subject to market-power scrutiny only when they take action to change it through M&A or, increasingly, when their

footprint has grown so big that small-fry are squashed. This reflects longstanding tradition that firms are free to grow or acquire other entities as long as they do not threaten consumers of all sorts, the ability of the economy to innovate, and the ability of new entrants to survive on their own.

Banks are, though, subject to three levels of market-power scrutiny: one due to embedded provisions of law and rule to prevent banks from market dominance derived from unique charter advantages, another embodied in banking-agency merger review, and a third via top-level antitrust assessment from the Department of Justice. This makes less sense than it used to in part because the banking agencies aren't using the powers they have to ensure that merged banks do not use greater size to adversely affect market integrity and access well before mergers are even contemplated. If these regulatory powers were fully deployed, it is likely that fewer mergers would be necessary because the inappropriate of bank market power would be considerably more difficult. It's past time to reinvigorate supervision and regulation when it comes to conflicts of interest and concentration derived from unique bank privileges – if any are still to be had. Bank-merger policy would then focus on safety-and-soundness and community need while the Justice Department does whatever else is needed to preserve broader market integrity and competition.

I'll turn also to another fundamental question: what criteria should dictate agency and DOJ merger-transaction approval after the parties demonstrate full and forward-looking compliance with market-integrity and prudential standards? As I'll discuss, the FDIC has now decided that big banks generally cannot merge even with smaller or weaker banks because it is unable to close a large insured depository. This means that banks cannot adapt to market forces that dictate sound growth to ensure viable franchises even when M&A rings no safety-and-soundness or antitrust bells.

If the FDIC keeps banks small because it can't close large ones, it will doom those that need a new lease on life to eventual rigor mortis or painful demise. This perverse consequence will of course do nothing to ensure the future of community and rural banking, although it might give private-equity firms and GSIBs juicier pickings in the next stress scenario.

<u>The Fair-Competition Rulebook</u>

One pillar of both the Bank Merger Act and the agencies' merger policies is that banks are different than other companies because banks have unique access to public benefits thanks to their chartered express, statutory public-good mission. I will leave for another day the question of just how unique taxpayer backstops are to regulated banks in the wake of so many bail-outs and emergency-liquidity facilities, but it remains the case that banks are subject not just to layers of antitrust law and rule beyond that governing all other companies, but also to many pages in the prudential rulebook mandated in law to block banks from using their unique public privileges for private profiteering. These are sometimes lost in rulebook obscurity, but they are critical to considering the proper configuration of bank-merger policy. Knowing where bank conflict, concentration, and activity standards end is vital to knowing where antitrust constraints should begin.

Bank-merger policy is having a makeover due to pending proposals from the OCC[1] and FDIC.[2] Although the Federal Reserve's ostensible policy has been unchanged since 1995,[3] its actual decisions often break new ground – see, for example, the prophylactic application of category II standards to US Bancorp in its Union Bank acquisition.[4] Much in all of these actions is said to address safety-and-soundness considerations, considerations buttressed by Dodd-Frank's demand that merger review now also consider financial-stability risk.[5]

But, how much of this is necessary in merger review and how much could be accomplished by better prudential regulation along with vigilant supervision and meaningful enforcement? Even more importantly, what should bank-merger policy really look like if the banking agencies use the manifold tools they have in current law and rule to address many of the most important ways in which market power distorts market integrity and fair access?

I am indebted in this thinking to a recent paper from Saule Omarova and Graham Steele,[6] a Biden nominee to be Comptroller and former Treasury Assistant Secretary. There is much with which I disagree in the paper, most notably that it wants double-barreled prudential standards and merger policy that would do the same thing twice via new prudential rules and still more sweeping antitrust thresholds from both the banking agencies and DOJ. Still, the paper is the first I know to make an important, often-overlooked point: much in banking law and rule for many years limits and in some cases bars bank use of whatever special privileges they still enjoy.

What if the banking agencies deployed them, added a vital safety-and-soundness and financial stability overlay along with other statutory merger factors, and then left it to the Justice Department to assess market-configuration, pricing, information dominance, and other critical issues that arise in almost all mergers and most especially in large ones, bank or nonbank?

Many safety-and-soundness standards are in fact aimed at limiting the risk-taking that comes with undue market advantage. A short list prompted in part by the Omarova/Steele paper includes inter-affiliate transaction restrictions to protect insured depositories from the ravages possible from nonbank-affiliates and anti-tying constraints in the Bank Holding Company Act (restrictions the Fed ignored in Silicon Valley Bank and to this day seems to think optional).

Even more potent restrictions bar banks from commerce to ensure fair financial competition. It's important to remember that allowing banking and commerce to cohabit is not necessarily unsafe; indeed, it's likely safer than the current ban if one thinks of portfolio-diversification theory and the hard experience of monoline firms. Congress mandated what it hoped would prove a firewall between banking and commerce to prevent banks from using unique privileges to support only favored companies or ventures that returned the favor. The integrity of financial intermediation hangs in the balance, or at least it did until the last decade or so when nonbanks began so adroitly to cherry-pick key points of value in the intermediation chain.

There are also unique, broad director-interlock restrictions and – again unique to banks – a prohibition on being a bank without a federal charter binding the company not just to compliance with many rules above and beyond those I've mentioned, but also with a public-service obligation via the Community Reinvestment Act. Even the government-sponsored enterprises have more lenient public-service obligations than banks. They are also not barred by express growth ceilings like those crimping bank mergers outside systemic rescues for banks with more than a ten percent deposit share.

Is This Enough?

Of course not. Banking-agency merger review can and should ensure that a new company will honor all of these obligations diligently and without added risk to the financial system or macroeconomy.

However, this is not the same as ensuring that merged banks are impregnable. The most puzzling aspect of the FDIC's proposed merger policy lays out why the agency will approve very few mergers because it fears that all but the smallest and simplest flummox its resolution capability. This is a

shocking admission that the FDIC cannot do the job for which it was chartered in 1932 and greatly empowered even for systemic crises in 2010, but so it is. To quote:

> In particular, the failure of a large IDI could present greater challenges to the FDIC's resolution and receivership functions, and could present a broader financial stability threat. For various reasons, including their size, sources of funding, and other organizational complexities, the resolution of large IDIs can present significant risk to the Deposit Insurance Fund (DIF), as well as material operational risk for the FDIC. In addition, as a practical matter, the size of an IDI may limit the resolution options available to the FDIC in the event of failure.[7]

In short, the FDIC's merger policy must ensure that merged banks cannot fail because the FDIC can't handle a failed bank. Read literally, banks of size or complexity cannot merge to meet new market conditions in a manner found to be satisfactory from both a prudential and competitive perspective because the FDIC can't honor its obligations to ensure that a merged company's failure hurts only the investors who thought it wise, executives who likely profited mightily thereby, and counterparties that should have known better.

This policy rationale is still more puzzling when one reads on in the FDIC's proposal. For example, it would bar mergers only if it believes that communities will be better served by the new bank rather than by allowing each bank to remain as is. No franchise-viability consideration is mentioned as an offset to this criterion, meaning that two banks with outstanding CRA ratings might be forced to remain as is even if one of them had sagging profits and a dubious future without new capital.

Here, as elsewhere in the proposal, the FDIC appears to be forcing banks to the brink of failure or beyond before contemplating a permissible merger no matter that it also says it wouldn't know what to do with the merged bank should it land on the resolution doormat.

Conclusion

A raft of reasons – technological change, costly rules, rapacious nonbank competition for starters – makes it most unlikely that many banks will be able to maintain market-essential return on investment solely via organic growth. Will investors be satisfied as uncompetitive banks are confined to the businesses that unregulated competitors discard even if banks can stay in these less-profitable areas without new capital or capabilities? Will this ensure the continuation of the relationship banking that distinguishes smaller banks if smaller banks cannot meet investor demands and thus buy into the new technological and regulatory environment? Will communities really be better served if the only financial entities left to serve them under an affirmative duty to do so fade away or, worse, fail?

Banks without sound merger options are banks without a viable business future and many will fail because no one can buy them and then put them to better use. Perhaps the FDIC will figure out how to resolve banking organizations and also be ready to deploy its orderly liquidation authority because some of the banks will be big. Let's hope so.

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