

When Do Acquisitions Endanger the Financial System?

BY DAVID A. PRICE

In the Dodd-Frank Act of 2010, passed in response to the 2008-09 financial crisis, Congress directed regulators to carry out a “financial stability review” when banks and some other financial institutions seek approval for mergers and acquisitions. Congress did so based on concerns that the crisis had been driven in part by the scale of the largest institutions, and the dependence of the rest of the financial sector on their soundness. The law therefore requires the Fed and other regulatory agencies to consider whether a proposed merger or acquisition would lead to increased systemic risks to the stability of the U.S. financial system. The Fed’s approval in February of an acquisition by Capital One Financial Corp., a Fifth District institution, provided some insight into how the Fed will assess those risks.

Capital One, based in McLean, Va., had requested the Fed’s approval to acquire ING Bank of Wilmington, Del., which had no branches, but which did business nationally through the Web. Measured by the amount of deposits, Capital One and ING Bank were the eighth-largest and 17th-largest depository institutions in the United States, respectively. After the proposed merger, their combined size would make the resulting enterprise the fifth-largest depository institution in terms of deposits and the 20th largest in terms of assets.

After Capital One submitted its application for approval to the Richmond Fed, the Richmond Fed transferred it to the Board of Governors in Washington, D.C. It did so because the financial stability review was a new requirement and because public interest in the case was high, according to Sabrina Pellerin, bank structure manager at the Richmond Fed. The Board held several public hearings on the application and received hundreds of letters pro and con.

The Dodd-Frank Act added the stability review to an already-existing set of requirements for assessing mergers and acquisitions. In addition to financial stability, the Fed was required to determine, among other factors, whether Capital One’s proposed acquisition would have a significantly adverse effect on competition, whether its financial and managerial resources would be adequate for the acquisition, and whether it had a good record of performance under the Community Reinvestment Act. In connection with that review, the Board did not find any basis to disapprove the application, but it did impose conditions related to compliance with fair lending and other consumer protection laws.

With regard to the stability review itself, the Board said it would consider “a variety of metrics.” The metrics that it named were the size of the combined firms as a share of the overall size of the U.S. financial system, the availability of

substitutes for any “critical” products and services offered by the firms, the interconnectedness of the firms with the rest of the banking or financial system, the extent to which “the resulting firm contributes to the complexity of the financial system,” and the extent of its international activities.

But the Board stopped short of specifying numerical limits on these measures that would lead to disapproval, apart from limits already written into federal law (such as the limit of a 10 percent share of nationwide deposits or nationwide liabilities). The Board also stated that it would consider qualitative factors, such as the complexity of the institution’s internal organization, that would shed light on the likely difficulty of resolving the institution in case of financial distress. In addition, the Board indicated that its lists of quantitative and qualitative factors were not all-inclusive.

Applying this guidance to Capital One’s application, the Board found that although the acquisition would leave it “large on an absolute basis,” its assets, liabilities, leverage exposures, and deposits relative to the U.S. financial system as a whole — between 1.1 percent and 2.3 percent, depending on the metric — would be “modest.” Because the business of the combined firm would be mainly in traditional retail banking activities that are competitive, the Board determined that the availability of substitutes was not a concern. The Board also found no issues regarding interconnectedness, complexity, or international activities.

The approach described by the Board in the Capital One case, with its reliance on case-by-case judgment, was somewhat in contrast with the approach set out in November by the Basel Committee on Banking Supervision for identifying global systemically important banks. The Basel Committee’s framework relies on a series of formulas to arrive at weighted scores that represent a bank’s level of systemic importance. The scores can be overridden on the basis of supervisory judgment, but only in “exceptional” cases.

The Board did announce numerical cut-offs in its Capital One decision for one part of its acquisition approval process: It stated that if a proposal involves an acquisition of less than \$2 billion in assets, results in a firm with less than \$25 billion in assets, or is a reorganization of an existing holding company, then it “may be presumed not to raise financial stability concerns” unless there is evidence to the contrary.

Future acquisition applications referred to the Board may yield more detailed insight into the Board’s approach. In an *American Banker* online poll in February, following the Capital One announcement, a plurality of 46 percent of respondents held that “until the Fed actually rejects a deal, it’s hard to tell whether the line has shifted.” **RF**