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A Path Forward for Bank Acquisitions

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The Federal Reserve's approval recently of Capital One's application to acquire ING Bank, fsb, taken together with its December approval of PNC's proposed acquisition of RBC Bank (USA), marks a path forward for bank acquisitions. Despite broad industry concerns about unrealistic capital expectations by the regulators and Dodd-Frank's mandate that the Federal Reserve consider financial stability risk factors in M&A applications, Capital One and PNC demonstrate that with advance preparation and thoughtful structuring, it is possible for large banks to navigate the regulatory process and make strategic acquisitions. However, the regulatory process has clearly changed post-crisis, and larger banks should be prepared for a more extended and thorough vetting of their acquisitions by the regulators.

The Federal Reserve processing of the Capital One and PNC filings took approximately seven months and four-and-a-half months, respectively. The Capital One processing was extended as a result of a large number of internet-based protests organized by certain community groups, three public hearings and the Federal Reserve's refinement of its framework for evaluating financial stability risk. Going forward, acquirors should expect renewed regulatory focus on consumer and CRA compliance matters and inquiries concerning all allegations raised by community groups and others, even those that may be regarded as non-substantive. Acquirors will need to demonstrate the sufficiency of their compliance and other risk-management systems, including in connection with their expanded operations and increased size.

Both Capital One and PNC consulted extensively with Federal Reserve staff prior to entering into their transactions regarding their proposed deals and their operational, capital and financial impact, integration plans and resources. Moreover, as part of due diligence, these acquirors conducted stress tests for both their own and regulatory purposes. During the processing period, Capital One and PNC provided Federal Reserve supervisory staff with updated capital plans to reflect the proposed acquisitions, and submitted detailed pro forma financials.

In each case, the Federal Reserve determined under a new regulatory framework that an acquisition of primarily retail banking organizations by a large bank holding company would not materially increase the risk to financial stability of the U.S. financial or banking system. Importantly, the Federal Reserve confirmed that the resulting increase in size of these bank holding companies, alone, was not the determinative factor in its assessment of financial stability risk.

The Federal Reserve in each case evaluated the likelihood that a failure of the resulting firm may materially damage the broader economy due to:

- the size of the resulting firm,
- a reduction in the availability of substitute providers for the services offered by the resulting firm that are critical to the functioning of the U.S. financial system,
- the extent of the resulting firm's interconnectedness with the rest of the U.S. financial system,
- the degree to which the resulting firm contributes to the complexity of the U.S. financial system, and
- the extent of the resulting firm's cross-border activities.

These factors correspond to those considered by the Basel Committee on Banking Supervision in identifying global systemically important banking organizations. The Federal Reserve's reviews, however, are broader, rely on different metrics and differ in certain other respects. The Federal Reserve considered these factors and other criteria, individually and in combination. In addition, the Federal Reserve evaluated the relative degree of difficulty of resolving the resulting firm, including after considering the extent of the opaqueness and complexity of the firm's internal organization. This suggests that the quality of an organization's resolution plan, or "living will," could become relevant in the Federal Reserve's financial stability risk analysis.

The Federal Reserve's orders indicate that an adverse effect on financial stability must be "significant" and the expected resulting damage must be "material." In addition, the impact on the ability of other financial institutions to conduct business or the disruption to credit availability or financial services must be "serious." This indicates that highly theoretical effects or potential effects below some reasonable threshold will not bar a transaction under the financial stability risk factor. Importantly, the Federal Reserve acknowledged that certain transactions may be presumed not to raise financial stability concerns (absent significant increases in interconnectedness, complexity, cross-border activities or some other factor)—i.e., an acquisition of less than $2 billion in assets resulting in a firm with less than $25 billion in total assets or a corporate reorganization.

Parties, particularly where the acquiror has consolidated assets exceeding $50 billion (those subject to more stringent supervision) or even $25 billion, should carefully assess proposed transactions under the Federal Reserve's framework for evaluating financial stability risk. As part of due diligence, potential acquirors should develop a persuasive case as to why the proposal would not materially increase such risk. Any offsetting stabilizing features of a proposed acquisition should be identified and noted. Such an analysis is even more critical for proposed acquisitions involving more complex or interconnected organizations than Capital One or PNC or their respective targets, or those engaged in critical financial services with few substitute providers or significant cross-border activities.

Although the Capital One and PNC approvals contain new regulatory standards and analytical frameworks, they reaffirm that despite the challenging regulatory climate and the thicket of new regulations resulting from by Dodd-Frank, bank M&A is alive and well. In this slow growth environment, industry consolidation will continue to play a vital role in returning the banking industry to health. The challenges presented by bank M&A in the current environment require careful advance planning and time and effort between signing and closing. But, as PNC and Capital One have demonstrated, the resulting opportunities are both considerable and attainable. Just as importantly, they have marked a regulatory path for other acquirors to follow.