SIMPSON THACHER MEMORANDUM

The Federal Reserve's Evolving Financial Stability Analysis in Bank and Nonbank Acquisitions

February 17, 2012

On February 14, 2012 the Board of Governors of the Federal Reserve System (the "Federal Reserve") issued an order approving Capital One Financial Corporation's proposed acquisition of ING Bank, fsb. The Capital One order, together with the Federal Reserve's earlier order approving the acquisition of RBC Bank (USA) by The PNC Financial Services Group, Inc.,[1] are the first interpretations of the new "financial stability" factor, which the Federal Reserve is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") to consider in connection with approving acquisitions.

The Federal Reserve describes in the Capital One order the quantitative metrics and other qualitative factors it will use to assess the impact of a proposed acquisition on U.S. financial stability. The metrics give the Federal Reserve substantial flexibility to assess systemic risk, as discussed in detail below. Although the transaction significantly increased Capital One's size (from eighth to fifth largest depository in the U.S. by deposits), this was not considered an adverse factor by the Federal Reserve, despite critics of the deal who generally oppose larger banks. The analysis suggests that while large bank acquisitions will not be discouraged, at least among domestically-focused U.S. institutions engaged principally in traditional banking activities, acquisitions among the very largest institutions (which have reached, or are approaching, the nationwide deposit cap) or those engaged in more complex, foreign or other activities that would complicate their resolution in the event of distress, may involve challenges under the new financial stability standard.

BACKGROUND

Dodd-Frank added a new, so-called "financial stability" factor to the criteria used by the Federal Reserve in evaluating mergers and acquisitions between banking organizations and acquisitions by banking organizations of nonbanking companies. The Federal Reserve must now take into consideration the risk to "the stability of the United States banking or financial system" posed by such transactions.[2]

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1 On December 23, 2011, the Federal Reserve issued an order approving the acquisition by The PNC Financial Services Group, Inc. of RBC Bank (USA).

2 Section 604(d) of Dodd-Frank requires the Federal Reserve to take into consideration the extent to which a proposed bank merger "would result in greater or more concentrated risks to the stability of the United States banking or financial system." Similarly, for acquisitions by banking organizations of nonbanks, Section 604(e) of Dodd-Frank requires the Federal Reserve to consider whether a proposed transaction presents "risk to the stability of the United States banking or financial system." A financial stability factor was also added to the Bank Merger Act by Dodd-Frank. *See* 12 U.S.C. § 1828(c)(5); Dodd-Frank, § 604(f).

The Capital One and PNC orders provide a framework, compatible with the Basel Committee on Banking Supervision's methodology for identifying global systemically important banks,[3] for evaluating the impact on U.S. financial systemic risk going forward.

THE FEDERAL RESERVE'S FINANCIAL STABILITY ANALYSIS

General Standard. In general, the Federal Reserve will "find a significant adverse effect [on financial stability] if the failure of the resulting organization, or its inability to conduct regular-course-of-business transactions, would likely impair financial intermediation or financial market functioning so as to inflict material damage on the broader economy." The Federal Reserve notes such damage could occur by "seriously compromising the ability of other financial institutions to conduct regular-course-of-business transactions or seriously disrupting the provision of credit or other financial services."

Metrics. The Federal Reserve employs in the Capital One order five quantitative metrics—which it considered independently and in combination—to assess the likelihood that failure of the resulting organization may inflict damage on U.S. financial stability:

- *Size*—The Federal Reserve considered Capital One's size relative to the U.S. financial system, measured in terms of its rankings and shares for consolidated assets, consolidated liabilities, total leverage exposure and U.S. deposits. While the Federal Reserve acknowledged the resulting organization's large absolute size and the increase in its rankings in many of these categories, it found more significant that Capital One's shares in all categories remained relatively small (the largest being a 2.3% share in deposits) and "well below the 10 percent limitations set by Congress."[4]
- *Substitutability*—The Federal Reserve examined whether the institutions engage in any activities that are critical to the functioning of the U.S. financial system and whether there would be adequate substitute providers that could quickly step in to perform such activities should the combined organization suddenly be unable to do

3 *See* Basel Committee on Banking Supervision, "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement," November 2011, *available at* http://www.bis.org/publ/bcbs207.pdf. While the factors and metrics considered by the Federal Reserve are similar to the Basel Committee's approach to assessing the systemic importance of globally active banking organizations, the Federal Reserve's approach to measuring financial stability differs in significant respects. The Federal Reserve's metrics are broader and focus on the resulting organization's position within the United States (rather than global) financial system. Moreover, the Basel Committee determines significance on the basis of a weighted average of all criteria, while under the Federal Reserve's more flexible qualitative approach, any *one* factor could cause a transaction to be deemed to pose unacceptable risk to U.S. financial stability.

4 The Federal Reserve noted in the Capital One order that Congress has placed other limits on the nation's largest financial institutions that are helpful indicators of potential systemic risk, including the 10% nationwide deposit cap, a 10% nationwide liabilities limit, and Dodd-Frank's "enhanced prudential standards" for bank holding companies with $50 billion in assets and other systemically important financial firms.

so as a result of severe financial distress. The Federal Reserve found that, in the case of most of Capital One's activities, the resulting organization would have a small market share on a nationwide basis and numerous competitors would remain in the market. With regard to the market for credit cards—historically Capital One's principal product—the Federal Reserve noted that although the resulting organization would be the fourth largest card issuer, with approximately 12% of the market, three competing lenders would have substantially larger outstanding credit card books, leading the Federal Reserve to conclude there would be no significant disruptions in the supply of credit card loans if the bank were to experience distress.[5] In many respects, the Federal Reserve's quantitative analysis as to substitutability resembles an antitrust analysis, which focuses on market share, ranking and the availability of new entrants or other likely competitors.

- *Interconnectedness*—This metric examined whether financial distress within the combined organization could be transmitted to other U.S. institutions or markets. The Federal Reserve concluded that Capital One does not engage in activities that pose significant risks to other institutions, after looking at the combined organization's (i) use of wholesale funding as a share of U.S. wholesale funding overall, and (ii) shares of U.S. intra-financial system assets and liabilities and finding, in each case, that the resulting organization would have less than 1% of the market.[6] The Federal Reserve also noted that the transaction would not increase exposure to any single counterparty among the top-three counterparties of either institution prior to the proposed combination.
- *Complexity*—The Federal Reserve considered the extent to which the combined organization would contribute to the overall complexity of the U.S. financial system by looking at its complex assets,[7] trading book and available-for-sale securities—again, as a share of the U.S. financial system. Central to this analysis was the degree

5 This analysis suggests that, in addition to the largest, most complex banking organizations, organizations providing unique financial services (such as wholesale settlement or clearing) or operating in more concentrated markets (like certain payments markets), might have more challenges in meeting this criteria, notwithstanding their size relative to larger institutions.

6 In response to comments, the Federal Reserve also reviewed Capital One's share of the securitization market, finding its total share of all such securitizations to be less than 9%, and noting recent accounting and regulatory capital changes that require credit card securitizations to be consolidated on the balance sheets of the issuing banks that, among other factors, presumably reduce the riskiness of the financing source.

7 The Federal Reserve did not define the term "complex assets" in the Capital One and PNC orders. Under the Basel Committee's methodology (discussed above in footnote 3), an organization's complexity is assessed based on its gross notional value of non-centrally cleared (*i.e.*, OTC) derivatives and its Level 3 assets, as well as the other metrics considered by the Federal Reserve in assessing an organization's complexity.

to which the complexity of the combined organization's activities would complicate the resolution process.[8]

- *Cross-Border Activity*—Finally, the Federal Reserve reviewed the cross-border activities of the acquiring and target institutions to determine whether they would present difficulties in coordinating any resolution in the event the resulting institution experienced distress, thereby significantly increasing the risk to U.S. financial stability. The Federal Reserve noted Capital One's overseas credit card operations were "similar to" its U.S. operations and would not add any substantial complexity.

Safe Harbors. The Federal Reserve identified three types of transactions that could be subject to prior approval or notice under Section 3 or 4 of the Bank Holding Company Act, but that the Federal Reserve recognizes are unlikely to raise financial stability concerns:

- an acquisition of less than $2 billion in assets;
- a transaction that results in an organization with less than $25 billion in total assets; or
- a corporate reorganization.

Qualitative Factors. In applying its quantitative metrics, the Federal Reserve also considered qualitative factors that could add to the difficulty of resolving the resulting organization, such as the "opaqueness and complexity of an institution's internal organization," as noted above in the discussion of the metrics.

Conclusion. Building on a framework initially outlined in the PNC order, the Capital One order reveals a new regime of heightened regulatory scrutiny with regard to systemic risk mandated by Dodd-Frank. Acquisition-minded banking organizations should be prepared for this scrutiny. While the Capital One and PNC orders provide valuable insights for potential acquirers as to the factors the Federal Reserve will consider, the orders contain few bright line standards, and each transaction will be evaluated on the basis of its unique risk characteristics, within the evolving framework discussed in these orders.

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8 The Federal Reserve mentioned core clearing and settlement services—which Capital One does not engage in—as the type of "complex activities" that could complicate the resolution process.

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