The Financial Stability Factor in Bank M&A: Lessons from the BB&T Order

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In reviewing an acquisition under Section 3 of the Bank Holding Company Act, the Federal Reserve Board is required to consider, among other factors, “the extent to which a proposed [transaction] would result in greater or more concentrated risks to the stability of the United States banking or financial system.” In November, the Federal Reserve Board issued its Order approving the merger of BB&T and SunTrust. While much of the financial stability discussion in the BB&T Order was appropriately brief (and indeed tracked a 2012 Order approving an acquisition by Capital One), it is worth considering what a more in-depth analysis would include in a case of a larger financial services holding company or a company with significant activities housed in a non-bank affiliate.

In making its financial stability assessment, the BB&T Order considered five factors in determining the “systemic footprint” of the merged firm: size; substitutability of providers for critical products and services; interconnectedness; contribution to complexity of the financial system; and the extent of cross-border activities. These factors roughly align with the factors that the Board (and Basel Committee) has used to determine systemic risk for purposes of determining whether a firm is a “global systemically important bank” (GSIB) and thereby subject to higher loss absorbency requirements.

Still, while each factor is indicative of the systemic importance of a particular firm, none was specifically considered in the regulatory context in which the combined firm would operate, and therefore with an eye towards “the stability of the United States banking or financial system” – the statutory standard. Application of the standard in a case requiring a more detailed analysis would appear to require consideration of many additional factors – most notably, the capacity to resolve the merged firm – that the BB&T Order did not consider, or considered only briefly, as well as how those factors interrelate.

Set forth below is a description of how the BB&T Order assessed each factor, and what a more expansive analysis might look like in the context of an acquisition involving greater size or substantial non-banking assets.

**Size.** The Order’s statements on size did not provide a basis for translating increased size to increased risk to financial stability. The Order states:

An organization’s size is one important indicator of the risk that the organization may pose to the U.S. banking or financial system. Congress has imposed specific size-based limitations on the amount of deposits and liabilities a banking organization may control. In addition, section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act … requires the Board to apply enhanced prudential standards to bank holding companies with $250 billion or more in total consolidated assets. Size also is among the factors that the Board must take into consideration in differentiating among banking organizations under section 165.

Size can be an indication of systemic risk, but the Order contains no analysis of how size *per se* could translate to a threat to the financial stability of the United States banking or financial system, and the quoted observations seem inapposite. First, the fact that Congress chose to impose specific size-based limitations on the amount of deposits and

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1 Section 3 of the BHC Act generally requires prior approval of the Federal Reserve Board for any transaction that involves the merger or consolidation of bank holding companies or the acquisition by any bank holding company of a bank. 12 U.S.C. § 1842.
4 Id. at 54.
liabilities that a banking organization may control is a reason for the Federal Reserve to avoid, not pursue, a size-based analysis. Those provisions did not impose a 10 percent cap on bank deposits or financial company liabilities “or such lower percentage as the Federal Reserve might establish”; they grant the Federal Reserve no regulatory authority to lower (or raise) those standards. Second, the fact that Congress directed the Federal Reserve to apply enhanced prudential standards to banks over $250 billion is an explicit recognition that banks would continue to operate at that size, not a mandate to the Federal Reserve to determine whether they should. The comprehensive, rigorous regime applied above that asset level is designed to reduce any risk associated with greater size.

In an earlier case, involving the acquisition by Goldman Sachs of assets and liabilities of GE Capital Bank, the Board actually found that an increase in size would enhance financial stability:

[T]he transaction would provide GS Bank with approximately $17 billion in deposits, a deposit customer base, and a platform for increasing its deposit funding in the future. As a result, the proposal would immediately improve the stability of GS Bank’s funding profile by diversifying sources of funding and increasing stable funding and would allow the bank to maintain and further improve its funding profile in the future. This should enhance financial stability.\(^6\)

**Substitutability.** The Order states, “The Board has examined whether BB&T or SunTrust 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 perform such activities should the combined organization suddenly be unable to do so as a result of severe financial distress.” The analysis was rather brief, as the combined firm was primarily engaged in lending and deposit taking, for which there were innumerable substitute providers. Indeed, given the level of competition in U.S. financial services, there would seem to be few cases where there would not be substitute providers.

In the unlikely case where a firm did have substantial market share in products for which there were not a ready substitute, it would seem quite relevant that the purpose of the U.S. resolution framework under Titles I and II of the Dodd-Frank Act, as now implemented by the Board and the FDIC, is to ensure that a systemically important financial institution can not only suffer “severe financial distress” but actually *fail and be placed into bankruptcy or receivership* without imposing substitutability concerns. For a company like Capital One or Truist, where the great majority of the assets and activities are housed in the insured depository institution subsidiary, orderly resolution can occur through a traditional FDIC receivership of the insured depository institutions; this is so regardless of the size of the bank holding company. (Put another way, for this kind of company, the non-bank affiliates pose no systemic risk.) For bigger and complex financial institutions, including all eight of the U.S. G-SIBs, resolution occurs through a single-point-of-entry resolution whereby holding company debt holders are “bailed in” to absorb loss, with all subsidiaries (including all the ones providing systemically important services) remaining open and operating. Either way, Titles I and II of the Dodd-Frank Act ensure that large firms will continue to provide critical functions even in failure, and thus substitutability should not be a major concern.

The Order does briefly note the resolution framework, but in a passage that is difficult to understand:

In addition to these quantitative measures, the Board considers qualitative factors, such as the opaqueness [sic] and complexity of an institution’s internal organization, that are indicative of the relative degree of difficulty of resolving the resulting firm. A financial institution that can be resolved in an orderly manner is less likely to inflict material damage to the broader economy.

It is hard to imagine a lot of opacity in internal organization at this point, after multiple resolution plan cycles. Complexity of an organization can complicate resolution, but less so in a single-point-of-entry resolution, where subsidiaries remain open and operating and loss absorbency occurs by bailing in equity holders and a single class of long-term debt holders at the parent holding company, which is a non-operating entity. And obviously an institution that can be resolved in an orderly manner is less likely to pose systemic risk, or in this formulation “material damage to the broader economy,” but that is a truism, not a standard for review. The proper standard of review under this factor would seem to be: “Will the organizational structure of the combined entity be so complex that the filing of a credible resolution plan would be unlikely?”

\(^6\) Federal Reserve Board Order No. 2016-03 (March 21, 2016) at 23.
Interestingly, the Board seemed to apply just such a standard in its earlier Capital One Order. The Board stated, “A financial institution that can be resolved in an orderly manner is less likely to inflict material damage to the broader economy.” It also included a section entitled “Financial Stability Factors in Combination” that analyzed whether the individual factors “might interact so as to mitigate or exacerbate risks suggested by looking at them individually.” (The BB&T/SunTrust Order did not include such an analysis.) In this regard, the Board noted:

The Board’s level of concern also would be greater if the structure and activities of Capital One were sufficiently complex that, if Capital One were to fail, it would be difficult to resolve quickly without causing significant disruptions to other financial institutions or markets....The Board also has considered other measures that are suggestive of the degree of difficulty with which Capital One could be resolved in the event of a failure, such as the organizational and legal complexity and cross-border activities of the resulting firm. These measures suggest that Capital One would be significantly less complicated to resolve than the largest U.S. universal banks and investment banks.

**Interconnectedness.** The Order notes approvingly that “BB&T and SunTrust do not engage in business activities or participate in markets to a degree that would pose a significant risk to other institutions in the event of financial distress of the combined organization.” Again, this merger presented an easy case, as neither firm nor the combined entity was a major securities dealer; hedging transactions among dealers are a primary source of interconnectedness. If this factor did require more robust analysis, a host of issues would need to be considered, as the fact that a firm is interconnected with others marks the beginning, not the end, of a financial stability analysis.

- First, as noted above, the current resolution regime is designed to ensure that not only financial distress but also actual failure would not result in systemic risk through a counterparty failure (given that derivatives are traded at the operating subsidiary level, which remains a going-concern in resolution, and not the level of the holding company that would enter bankruptcy or resolution).
- Second, with regard to market activities, counterparty risk has been significantly reduced by central clearing, margin requirements and the ISDA resolution protocol for derivative exposures. The ISDA protocol explicitly prohibits a dealer from closing out a derivative position with another dealer based upon the failure of its parent holding company.
- Third, explicit counterparty credit limits apply. The limits, which are intended as a backstop to risk-based capital requirements, cap the size of linkages between a firm and a single counterparty or related group of counterparties in order to limit the maximum loss the firm could face in the event of a sudden counterparty failure to a level that does not endanger the institution’s solvency.
- Fourth, the Board’s annual CCAR stress test requires a bank with significant trading businesses to be able to survive, and remain active as a lender and market maker, despite the failure of its largest counterparty.
- Fifth, interconnectedness is one of the factors used to calculate a firm’s GSIB surcharge – a surcharge expressly designed to offset the cost of a disorderly, systemic failure by the firm.

Collectively, these measures are designed not only to reduce interconnectedness but also to ensure that one firm’s failure would have no systemic impact by causing the failure of another firm. Absent evidence that these measures are insufficient, it is difficult to imagine how interconnectedness could cause a merger to be found to pose risk to the financial stability of the United States.

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8 Id. at 36.
9 Id. It is worth noting that the Capital One order was issued in 2012, at a time when the single-point-of-entry resolution strategy for universal banks was still under development. Presumably, seven years of experience with that strategy, and those banks’ implementation of the ISDA resolution stay protocol and compliance with the Board’s 2016 rule on total loss-absorbing capacity, has made resolution of those banks less of a concern.
10 Although interconnectedness appears to be a legitimate financial stability concern, its role should not be exaggerated. Despite a widespread assumption that interconnectedness played a key role in the 2008-09 global financial crisis, evidence appears to suggest that contagion was a more significant problem.
**Complexity.** This element of the analysis focused on factors including the resulting institution’s derivatives exposures; holdings of Level 3 assets; and volume of trading book and available-for-sale assets. In the BB&T Order, the Board noted that the combined firms would hold low levels of derivatives and Level 3 assets. It then noted:

The Board also has considered whether the complexity of the combined organization’s assets and liabilities would hinder the organization’s timely and efficient resolution in the event the organization were to experience financial distress. BB&T and SunTrust do not engage in complex activities, such as being a core clearing and settlement organization for critical financial markets, that might complicate the resolution process by increasing the complexity, costs, or timeframes involved in a resolution. Under the circumstances, resolving the combined organization would not appear to involve a level of cost, time, or difficulty such that it would cause a significant increase in risk to the stability of the U.S. banking or financial system.

Again, these observations were sufficient to determine that complexity was not a ground for denying the merger application of BB&T and SunTrust because neither institution engaged in complex activities. The result should be the same if only one of the two institutions engaged in such activities to a material extent; otherwise, the transaction would not trigger the statutory standard of “greater or more concentrated risk.” If both institutions engaged in such complex activities, the inquiry should then include not only the level of combined risk but also the extent to which capital, liquidity and margin requirements mitigate that risk.

**Cross-border activity.** The Order notes that the Board “has examined the cross-border activities of BB&T and SunTrust to determine whether the cross-border presence of the combined organization would create difficulties in coordinating any resolution, which could significantly increase the risk to stability of the U.S. banking or financial system.” The Order appropriately deals only briefly with this issue given that Truist will not be a global bank for the foreseeable future, but any analysis of a merger with an internationally active bank would have to include a wide range of mitigating factors, including the resolution issues described above.

**GSIB surcharge.** More broadly, in describing its analysis under the financial stability test, the Order states:

To assess the likely effect of a proposed transaction on the stability of the U.S. banking or financial system, the Board considers a variety of metrics that capture the systemic “footprint” of the resulting firm and the incremental effect of the transaction on the systemic footprint of the acquiring firm. These metrics include measures of the size of the resulting firm, the availability of substitute providers for any critical products and services offered by the resulting firm, the interconnectedness of the resulting firm with the banking or financial system, the extent to which the resulting firm contributes to the complexity of the financial system, and the extent of the cross-border activities of the resulting firm.

But these factors are (and likely not coincidentally) included in a bank’s score for purposes of the GSIB capital surcharge—size, interconnectedness, complexity. (Also considered, though not relevant to this merger, is reliance on short-term wholesale funding.)

The premise and effect of the GSIB surcharge is that, as these factors increase, the firm’s score increases, and its capital surcharge increases. The avowed purpose of that surcharge is to offset the systemic risk of a disorderly failure of a GSIB. Any future order would need to consider why that surcharge is insufficient to meet its goal.

**CONCLUSION**

The Dodd-Frank Act instructs the Federal Reserve Board to consider financial stability in reviewing acquisitions under Section 3 of the Bank Holding Company Act. Post-crisis, there have been relatively few such applications, and none that involved a substantial change to the business of a systemically important financial institution. If such an application is filed, the Board will need to consider a wide range of factors that have substantially mitigated the systemic risk posed by U.S. banking institutions.

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