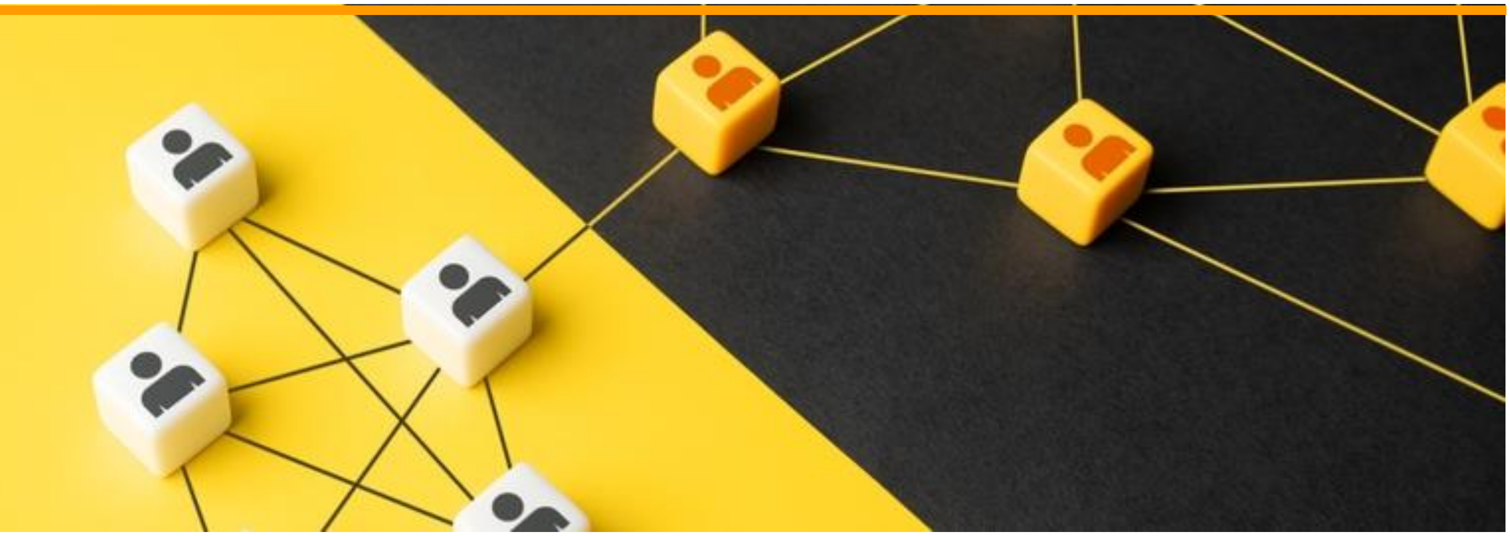


Mergers Involving GSIBs Do Not Inherently Increase Financial Stability Risk

Francisco Covas, Sarah Flowers and Benjamin Gross | May 16, 2024

A well-designed merger policy is crucial for fostering a diverse and dynamic banking system. Mergers play a vital role in promoting competition within the banking industry by enabling banks to spread their fixed costs, such as investments in new technologies and infrastructure, over a larger volume of revenues. This cost-spreading effect is particularly important in an era of rapid technological advancement, where banks must continually innovate to remain competitive and meet evolving customer needs.

According to the Bank Merger Act, federal banking agencies reviewing an application must consider the following five factors: competition; financial, managerial and other supervisory considerations; the convenience and needs of the community to be served; the risk to the stability of the United States banking or financial system; and the effectiveness of the involved institutions in combating money laundering activities.[1]

Recently, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have proposed policy statements that, if adopted, would significantly alter their historical approach for assessing bank merger applications.

Under the OCC's proposal, a merger application would be unlikely to receive approval if the acquiring entity is a global systemically important bank or a subsidiary of a GSIB. The proposal states that such an application would "raise supervisory or regulatory concerns,"[2] although the nature of such concerns is

[1] See Baer, Greg, Bill Nelson and Paige Paridon, "Financial Stability Considerations for Bank Merger Analysis," available at https://bpi.com/wp-content/uploads/2022/05/Financial-Stability-Considerations-for-Bank-Merger-Analysis.pdf. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the BMA to include the financial stability factor in 2010.
[2] Office of the Comptroller of the Currency, Business Combinations under the Bank Merger Act, 89 Fed. Reg. 10010, 10016 (Feb. 13, 2024).

not specified in the proposal. Furthermore, for a merger application to be approved, the combined entity after the merger should have total assets of less than $50 billion.[3]

Similarly, in its own recent proposed policy statement on bank merger transactions, the FDIC states with respect to the financial stability factor that a resulting institution with $100 billion or more in total assets would be subject to heightened scrutiny due to financial stability concerns – which will certainly be read by banks as a no-go.[4]

There is no statutory basis for the thresholds established by the agencies and the effective ban on M&A transactions by GSIBs. Indeed, Congress spoke to this issue and foreclosed acquisitions only if the resulting entity would hold more than 10 percent of insured deposits or 10 percent of financial system liabilities.[5] Instead, the FDIC policy statement finds that any bank over $100 billion would be "more likely" to present financial stability concerns. One might assume that the OCC's justification is the same.

However, analysis and the Federal Reserve's prior analysis demonstrate that it is not true that a merger involving a GSIB acquirer would necessarily lead to increased financial stability risk. In fact, many combinations involving a GSIB acquirer and a large regional bank would in fact *decrease* systemic risk, according to the Fed's flagship measure of a firm's systemic risk.[6]

Measuring Systemic Footprint

The Federal Reserve uses a framework known as Method 2 to assign risk-based capital surcharges for U.S. GSIBs. This framework assesses a bank holding company's systemic risk profile using five components: (1) total exposures of the bank (size), (2) interconnectedness with other financial institutions, (3) reliance on short-term wholesale funding, (4) involvement in complex financial products, and (5) bank's global footprint and cross-border claims and liabilities. All these measures are reported by firms on a Systemic Risk Report (FR Y-15).[7]

The Method 2 score includes a measure of short-term wholesale funding to address the risks posed by these funding sources. The Federal Reserve's own analysis concludes that a bank's use of short-term wholesale funding significantly determines the impact of its failure on U.S. financial stability.[8] Of course,

[3] Office of the Comptroller of the Currency, Business Combinations under the Bank Merger Act, 89 Fed. Reg. 10010 (Feb. 13, 2024).

[4] FDIC, Request for Comment on Proposed Statement of Policy on Bank Merger Transactions (Mar. 21, 2024) at 47.

[5] Pub. L. No. 103-328, 108 Stat. 2338, 2339 (1994) (concentration limit provision of the Riegle-Neal Interstate Banking and Branching Efficiency Act establishing a cap of 10 percent of the total amount of deposits of IDIs in the United States); *see also* Pub. L. No. 111-203, § 622(b), 124 Stat. 1376, 1601, 1633 (2010) (concentration limit provision of the Dodd-Frank Act establishing a 10 percent cap on total consolidated liabilities of any one institution in relation to all banking liabilities). Note that this limitation would effectively preclude M&A transactions by only two GSIBs—JPMorgan Chase & Co. and Bank of America Corporation.

[6] The GSIB capital surcharge methodology is the only codified measure of the systemic risk presented by a firm in Federal regulation. The Federal Reserve has explicitly adopted this methodology for assessing mergers in certain cases. Furthermore, the metrics it has used in assessing financial stability risk in other cases coincide with the components of the GSIB surcharge, and the GSIB surcharge is the only rule that provides metrics for those risks. That said, it significantly overstates systemic risk, and further assessment in the merger context would need to correct for this bias. See footnote 1.

[7] The Systemic Risk Report form (FR Y–15) collects systemic risk data from U.S. bank holding companies and covered savings and loan holding companies with total consolidated assets of $100 billion or more, among others. The data collected on the FR Y–15 is used "to identify other firms that may present significant systemic risk, [and] to analyze the systemic risk implications of proposed mergers and acquisitions." Federal Reserve, *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)*, 88 Fed. Reg. 60385 (Sept. 1, 2023).

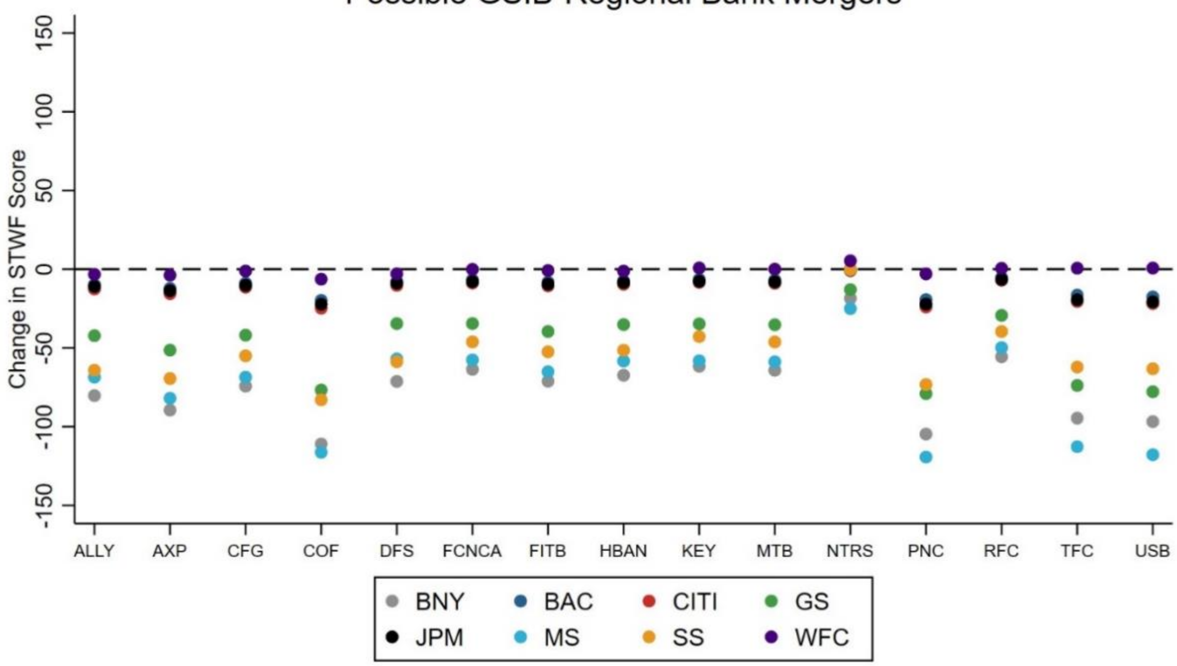
[8] In adopting its bespoke Method 2 score for determining GSIB capital surcharges in 2015—a departure from the Basel-based Method 1 score that does not include a measure of short-term wholesale funding—the Federal Reserve noted in the preamble to the final rule that Method 2 "includes a short-term wholesale funding component because use of short-term wholesale funding is a key determinant of the impact of a firm's failure on U.S. financial stability." 80 Fed. Reg. 49082, at 49088 (Aug. 14, 2015).

this conclusion is consistent with experience during the Global Financial Crisis, when short-term-funded nonbanks like Bear Stearns and Lehman Brothers collapsed when their overnight funding dried up.

To calculate its short-term wholesale funding score, a bank divides its weighted short-term wholesale funding by its average risk-weighted assets. Consequently, if a bank that is more dependent on wholesale funding acquires a bank that primarily relies on retail deposits, the short-term wholesale funding score of the combined entity would decline. In many cases, this decrease could be significant enough to offset the increase in the other components of the score, such as the size component.

Using the most recent FR Y-15 data for each firm, we looked at all possible combinations between a U.S. GSIB and a regional bank in Categories II through IV to determine the impact of a hypothetical merger on the combined entity's short-term wholesale funding score. As shown in Figure 1, a significant portion of all possible combinations between GSIBs and large regional banks would materially reduce the short-term wholesale funding score of the combined entity.[9]

Figure 1: Change in Short-Term Wholesale Funding Score Across All Possible GSIB-Regional Bank Mergers



Sources: BPI Calculations, Form FR Y-15, Systemic Risk Report.

Overall, these findings suggest that 95 percent of all possible GSIB-regional bank mergers would materially reduce the short-term wholesale funding score of the combined entity.[10] Moreover, the decline in the short-term wholesale funding score can be as high as almost 70 percent in some cases, highlighting the significant impact that the funding profile of the target bank can have on the systemic risk of the merged entity.

[9] For simplicity, Figures 1 and 2 exclude Category II, III and IV banks that are intermediate holding company subsidiaries of a foreign banking organization as well as The Charles Schwab Corporation.

[10] For the subset of 15 Category II, III and IV institutions depicted in Figure 1, approximately 95% of possible mergers with a GSIB acquirer would reduce the score; when all Category II, III and IV institutions are included (i.e., adding the IHCs and Charles Schwab), approximately 74% of all possible combinations would reduce the score.

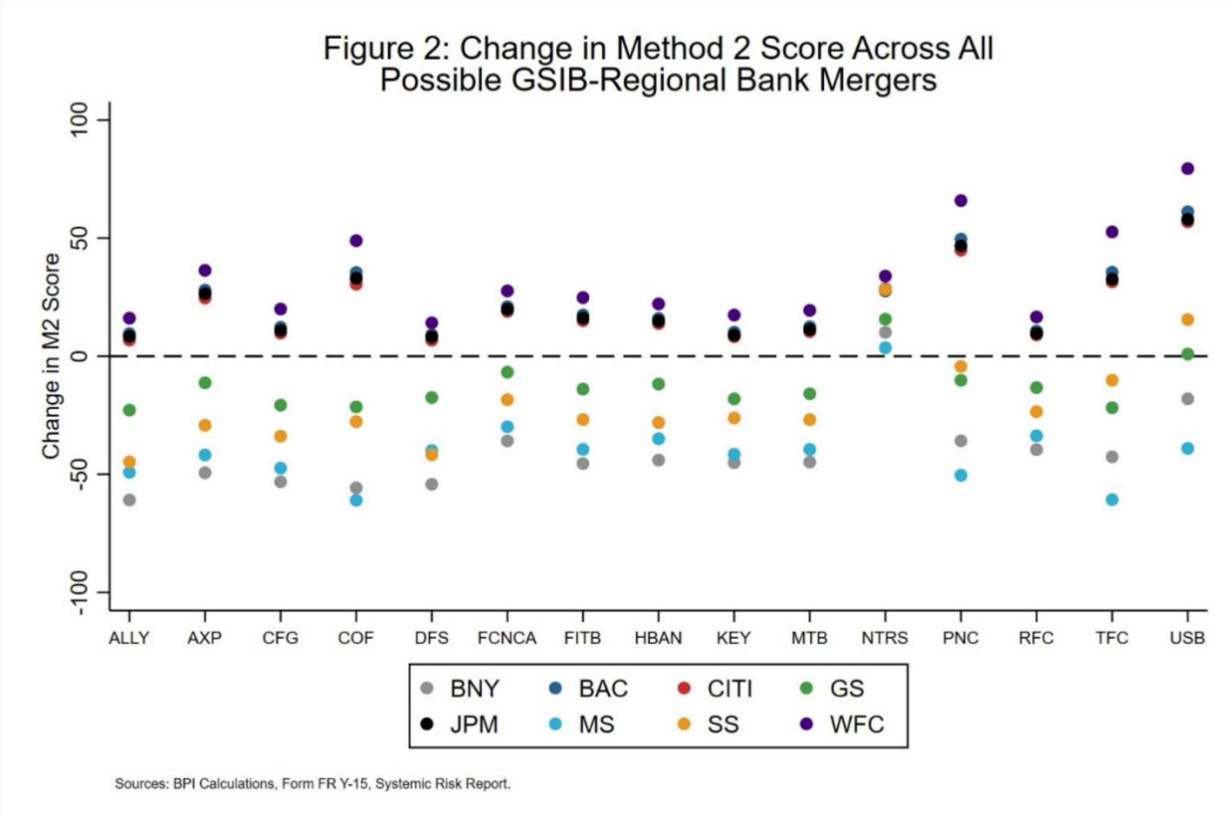


Figure 2 illustrates the effect on the Method 2 score for all potential combinations of GSIB acquirers and large regional bank targets. In these hypothetical mergers, the size, interconnectedness, complexity and cross-jurisdictional activity components of the Method 2 score would increase due to the larger scale of the combined entity. However, the reduction in the short-term wholesale funding score, as shown in Figure 1, can offset these increases.

Remarkably, despite the growth in other risk factors, approximately 43 percent of all possible GSIB-regional bank mergers would lead to a net decrease in the overall Method 2 score.[11] This finding indicates that the resulting institution would have a lower systemic risk profile compared to the GSIB acquirer before the merger.

When the Method 2 score was initially developed, the intention of the Fed was to give each of the five components of the Method 2 score calculation a 20 percent weight. In practice, however, the short-term wholesale funding component ended up with a weight closer to 30 percent in aggregate. Moreover, the actual weight of each component in the score varies depending on the bank's business model. For instance, banks that heavily rely on short-term wholesale funding may have a weight for this indicator that is significantly above 20 percent. As a result, a substantial improvement in the short-term wholesale funding component can potentially offset and outweigh moderate or modest increases across multiple other components. In other words, a material reduction in one component can compensate for and overshadow relatively smaller increases across several other components.

[11] For the subset of 15 Category II, III and IV institutions depicted in Figure 2, approximately 43% of possible mergers with a GSIB acquirer would reduce the Method 2 score; when all Category II, III and IV institutions are included, approximately 31% of all possible combinations would reduce the score.

These results challenge the presumption that any merger involving a GSIB would necessarily increase systemic risk. Instead, they suggest that the specific characteristics of the merging entities, particularly the target bank's funding profile, play a crucial role in determining the net impact on financial stability. Neither the FDIC nor the OCC presents any data or analysis to suggest otherwise.

Furthermore, in some cases, the reduction in the Method 2 score would be significant—enough to lower the capital surcharge applicable to the resulting bank compared to the surcharge applicable to the GSIB acquirer before the merger. Put differently, under the Fed's systemic risk framework, the merged entity would, in some instances, be required to hold less capital than its GSIB acquirer was required to hold prior to the hypothetical merger transaction. This is because the failure of the resulting institution would be assessed to present less systemic risk to the financial system.

To illustrate this point, consider the Fed's GSIB surcharge proposal, which stipulates that the GSIB surcharge would decrease by 10 basis points for every 20-point reduction in the GSIB score.[12] Based on the analysis presented in Figure 2, approximately 30 percent of all potential combinations would lead to a sufficient reduction in the Method 2 score to move the merger entity into a lower capital surcharge bucket, effectively lowering its capital requirements.

This makes intuitive sense, as acquisition of a large regional bank with diverse sources of stable funding by a GSIB with fewer sources of stable funding would in fact present lower risk to financial stability when combined. Indeed, in public orders considering potential financial stability *benefits* of proposed transactions, the Federal Reserve has found that certain transactions involving GSIB acquirers would "immediately improve the stability of [the firm's] funding profile by diversifying sources of funding and increasing stable funding" thereby "enhance[ing] financial stability."[13] Notably, unlike the OCC and the FDIC, the Federal Reserve thus far has not proposed to revise its framework for evaluating merger applications.

Final Thoughts

The GSIB surcharge framework, despite its flaws, plays a crucial role in assessing systemic risk, including in the context of proposed merger transactions. Our analysis underscores the importance of relying on empirical evidence and data-driven analysis when making policy determinations about mergers involving GSIBs, rather than unverified assumptions or arbitrary size thresholds.

It is important to note that Congress has not implemented any specific prohibitions or presumptions against GSIB-related acquisitions in the BMA or the companion bank holding company merger provisions of the Bank Company Holding Act. Instead, lawmakers have opted for specific deposit-based and liability-based caps and have imposed higher regulatory standards outside of the business combination context.

[12] Board of Governors of the Federal Reserve System, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15), 88 Fed. Reg. 60385, 60389 and 60401 (Sep. 1, 2023).

[13] Federal Reserve Board Order No. 2016-03 (March 21, 2016) at 23. *See also* Federal Reserve Board Order no. 2020-05 (September 30, 2020) at 23.

Given this legislative context, the OCC and the FDIC must provide clear explanations for their proposed merger policies. They should justify how the use of arbitrary asset caps and presumptions of disapproval in evaluating merger applications aligns with the Congressional direction set forth in the BMA. Moreover, these agencies must demonstrate how their proposals for merger policy are supported, or at the very least informed, by robust empirical data and sound analysis.

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