Bank Mergers & Acquisitions

Federal Reserve Details New Financial Stability Analysis in Approving PNC’s Acquisition of RBC Bank (USA)

SUMMARY

A recent acquisition approval order of the Board of Governors of the Federal Reserve System (the “FRB”) provides the first analysis of the “financial stability” factor in Section 604(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). This section amended Section 3(c) of the Bank Holding Company Act of 1956 (“BHC Act”) to require the FRB, when evaluating a proposed bank acquisition, merger, or consolidation, to consider “the extent to which [the] proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system”. Section 604(e) of the Dodd-Frank Act similarly amended Section 4(j)(2) of the BHC Act to require the FRB to consider financial stability concerns when reviewing notices by bank holding companies to engage in nonbanking activities.

On December 23, 2011, the FRB issued an order (the “Order”) explaining its reasons for approving the acquisition of RBC Bank (USA) (“RBC Bank”) by The PNC Financial Services Group, Inc. (“PNC”). (The FRB announced its approval of the transaction on December 19, 2011 but, unusually, the Order was not released until several days later.) The Order constitutes the first articulation by the FRB of how it will analyze proposed transactions under the new financial stability factor. The FRB stated in the Order, however, that it expects to issue a notice of proposed rulemaking implementing this change to Section 3(c) of the BHC Act as well as other provisions of the Dodd-Frank Act that require the FRB to consider the effect on financial stability of other proposals by financial institutions, and that this will afford the public an opportunity to provide comments on how the FRB should take financial stability into account when reviewing applications and notices.

Based on the extensive analysis in the Order, the FRB is likely to devote substantial attention to the financial stability factor in evaluating future applications under the BHC Act by, or that would create,
organizations of significant size or complexity. The FRB approved the acquisition by PNC of RBC Bank, but it did so only by performing, as described in the Order, a detailed analysis of the likelihood that the transaction – which many observers believed not to present any significant systemic risk issues (given the sizes and business models of PNC and RBC Bank) – would create increased risk for the U.S. financial system. In performing this analysis, the FRB considered whether the acquisition would result in a material increase in risks to financial stability using, in part, the Basel Committee on Banking Supervision’s methodology to assess the systemic importance of globally active banking organizations. Although concluding that PNC’s acquisition of RBC Bank would not materially increase risks to the stability of the U.S. financial system, the analytical criteria described in the Order may call into question the future of bank mergers, acquisitions and consolidations by larger financial institutions, and increases the burden of the application process for all applicants.

BACKGROUND
Section 3 of the BHC Act requires FRB approval for any company to acquire any bank or bank holding company, or for any bank holding company to merge or consolidate with another bank holding company or to acquire 5% or more of the voting securities of any other bank or bank holding company. Section 3(c) of the BHC Act provides that, in reviewing applications under Section 3, the FRB must consider certain specific factors, including, among others, the competitive effects of the proposal, the financial and managerial resources and future prospects of the companies involved, the effect of the proposal on the convenience and needs of the communities affected by the proposal and certain supervisory factors. Section 604(d) of the Dodd-Frank Act amended Section 3(c) to add to this list a requirement that the FRB consider whether a proposal would result in greater or more concentrated risks to the stability of the U.S. banking or financial system.¹

THE FRB’S FINANCIAL STABILITY ANALYSIS
In the Order, the FRB explicitly draws on the Basel Committee on Banking Supervision’s methodology to assess the systemic importance of globally active banking organizations to structure its analysis of the PNC/RBC Bank transaction. The categories developed by the Basel Committee, and used by the FRB in the Order, are whether the proposed transaction would result in a material increase in risks to financial stability due to the increase in size of the combining firms, a reduction in the availability of substitute providers for the services offered by the combining firms, the extent of interconnectedness of the combining firms and the rest of the financial system, the extent to which the combining firms contribute to the complexity of the financial system and the extent of cross-border activities of the combining firms. The FRB also considered the relative degree of difficulty of resolving the combined firm. The FRB analyzed these factors individually and in combination.
Size

The FRB assessed the size of PNC and of a combined PNC/RBC Bank organization, relative to the U.S. financial system (“USFS”) using several different measures, including the amount of PNC’s pro forma consolidated assets, leverage ratio exposures, and its share of U.S. deposits. The Order acknowledges that acquirer size could understate or overstate financial stability risks. As calculated by the FRB, PNC would become, as a result of the acquisition, the 19th largest U.S. financial institution based on assets, with $291 billion or 1.1 percent of all U.S. financial institution assets. It would become the 16th largest U.S. financial institution based on leverage exposures, with $420 billion or 1.2 percent of the U.S. financial system’s leverage exposures, and would become the fifth largest U.S. financial institution based on U.S. deposits, with $201 billion or 2.2 percent of total U.S. deposits.

The FRB recognized that PNC would be large on an absolute basis following the acquisition but still considerably smaller than the largest financial institutions in the United States. For example, the FRB noted that three U.S. financial institutions would have between six and eight times the assets of PNC, and seven other institutions would have at least twice the assets of PNC. The FRB also noted that PNC’s overall national market share for deposits of approximately 2.2 percent and its market share of national liabilities of approximately 1.4 percent are well below the 10 percent limits set by Congress. The FRB also mentioned that although PNC would become the fifth largest bank in the United States based on U.S. deposits, its size alone would not result in more concentrated risks because both PNC and RBC Bank principally engage in relatively traditional commercial banking activities. It is for these reasons that this proposed transaction had not generally been expected to require the FRB to conduct an in-depth analysis of potential systemic risks.

The FRB’s analysis leads naturally to the question of what view it will take of expansionary proposals by institutions materially larger than PNC, and suggests that it may be difficult for such institutions to persuade the FRB that acquisition proposals do not, based on the size of the target alone, present materially increased risks to the USFS. As is explained further below, the analysis will be more complicated for institutions that are significantly engaged in activities other than traditional commercial banking, which is focused on deposit-taking and lending. As for PNC, the FRB concluded that “PNC’s size does not rise to the level where the [FRB] would be inclined, solely on that basis, to restrict its ability to make a $27 billion acquisition.” The FRB therefore went on to evaluate the proposal under the other criteria it identified as relevant to the financial stability analysis.

As an example of how the factors were analyzed in combination, the Order notes that “a relatively small institution that operates in a critical market for which there is no substitute provider or that could transmit its financial distress to other financial organizations through multiple channels” could present material risks to financial stability. The FRB’s analysis demonstrates that size will not necessarily be determinative under the financial stability factor.
Substitutability
The FRB examined whether PNC or RBC Bank engages in activities that are critical to the functioning of the U.S. financial system and whether substitute providers would remain that could perform such activities if the combined entity would be unable to do so as a result of severe financial distress. The only such activity discussed by the FRB was business and consumer credit, which PNC and RBC Bank both provide. The FRB determined that numerous U.S. financial institutions (“USFIs”) provide business and consumer credit and that the PNC/RBC Bank combination would “not create, solidify, or maintain the position of a single entity” that would pose a risk to the U.S. financial system. The FRB also noted that PNC and RBC Bank perform other unspecified “critical activities,” but that many substitute providers exist for those services. An element to the analysis under this factor appears to be the speed at which substitute providers can step in. It is, however, unclear how readily substitute providers would need to be able to provide substitute services to be factored into this analysis (and whether applicants would be in a position to provide a sufficient level of information on competitor readiness as part of an application process).

Interconnectedness
The FRB examined what the combined entity’s relationships to other market participants would be and the similarity of product offerings that could transmit financial distress to counterparties. Specifically, the FRB determined that the combined entity’s expected use of wholesale funding is lower relative to all USFIs than its corresponding share of the consolidated assets of all USFIs, and found that the transaction would not concentrate the combined entity’s exposure to any one of the top three counterparties of either PNC or RBC Bank. The FRB also noted that, although distress in an institution of PNC’s size “could clearly have an effect on other market participants, that effect would not appear to be so adverse as to have a material impact on market stability.”

Complexity
The FRB considered the extent to which the combined entity would contribute to the overall complexity of the USFS. The FRB observed that the combined entity’s share of the USFS’s “complex assets” would be largely consistent with its share of consolidated assets, and further noted that neither PNC nor RBC Bank engages in complex activities, such as serving as a core clearing and settlement organization, that could complicate the resolution process. Although the FRB noted that bank holding companies with more than $50 billion in assets, such as PNC, are required to prepare and submit resolution plans under Section 165(d) of the Dodd-Frank Act, it did not explain whether or how the existence of such a plan would impact the assessment of an institution’s complexity under this element of the financial stability factor analysis.

Cross-Border Activity
The FRB also considered the cross-border activities of PNC and RBC Bank to determine whether they could make it difficult to coordinate a resolution of the combined entity in a way that would materially
increase risks to U.S. financial stability. Although both PNC and RBC Bank have some non-U.S. subsidiaries or branches, the FRB did not appear to deem them to be significant and noted that the combined organization is not expected to engage in additional activities outside of the United States and would not engage in “critical services whose disruption would impact the macroeconomic condition of the United States.”

Financial Stability Factors in Combination
Finally, as noted above, the FRB explained that it also evaluated each of the above considerations in combination to determine whether interactions might mitigate or exacerbate risks. In concluding that this would not be the case, the FRB noted that concerns related to PNC’s size would have been greater if either it was highly interconnected to multiple different segments of the USFS (e.g., via counterparty relationships or participation in short-term funding and capital markets), or if it had structural complexities that would make it difficult to resolve quickly without significantly disrupting other institutions or markets. In connection with this latter consideration, the FRB noted that other factors also supported the view that “PNC would be significantly more straightforward to resolve than large universal banks or large investment banks.”

Implications for Acquirers
The financial stability factor will likely be a focus by the FRB in reviewing applications under Section 3 of the BHC Act (and Section 4 notices) for some time to come, particularly before it issues and adopts regulations implementing Section 604(d) of the Dodd-Frank Act. This will likely be the case for all applications, regardless of the size of the resulting organization. The financial stability analysis is in-depth and for larger institutions requires the provision of a substantial amount of information about the businesses of both the acquirer and the target. For larger, more complex institutions, this factor will substantially increase the burden of preparing applications and responding to FRB information requests, which will in turn extend the timeframe for completion of the application process. It is also important to note that Section 604(f) of the Dodd-Frank Act amended the Bank Merger Act to require analysis of the risk of bank mergers and other similar transactions to financial stability. The Office of the Comptroller of the Currency appears to be adopting the methodology articulated by the FRB in the Order for analyzing the financial stability factor for Bank Merger Act applications. Finally, Section 163(b) of the Dodd-Frank Act also requires the FRB to conduct a financial stability analysis when reviewing notices by bank holding companies with total assets of $50 billion or more, or nonbank financial companies supervised by the FRB, to acquire voting shares of companies with total assets of $10 billion or more. It is likely that the FRB will follow the model described in the Order for those analyses as well.

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3 In an interesting footnote, the FRB explained that although PNC is deemed to control BlackRock, Inc. (“BlackRock”) for purposes of the BHC Act, the FRB treated BlackRock as an equity investment of PNC, and not a subsidiary, for purposes of this financial stability analysis. The FRB explained that it took this approach because PNC owns only a minority of BlackRock’s shares, does not consolidate BlackRock under GAAP or public reporting rules, and because PNC’s financial operations are not integrated with BlackRock’s and the companies have only limited operational ties. The FRB went on to note that any additional investment by PNC in BlackRock would require FRB approval under Section 163(b) of the Dodd-Frank Act, in order to determine whether such an increase would result in “greater or more concentrated risks to the United States banking or financial system.” See 12 U.S.C. § 5363.

4 Liabilities were apparently computed by the FRB under the limitations on consolidated liabilities of Section 622 of the Dodd-Frank Act.

5 Section 622 and Section 623 of the Dodd-Frank Act impose a specific 10 percent nationwide deposit limit and a 10 percent nationwide liabilities limit on potential combinations by banking organizations.

6 12 U.S.C. § 5365(d). The deadline for the initial submission of such plans by the largest bank holding companies – those with $250 billion or more in nonbank assets – is July 1, 2012. See Resolution Plans Required, 76 Fed. Register 67,323 (Nov. 1, 2011).


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