Comment on Statement of Policy for Bank Merger Transactions

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Summary

Bank mergers are too hard for any single agency to analyze. A proper analysis requires expertise in (1) antitrust, (2) systemic financial stability, and (3) "convenience and needs" of consumers, including consumer financial protection and fair lending considerations. And that's in addition to the base of (0) proper management and processes, including vital concerns like anti-money laundering compliance.

I propose a sketch of a solution that leverages other government agencies – experts in the topics above – to provide formal input and propose any remediation that merged parties might be able to do, allows the prudential regulator (like the FDIC) to make the final decision, and outlines responsibilities of various parties involved. I also provide a concrete example, Capital One and Discover.

Congressional intent via Dodd-Frank Act and Bank Merger Act

Congress, via Dodd-Frank Act, outlined how bank mergers are fundamentally different from other companies merging. Some banks might pose a threat to systemic financial stability, and that is why we have the FSOC (and the OFR). And some banks and some bank products might be dangerous for consumers to use, at least without standardized disclosures or other rules, and that is why we have the CFPB.

Consistently, in the Bank Merger Act, Congress spelled out that, in addition to typical antitrust concerns, the prudential regulator has to also consider issues of financial stability and the "convenience and needs" of consumers (presumably including, for example, whether financial products are good for consumers, and whether consumers have avenues to resolve disputes with banks).

Prudential regulators, including the FDIC, can't be experts in all the areas above. If they were experts in all the areas above, we would not have had either the CFPB, the FSOC, or the OFR, and we would not require the DOJ's involvement in bank merger decisions.

How exactly would this work?

Upon a submission of a merger application, the prudential regulator simultaneously informs (1) the DOJ, (2) the FSOC, and (3) the CFPB of the application, and gives these three agencies a month to submit a formal comment letter on their area of specification, including explicitly suggesting which practices the merging parties might need to commit to for the merger to be publicly beneficial, ideally making these comment public. Meanwhile, the prudential regulator evaluates applicants' (0) various managerial and operational preparedness. The prudential regulator can also request public comments on exactly the same timeline.

Upon the receipt of these submissions (with no submission resulting in a presumption that the relevant agency does not believe that the merger presents any concerns in its area of expertise), the prudential regulator combines these four threads, and decides what changes and commitments to insist upon from the merging entities, or that no realistic changes can be made and therefore the application should be denied. Unlike less regulated firms in most other industries, any commitments can be binding in banking – otherwise, their supervisory ratings will suffer, and their prudential regulator can ensure that the merged entity does not escape its commitment.

A crucial detail is that there is no weighting of the thread – the merger can't make up, say, being anticompetitive by presenting a solid financial stability part, or vice versa. The prudential regulator needs to ensure that each of the four threads is satisfactory and ideally leaves consumers and financial stability better off.

An important outcome is a clear division of responsibility. Suppose a merged entity requires a bailout or fails within a decade after the merger. If the FSOC's report did not identify any issues, then FSOC should take the responsibility. If the FSOC report did identify the issue and proposed remedies (or made it clear that the merger should not occur), yet the prudential regulator went through with the merger (and did not require FSOC's proposed remedies), then the prudential regulator clearly has the responsibility for the failure.

I now go through each of the four threads with a bit more detail, and end my comment with an example.

(0) Managerial and operational preparedness
This is the thread with which the prudential regulators are by far the most familiar with, it is their expertise. This thread includes the management ratings that banks routinely receive and anti-money laundering procedures. While the focus on the acquirer bank is understandable, if the acquired bank presents potential risks, there needs to be a clear plan and timed commitments from the acquirer to fix the issues at the acquired bank.

Another clear concern is forum shopping by merged entities, for example in the NYCB and Flagstar transaction.[1] Prudential regulators should commit not to approve mergers by banks that switched regulators in, say, the last five years before the merger.

(1) Antitrust
The DOJ and the FTC routinely review merger cases, their staff is up to date on both the latest court cases and the latest economic thinking and techniques, and the two agencies periodically update their merger guidelines, with the latest update from December 2023. The agencies routinely consider both horizontal issues, as well as vertical issues (for example, a bank that is primarily a credit card issuer acquiring a bank with a strong credit card payment network). These agencies are by far the best situated to decide on, for example, market definition, which HHI

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[1] See, e.g.,
https://bettermarkets.org/wp-content/uploads/2024/03/Fact-Sheet-NYCB-Flagstar-Update-3-1-2024.pdf.

thresholds to use (if any), or whether job losses from potentially closed branches in the future should count in the calculations.

(2) Financial stability

FSOC was created by Congress to "identify and assess emerging threats to U.S. financial stability." It has the advantage of evaluating risks from multiple perspectives, including risks that non-banks might present or ameliorate – something that the prudential regulators (either FDIC or OCC) do not typically know first hand. FSOC can use its own staff, or rely on the OFR to perform the bulk of the analysis. FSOC would also be in the best position to recommend higher capital requirements. FSOC could also recommend that the merged entities abstain from a particular practice going forward, for example particular type of derivative trading or exposure to private equity, especially when it's not material for either of the two merged entities at the time of the merger.

The current prudential capital requirements are calibrated to strike a balance between financial stability and the cost of additional capital.[2] A merger should have a much higher standard – not create more systemic risk and should not exacerbate any too big to fail (TBTF) concerns. For example, JP Morgan Chase, Bank of America, and Citi all adhere to the current capital requirements. However, the current market structure clearly has a bigger TBTF concern than if each of these three banks would split into two well-capitalized entities. Mergers should adhere to this higher standard. The only way to get there for the merged entity is to require substantially more capital than the current prudential capital requirements – TBTF is a much smaller concern when a bank is so capitalized that it would never need government support.

(3) Convenience and needs

As the sister-proposal from the OCC notes, "convenience and needs factor under the BMA is separate and distinct from its consideration of the CRA record." It is clear that typical CRA factors are insufficient. As many commenters pointed out during the CRA review last year, only a sliver of banks receives negative CRA ratings. Yet, there are plenty of bank abuses and potentially deceptive consumer financial products. With that in mind, the CFPB is the regulator with the right expertise to comment on convenience and needs. The CFPB can point out which products, product features, and practices are questionable, and what the merging banks can commit to, in order to ease the concerns of banks merging. While bigger banks face higher compliance burdens, one can simply look at the recent Wells Fargo record to see that big banks still get away with many problematic practices for years, if not decades. Fair lending concerns should feature in this section as well, and the CFPB has supervisory authority for banks over $10 billion in assets. For smaller banks, the relevant prudential regulator can provide the CFPB with the needed information.

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[2] Arguably the social cost of additional capital is very close to 0 – for example, it is not obvious why any social welfare calculation should consider tax minimization opportunity by banks as a social benefit, see , e.g., Admati, A.R., DeMarzo, P.M., Hellwig, M.F. and Pfleiderer, P.C., 2013. Fallacies, irrelevant facts, and myths in the discussion of capital regulation: Why bank equity is not socially expensive. Max Planck Institute for Research on Collective Goods.

Economic theory is clear that firms with market power provide suboptimal quality.[3] There are also concerns about consumer misunderstanding and products that are too complicated. Bigger banks have more scale, potentially allowing for more profit from products with UDAAP concerns and a much more sophisticated legal department to fight both consumer advocates and regulators.

Providing an official voice both to financial stability and consumer financial protection regulators, and making it explicit that the DOJ is solely responsible for a standard antitrust analysis clarifies responsibilities, and ensures that other agencies with deep expertise related to bank mergers can officially voice their concerns. Otherwise, many concerns might either not be raised (with many regulators preferring not to “interfere” with other regulators) or the only concerns that are voiced are either voiced in private (without public transparency) or by very activist regulators, pushing the prudential decision in one direction or another.

Prospective example: Capital One and Discover

The potential Capital One and Discover merger provides a potential case for how this evaluation can be done, and what potential remedies various agencies can suggest. Let’s suppose that the DOJ returns with a fairly innocuous antitrust report – yes, the merged entity will be bigger by some metrics, but there are multiple other large credit card providers, neither of the two merging firms is a maverick at this point in their history, and there might be a procompetitive justification in making the fourth credit card network stronger and enable it to try to compete better (or at least negotiate from a stronger bargaining position) with Visa and Mastercard.

From the financial stability angle, the merged entity eventually needing a bailout would likely shake any remaining consumer confidence in banking regulators and the system. Accordingly, strict supplemental commitments might be necessary to ensure that the merged entity will not need a bailout. It is clear that the current capital standards are insufficient to prevent bailouts, as evidenced by the bailouts of three large banks in 2023, with even uninsured deposit holders still made whole. For example, FSOC could request a much higher capital level than the merged entity would ordinarily be subject to, say 50% higher (percent, not percentage points). While that might sound draconian, it would still allow for immense leverage. Capital One’s current CET1 ratio requirement is under 10%, meaning that the bank can leverage over 10:1, and that’s on risk-weighted assets. The FSOC could also require that the capital equity is computed using mark-to-market on all assets, and that the merged entity does not engage in any new major trading activities (and stay focused on consumer credit and checking business).

From the consumer financial protection angle, the CFPB is rallying against high credit card late fees and checking account overdraft fees. Capital One should be commended for no overdraft fee checking accounts, and should be committing to maintain these accounts at the merged entity. Moreover, the CFPB could ask for a commitment on not charging excessive credit card

[3] See Spence, A.M., 1975. Monopoly, quality, and regulation. The Bell Journal of Economics, pp.417-429 for the argument on market power firms tailoring their quality for the marginal consumer, as opposed to the average representative consumer that the firms should tailor their quality for to maximize social welfare.

late fees, regardless of court decisions on the new CFPB rule. Finally, the CFPB could ask the merged entity to allow class action lawsuits (while being able to maintain mandatory arbitration clauses for individual disputes), to maintain market discipline even when regulators have insufficient knowledge or resources.