News Bulletin

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Recent Bank Holding Company Expansion Approvals Shed Initial Light on Systemic Risk in Financial Firm Expansion Activities

The Federal Reserve Board's (Board) December 2011 approval of PNC Financial's (PNC) purchase of RBC Bank (USA) from Royal Bank of Canada, and its February 2012 approval of Capital One Financial's (COF) purchase of ING Bank, fsb (ING Bank) from Netherlands-based ING Groep, NV (Groep),* are the first important "real-time" analyses by the Board of the financial stability implications of actual business combinations involving "significantly important financial institutions" (SIFIs) under the systemic regulation requirements of the Dodd-Frank Act. These two Board approvals currently provide the best available, albeit incomplete, insight into how the Board (and indirectly, the other federal regulatory agencies) will define and apply the financial stability framework for financial institution business combination transactions after the Dodd-Frank Act.

Background

The Dodd-Frank Act requires that in reviewing bank holding company applications to acquire banks under section 3 of the Bank Holding Company Act (BHCA), the Board must evaluate whether such an acquisition would result in greater or more concentrated risks to the stability of the U.S. banking or financial system (Dodd-Frank Act subsection 604(d)). A corresponding requirement exists for applications and notices (collectively, "applications") of bank holding company acquisitions of nonbanking companies (including savings banks) under section 4 of the BHCA, where the Board must evaluate as a potential "adverse effect" of any such acquisition, the risk to the stability of the U.S. banking or financial system (subsection 604(e)). A similar requirement exists under Dodd-Frank Act section 163, which requires the Board, in its reviews of SIFI acquisitions of "large" nonbanking companies (companies with consolidated assets of over $10 billion) that are engaged in "financial" activities under BHCA section 4(k), to evaluate whether a proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy. The Dodd-Frank Act added a parallel financial stability review requirement for applications to any U.S. bank regulatory agencies under the Bank Merger Act, 12 U.S.C. 1828(c) (subsection 604(f)).[1]

The Dodd-Frank Act provides no concrete guidance on how the Board or the other bank regulatory agencies must actually consider, weigh and apply financial stability considerations in reviewing BHCA and Bank Merger Act applications. The Board's financial stability obligations in reviewing BHCA applications, however, are relevant to how the Board and other financial regulators will configure and implement the broader systemic regulation scheme under Title I of the Dodd-Frank Act. Title I creates the regime for the regulation of financial institutions that are based or doing business in the U.S., and whose size, complexity, business activities, leverage and interconnectedness may pose a threat to the financial stability of the United States if such institutions were to fail or experience material financial distress. The core elements of the systemic regulation program consist of a process for the Board and the other federal regulators, through the Financial Stability Oversight Council (FSOC) and separately, to:

- identify and designate bank and nonbank financial firms as SIFIs (Dodd-Frank Act sections 113 and 115);
- impose more stringent regulatory, prudential and regulatory capital requirements for SIFIs (sections 115 and 165), and more stringent regulatory requirements for designated financial activities as recommended by the FSOC (section 120);
- require SIFIs to develop and submit to the Board and the Federal Deposit Insurance Corporation (FDIC) contingent resolution plans, or "living wills" (section 165(d));
- adopt a program for the early remediation of SIFIs that are experiencing financial distress (section 166); and
- require SIFIs to divest or terminate businesses that may pose a grave threat to U.S. financial stability (section 121).

Another core element of this general SIFI authority is the broad authority given by Title II of the Dodd-Frank Act to the FDIC to resolve, in an orderly manner, systemically significant financial services companies.

Post Dodd-Frank Act Applications

The systemic risk analysis that the Dodd-Frank Act requires for BHCA applications became fully effective in July 2011. Board approvals of U.S. and foreign banking organization applications under the BHCA and International Banking Act after that time, and before the PNC and ING Bank transactions, shed little light on how the Board would approach this analysis.[2] Given the modest impact on the U.S. financial markets that these other applications presented, the Board's discussions of financial stability considerations in these approvals were cursory and not very enlightening on the subject.[3]

The PNC and COF Transactions

The PNC acquisition of RBC (USA) was announced in June 2011 as a cash-and-stock transaction valued at just under $3.5 billion. While the timing of the transaction meant that the financial stability implications of the acquisition would have to be reviewed by the Board under the new Dodd-Frank Act standards, public interest in this combination did not focus extensively on the financial stability impact of the transaction. PNC's total consolidated assets at the time were about $263 billion, but the total assets of RBC's U.S. banking operations that were being acquired were about $27 billion. Thus, the modest growth in PNC assets that would result from the transaction may have had a palliative effect on public concerns about the systemic risk impact of the combination.

In contrast, from the time that it was first announced in June 2011 (just a few days before the announcement of the PNC/RBC transaction), COF's agreement to purchase ING Bank from Groep, in a much larger cash-and-stock purchase transaction valued at about $9 billion, attracted substantial public interest and criticism from a variety of public and private sources. Apart from the usual community and other public benefit issues that are routinely raised in large BHCA applications, the COF/ING Bank acquisition involved the proposed acquisition of a depository institution that, under the Dodd-Frank Act, was systemically important (ING Bank, with approximately $90 billion in assets) by another large systemically important banking organization (COF, with consolidated assets of approximately $200 billion). In turn, the resulting organization would be a banking organization of indisputably very substantial size (measured by bank deposits, the 5th largest in the United States). As a result, concerns were raised over the risk to U.S. financial stability that the resulting organization might present by reason of its size and activities in the U.S. financial markets.

Amidst the ongoing public discussion and controversy over this transaction during the summer and fall of 2011, and in response to requests from members of Congress and a number of community groups, the Board made the unusual decision to hold a series of public hearings on the application. These hearings were held in Washington D.C., Chicago and San Francisco in October and November 2011, and the financial stability considerations presented by this application were extensively discussed by hearing participants. The Board thereafter reviewed the application and the public record for over three months, a relatively long period of time that prompted further public speculation as to how the Board would evaluate the financial stability factors now required to be considered under the Dodd-Frank Act.

The Board's Approvals

PNC/RBC (USA). On December 19, 2011, the Board announced its approval of the PNC/RBC (USA) transaction; the actual approval (PNC Order) was issued on December 23. The Board's financial stability analysis was based squarely on the requirements of the governing provision of the Dodd-Frank Act (section 604(d)) that the Board consider "the extent to which a proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system." The Board evaluated this factor by express reference to the core factors that the Basel Committee on Banking Supervision (Basel Committee) previously set forth in its November 2011 systemic risk assessment methodology for globally systemically important banks (GSIBs): [4]

- the size of the firm;
- the availability of substitute providers for "critical products and services" offered by the firm;
- the "interconnectedness" of the firm with the banking and financial system;
- the extent to which the resulting firm contributes to the "complexity" of the financial system;
- the extent of the resulting firm's cross-border activities; and
- the relative degree of difficulty in resolving the combined firm.

The Board, however, applied these factors in relation to the U.S. financial system (unlike the Basel Committee benchmarks, which are applied on a global scope), and noted in passing that these factors are not exhaustive and that others could be applied.

On the merits of the PNC application, the Board discussed the above financial stability factors separately and then in relation to one another. On the size factor, the Board noted that although the combined organization would be large on an absolute basis, PNC would have only a modest share of U.S. financial system assets, leverage exposures and deposits, and that PNC would be significantly smaller than the largest U.S. banks. The Board also emphasized that the "relatively traditional" commercial banking activities of PNC and RBC (USA), and the increased size of the combined organization, would not increase the difficulty of resolving PNC's activities. The Board noted that the services provided by the resulting organization would have readily identifiable substitute providers, and that PNC's interconnectedness, as measured by its wholesale funding, lack of material increase in counterparty exposures and absence of evidence of other interconnectivities, made it unlikely that the resulting organization could transmit financial distress to other market participants or the markets in general. Finally, the Board observed that the level of PNC's cross-border activities did not pose a material increase in risk to the U.S. financial system, and that the relatively noncomplex nature of the resulting organization's activities would not involve "a level of time, cost or difficulty" that would cause a material increase in risks to the stability of the U.S. financial system.

The analysis of the six financial stability factors noted above in combination with one another led to a similar conclusion. The Board found no interactions among the six financial stability factors that would exacerbate the systemic risk of the resulting banking organization, but noted that concerns about PNC's size were mitigated by the banking organization's low level of interconnection and relative lack of resolution complexity.

COF/ING Bank. The Board's 40-page order (COF Order) approving the COF/ING Bank transaction was issued on February 14, 2012, after a twice-postponed Board meeting on the application (the postponements fueled yet more speculation about the Board's thinking on the financial stability aspects of the proposed acquisition), and almost two months after the PNC/RBC (USA) approval. In addition to a relatively detailed discussion of COF's financial and managerial resources, and community performance/compliance issues, the Board addressed, in a slightly different manner than was the case in the PNC Order, the financial stability aspects of the transaction by first setting forth a general framework for the analysis of the financial stability considerations, and then applying that framework to the transaction at hand.

The Board began its analysis with the general statement that a "significant adverse effect" of an acquisition would be present if the "failure of the resulting firm, 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." In turn, to make this ultimate determination, the Board stated that it would consider a variety of quantitative and qualitative metrics. The Board, however, made it very clear that these factors were not exhaustive. The Board also stated – which it did not in the PNC Order – that it would consider qualitative factors that are indicative of the "relative degree of difficulty in resolving a resulting financial institution," but used only "the opaqueness and complexity of a financial institution's organization" as an example of such a factor.

Not coincidentally, the explicit quantitative and qualitative factors cited by the Board essentially were the same as those addressed in the PNC Order, and thus generally tracked the Basel Committee's systemic risk assessment methodology. The Board, however, distinguished its analysis from the Basel methodology in three specific respects: (i) the Board noted it would "consider a broader and somewhat different set of metrics," albeit without specifying what those metrics might be; (ii) the Board would apply its systemic risk analysis relative to the U.S. financial system; and (iii) the Board could base an adverse determination on the systemic risk of an application on a simple category of metrics, rather than relying on the Basel Committee's "weighted average" approach in analyzing the systemic risk metrics.

The Board's substantive analysis of its systemic risk metrics (size, substitutability, interconnectedness, complexity, cross-border activities, resolvability) closely tracked its prior analysis in the PNC Order, largely because the organizational and business profiles of the constituent banking organizations were very similar to those in the PNC transaction. The size of the resulting COF organization's U.S. financial system assets, liabilities, leverage exposures and deposits was described as "modest" in relation to the U.S. financial system. The ready availability of substitute providers of products and services offered by COF and ING Bank, the relatively low level of interconnectedness of the firms to others in the U.S. financial system, the low complexity of the firms' organizational and resolution profiles, and the low level of the firms' cross-border activities, all were viewed by the Board as not adding significant risks to the U.S. financial system. Finally, the Board's analysis of its financial stability metrics in combination with one another concluded, as was the case in the PNC Order, that any financial stability concerns about the size of the resulting COF organization would be mitigated by the organization's relative lack of interconnectedness, complexity and cross-border activities.[5]

Some Observations on the Board's Orders

What is the significance of, and lessons that can be learned from, the Board's financial stability analyses in these two cases? Several observations come to mind:

- *"Financial stability" = no train wreck?* The Board characterized financial stability in the COF Order as being a function of the likelihood of "material damage on the broader economy" that a resulting firm's failure or distress could cause. This characterization may invite some wags to simplistically characterize the Board's analysis as a "train wreck" analysis. There is, however, some truth to this characterization, in that it plainly appears that the Board's ultimate test of whether an acquisition would pose a risk to financial stability is very simply whether the resulting firm's failure or financial distress could materially damage the U.S. economy. At the same time, the harm to the U.S. economy that the Board would consider apparently must result from an impairment to financial intermediation or financial market functioning, and not just a general perception of economic harm.[6]

- *Size matters – but how much size?* The Board's quantitative metrics predictably emphasized the importance of a resulting financial institution's size as a financial stability risk indicator, and examined the level of both PNC's and COF's assets, liabilities, leverage exposures and deposits relative to the U.S. financial system. It appears, however, that size would become a dominant financial stability consideration for the Board only in the case of an organization much larger than either PNC or COF. Indeed, the Board stated in the PNC Order that "PNC's size does not rise to the level when the Board would be inclined, solely on that basis, to restrict its ability to make a $27 billion acquisition." Further, the Board's analysis in the COF Order indicated that a large institution's acquisition of a small firm generally would pose fewer systemic risk concerns, although in the COF Order, the Board somewhat arbitrarily created a presumption of low systemic risk if an acquisition involved less than $2 billion of assets, resulted in a firm of less than $25 billion of assets, *or* (the disjunctive is significant!) represented a corporate reorganization.

- *The type of size certainly matters.* The Board determined that the scope and character of PNC's and COF's businesses, both of which would be primarily domestic, traditional bank product-based businesses with many other substitute providers in the markets, would not present sufficient U.S. financial system risks that would warrant denial of the applications. By the same token, a financial institution with extensive capital markets or OTC derivatives operations and relationships, or international activities, likely could be deemed to pose a significant systemic risk at a materially smaller size level than would be the case of a "traditional" banking organization. What that level might be, however, cannot be gleaned from the two Board actions. And, plainly, a banking organization that offers critical financial services functions or products where there are few competitors or substitute providers will attract closer regulatory scrutiny of systemic impact in a business combination transaction than will a banking organization that is active predominantly in highly competitive and traditional segments of the financial markets.[7]

- *The Basel GSIB framework is a guidebook, not a rulebook.* The PNC Order suggested, and the COF Order expressly stated, that the Board's financial stability analytical framework differs in important respects from the Basel Committee's GSIB analytical framework. Although the two approvals modeled their analyses of the financial stability factors on the GSIB framework, the Board made it plain that it was free to consider such other factors as it deemed appropriate. What other factors those might be, however, is not clear at this time, but hopefully the Board's expected future rulemaking on the financial stability analytical framework for BHCA applications (referenced in the PNC Order) will shed further light on this question.

- *Transparency and "resolvability" reduce systemic risk.* Both the PNC and COF Orders emphasized the relative transparency and balance sheet simplicity of the two applicant banking organizations. In turn, both orders concluded that the structure of these firms' balance sheets would not prevent a timely and effective resolution of these banking organizations in the event of financial distress. Embedded in this consideration may be a subtle but important "self-help" message for financial institutions that may want to reduce their systemic impact profile: do what you can to "demystify" your organization and your business lines for the benefit of your regulators. In this regard, there are least two types of concrete action that a large financial institution can take to accomplish this goal: (i) excellent financial disclosures, and (ii) excellent "living wills" or resolution plans (see discussion of resolution plans below). These actions may not fully address the transparency and resolvability of a *resulting* organization in a BHCA business combination, but they should be helpful to the Board in its financial stability analysis.

- *The orders do not provide much guidance on global banking transactions.* The PNC and COF approvals were made easier for the Board by reason of the fact that neither acquirer had international operations that were material in relation to its overall size either before or after the proposed transaction. What we therefore do not learn from these orders is how the Board might approach the financial stability analysis for a business expansion application involving a U.S.-based global banking organization. The Board could view material international operations of a U.S. banking organization as increasing the complexity, and reducing the resolvability, of the applicant banking organization, because factors such as the need for coordination with host country supervisors, and the possibility of multiple resolution proceedings if the banking organization needed to be resolved, would complicate the resolution process. The Board might have the same transparency and complexity concerns in the case of a global foreign banking organization making a material U.S. acquisition.

- *We don't know what the "qualitative" factors are, or which of them may matter.* As noted above, the Board stated in the COF Order that it would consider "qualitative factors" that are indicative of the difficulty in resolving a resulting financial institution, but used only "the opaqueness and complexity of a financial institution's organization" as an example of such a factor. More guidance is needed on what these qualitative factors may be and how they may be applied.

- *We don't know exactly how the Board will analyze nonbanking acquisitions.* The Board recognizes that the financial stability aspects of nonbank SIFI expansion activities are an important issue, but neither the PNC nor COF Orders involved the acquisition of a nonbanking company that had to be given a financial stability review. In the PNC Order, however, there was a brief but interesting footnote discussion of PNC's minority ownership of global investment management firm Blackrock, Inc., which had $3.4 trillion of assets under management at the time of the approval. Due to the minority nature of this ownership, the Board elected to treat PNC's investment of Blackrock as an equity investment and therefore excluded Blackrock from its financial stability analysis. The Board, however, cautioned that such an analysis would be required if PNC, among other things, elected to increase its ownership stake in Blackrock.

- *Global stability concerns?* In contrast to bank acquisitions under the BHCA, the financial stability analysis for acquisitions of significant nonbanking companies under section 163 of the Dodd-Frank Act is supposed to take into account the possible impact on global financial stability, and of course neither the PNC nor the COF Order shed any meaningful light on how the Board in practice would approach this global analysis.

- *The story is not fully written.* The Board's COF Order reflects some subtle but important changes (including the statement of general principles of the financial stability analysis, and the reference to qualitative factors) in the financial stability analysis from that used in the PNC Order. These changes underscore that the financial stability analytical framework for financial institution expansion activities is a work in progress. Presumably, the Board will shed more light on this subject when it proposes rules to implement more fully this analytical scheme. It is difficult to see, however, how the Board could depart in any material fashion from the framework as it currently exists, given its publicly stated positions in the PNC and COF Orders.

Impact on Financial Institution Expansion Activities

Taking into account the substance and reasoning of the two Board orders, the requirements of the systemic regulation scheme as they impact business combinations among financial institutions are beginning to emerge. There are, however, some issues about the significance of these actions on merger and other business combination activities that warrant discussion.

1. *Impact on the largest U.S. banking organizations.* The very biggest U.S. banking organizations will be closely scrutinized on their BHCA bank and nonbank acquisitions in general, and could be

materially constrained in their ability to make large acquisitions, even assuming they are able to comply with the Dodd-Frank Act's 10% statutory ceilings on nationwide deposit share and aggregate liabilities.[8]

- In most cases, "significant" acquisitions could involve companies with total assets of over $10 billion, which is the level at which sections 163 and 604 of the Dodd-Frank Act generally require prior approval of any bank holding company or nonbank SIFI application under the BHCA.

- Smaller acquisitions (in particular, those of less than $2 billion in assets) generally should be permitted to go forward for even the largest organizations absent unusual circumstances that suggest the presence of heightened systemic risk.

- The financial stability analysis for acquisitions of significant nonbanking companies under section 163 of the Dodd-Frank Act is supposed to take into account the possible impact on global financial stability. Neither the PNC nor the COF Order sheds any meaningful light on how the Board in practice would approach this global analysis. Logically, the primary test for global systemic impact here would be whether a nonbank acquisition in effect "exports" systemic risk to the international financial system. In turn, this possibility should arise only in highly unusual circumstances and therefore should not routinely be an application issue in a nonbank acquisition.

2. *Impact on other U.S. banking organizations.* Another interesting question is understanding the impact of the financial stability analytical framework on expansion activities of U.S. financial institutions below the level of the half-dozen or so largest banking organizations.

- BHCA applications to acquire a bank by *all* banking organizations, even those that are not SIFIs or aspire to be SIFIs, must be given a formal financial stability review. The Dodd-Frank Act requires this review and there are no exceptions to this requirement. Smaller banking organizations, however, reasonably can expect their combination applications to receive a *pro forma* financial stability review in normal circumstances. [9]

- A business combination between two banking organizations of under $50 billion in assets, even if it results in a combined banking organization of $50 billion or more in assets, should not raise significant financial stability concerns absent unusual circumstances. In turn, in the case of a merger of two "traditional" banks that predominantly offer mainline domestic deposit and loan products, we would not expect those unusual circumstances to be present. And, in the case of business combinations where the resulting banking organization is less than $25 billion in total assets, BHCA applications for these transactions would have the additional benefit of a Board presumption (stated in the COF Order) of nonsystemic risk.

- A business combination of two larger banking organizations, even two firms that are statutory SIFIs (as was the case in the COF application), similarly should pass muster under the BHCA financial stability analysis absent unusual circumstances, although the Board will apply a more rigorous analysis in such cases (again, as happened in the COF application). At the same time, it is quite clear that fewer financial stability concerns will be raised by the combination of "traditional" banking organizations.

- Is there an asset or deposit level above which an adverse financial stability determination becomes a meaningful risk? While the PNC and COF Orders do not answer this question – and the Board almost certainly would not publish any numerical benchmarks – it may be of some interest that the resulting banking organizations in both cases are in the range of $300 billion in assets, bearing in mind that both these applications involved the combination of firms predominantly engaged in traditional domestic deposit-taking and lending activities.

- Because there are relatively few banking organizations below the very largest banks that engage in material levels of complex or interconnected financial activities, or significant cross-border financial activities, the financial stability review process is unlikely to have a material impact on the business expansion activities of the large majority of U.S. banking organizations.

3. *Impact on foreign banking organizations.* Foreign banking organization acquisitions of bank and nonbank financial institutions in the U.S. that are subject to BHCA review are subject to the same financial stability analysis that applies to purely domestic combinations.

- We would expect the same considerations used by the Board for domestic applications to be used for foreign banking organization acquisitions in the U.S. One important consideration here for foreign firms, however, is that the Board will measure the impact of a proposed bank acquisition on the U.S. financial markets and economy, not the global markets (as would be done under the Basel Committee's GSIB analytical framework). A large nonbank acquisition, however, generally would require the Board to take into account the impact on global financial stability.
- A very large global banking organization (a GSIB) with modest U.S. subsidiaries or operations ordinarily should not face the prospect of an adverse financial stability determination in any U.S. expansion application under the BHCA, as long as the application does not entail a dramatic expansion of the foreign banking organization's U.S. activities.
- Foreign banking organizations that establish U.S. banking offices under the International Banking Act are subject to a "lighter" financial stability review that addresses the financial stability regulatory capabilities of the foreign banking organization's home country supervisor.

4. *Impact on nonbank SIFIs.* A big unknown at the present time is the impact of the Board's financial stability analytical framework on nonbank SIFIs, because we currently do not know which nonbank financial institutions will be designated as SIFIs. The BHCA financial stability analysis requirements, however, will become a very important aspect of the ongoing debate over nonbank SIFI designation and regulation.

- Under Dodd-Frank Act section 163(a), nonbank SIFIs are treated as "bank holding companies" for BHCA section 3 (bank) application purposes, which means, among other things, that a nonbank SIFI's direct or indirect acquisition of more than 5% of the voting shares of a bank would be subject to prior Board review and approval, including the systemic risk analysis.
- Under Dodd-Frank Act section 163(b), nonbank SIFIs, like bank SIFIs, are subject to prior notice requirements for acquisitions of all large (total consolidated assets of over $10 billion) nonbanking companies that are engaged in "financial" activities under BHCA section 4(k), although this requirement appears to exclude acquisitions of nonbanking companies that are engaged in "closely related to banking" activities and other designated activities under BHCA section 4(c), as well as securities underwriting, dealing and market-making activities. In reviewing these notices, the Board is required to consider the impact of such expansion proposals on U.S. financial and global stability and the U.S. economy. In turn, the Board's developing financial stability review determinations and methodology will become an important consideration in the expansion activities of regulated nonbank SIFIs as the new SIFI regulatory scheme for such firms is implemented.
- At the present time, there is no authoritative means of assessing the impact of the Board's financial stability analytical framework on nonbank financial institutions, but large investment banking, investment management and insurance firms located or doing business in the U.S., among others, should pay close attention to ongoing development in this area.

5. *Impact on "execution risk" for business expansion applications.* One impact of the COF application was a relatively extended timeframe (almost eight months) between the June 2011 announcement of the proposed ING Bank acquisition, and the Board's February 2012 COF Order. In addition, the multiple

hearings on the COF application gave community groups and others who opposed the application additional time to step forward and make their views known, which probably had the impact of further prolonging the regulatory review process.

Buyers and sellers in business combinations often wish to consummate their transactions promptly in order to minimize loss of human resources, minimize disruptions to their business operations and avoid significant customer outflows. A longer regulatory review and approval process, however, will increase these types of risks, and in some cases potentially could have an impact on the pricing, or even the consummation, of a transaction. The relative newness of the financial stability analysis and its application to a major bank combination transaction probably encouraged the Board to spend extra time reviewing the COF application, and to a lesser extent the PNC application. Given the current regulatory environment and the close public scrutiny of regulatory activities in this environment, along with the inherent sensitivity of size issues raised by large bank transactions, we would expect the Board to continue taking a highly deliberative approach in reviewing major BHCA applications until the Board's financial stability analytical framework has further developed.

The Impact of the Orders on Other Dodd-Frank Act Provisions and Financial Regulation in General

Several provisions of the Dodd-Frank Act, in addition to the amendments to the BHCA and the Bank Merger Act that are the basis for the two orders, require regulators to evaluate financial stability in the U.S. and the risks that may be posed by particular events. The reasoning in the orders will inform the implementation of at least three of these provisions and will create an interesting interplay between the interpretations of these provisions, and between the Board and other regulators.

Resolution planning. Among the factors that the Board considered in the COF Order was the resolvability of the resulting institution, that is, the "relative degree of difficulty in resolving a resulting financial institution." Essentially the same standard is one of the criteria by which a resolution plan will be measured, *i.e.*, whether the plan is credible, which is one of the requirements for resolution plans under the "living will" regulations of the Board and the FDIC,[10] and the FDIC rules for resolutions of large insured depository institutions (IDIs).[11] The meaning of resolvability will evolve, since the FDIC has yet to assess the credibility of a resolution plan.

In its IDI rule, however, the FDIC has said that a plan is credible if the resolution strategies (and other information in the plan) are "well-founded and based on information and data ... that are observable or otherwise verifiable and employ reasonable projections from current and historical conditions within the broader financial markets." This explanation is a little more specific than the Board's general reference to transparency and opacity in the BHCA orders. If the FDIC definition, however, were to become a touchstone for submissions to the Board, then an applicant might be encouraged, if not required, to prepare and submit a resolution plan as part of its application. Such a plan necessarily would be incomplete and ultimately of less utility for the BHCA financial stability analysis, since a robust plan will require access to information that will not be available until after the transaction has closed. That being said, the availability of a sound resolution plan of a participating banking organization in a business combination could assist the Board in becoming more comfortable with the resolvability of the resulting organization. In turn, it is possible that the interplay of these factors may lead acquisition-minded SIFIs to accelerate the preparation of their resolution plans to assure a better regulatory reception of a subsequent business expansion application.

In any event, the interplay between the approval of a merger or acquisition transaction that might decrease resolvability and the need for a resolution plan to demonstrate resolvability will be complex. The Board and the FDIC will begin review of resolution plans later this year and will begin to explore their credibility further. Assuming substantial financial institution expansion transactions are proposed, the Board may begin to elaborate separately on its own understanding of the term. Conceivably, the Board might ask the FDIC to weigh in on the issue in connection with the Board's review of an application, and an adverse impact on resolvability could at some point be sufficient to result in denial of an application. Alternatively, the Board's approval of a transaction and the accompanying determination that the resulting institution would not affect resolvability could force the FDIC's hand in analyzing this factor.

Orderly liquidation. Several considerations enter into the process for placing a SIFI in orderly liquidation under Title II, including the effect of default on financial stability. The Board's continuing interpretations of financial stability in future BHCA applications and its upcoming rulemaking will create a body of precedent for the application of this factor in the orderly liquidation decision. While the FDIC has said that it plans to invoke orderly liquidation rarely, if ever, it will have an interest in how the Board's decisions may affect its own decision-making. In an extreme case, differences in interpretation could support a legal challenge to the use of orderly liquidation. We would note that for any particular institution, however, the use of this factor at two separate decision points in its lifetime is unlikely to raise issues about consistency, since the two decisions hopefully should be greatly separated in time.

Enforcement referrals. Dodd-Frank Act section 162 authorizes the Board to recommend to the primary financial regulatory agency of a depository institution, or of a financial subsidiary of a nonbank SIFI, that it take supervisory or enforcement action against that company if the Board determines that the company or its activities pose a threat to financial stability. The Board presumably will seek to maintain consistency between these determinations and decisions on merger or acquisition transactions, but it may be a difficult balancing act. Leniency on the transaction approvals may raise the bar for any determinations under section 162. Conversely, aggressive use of the section 162 authority may result in greater scrutiny of the financial stability factor in the review of applications. Another interesting consequence of section 162 is that agencies other than the Board will be in a position to make decisions about the appropriate supervisory response to risks to financial stability.

Conclusion

The Board's PNC and COF Orders provide some initial clarity to how the Board will perform the required financial stability analysis in reviewing BHCA business expansion applications, and confirm that the Board's concerns over the systemic impact of a banking organization business combination should not be a significant expansion issue or impediment for most of the U.S. banking industry. At the same time, the Board's references to unidentified "other factors" (quantitative and qualitative) that it may consider in reviewing such applications will leave interested observers guessing as to what those other factors might be. Hopefully, the Board's upcoming rulemaking in this area will help reduce this guesswork. What is also less clear at this point is how the Board's evolving concept of "financial stability" will inform the implementation of other provisions of the Dodd-Frank Act that pertain to financial stability.

More broadly, the PNC and COF Orders underscore that the current regulatory climate favors the "traditional" bank business model of domestic mainline lending and deposit-taking. The financial stability analysis in the two orders indicates that the Board currently considers the traditional banking model to be a low-complexity and high-transparency model for financial stability purposes, and we may expect that attitude to influence the regulatory agencies' broader exercise of their Dodd-Frank Act systemic regulatory authority. By contrast, banking organizations with extensive and interconnected funding, capital markets and derivatives activities, among other activities, may expect materially higher levels of "systemic" regulatory scrutiny not only in their business expansion activities but in their non-core banking activities and operations in general. That approach would be consistent with the overall "tone" of the Dodd-Frank Act and many of its core requirements, including the "Volcker Rule" and the Lincoln Amendment push-out provisions. Given the fact, however, that most significant "interconnected" financial activities are concentrated among a relatively small number of financial services organizations, the developing financial stability regulatory framework should not present meaningful regulatory issues, at least in the short term, for most of the U.S. banking industry. Whether and to what extent it will present a challenge for nonbank financial institutions, however, is not nearly as clear at the present time, inasmuch as the answer to that question will be heavily influenced by which organizations will be made subject to the financial stability regulatory scheme.

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* Morrison & Foerster LLP acted as counsel to ING Bank, fsb, in the COF transaction discussed in this analysis.

1 In reviewing applications of foreign banking organizations to establish banking offices in the U.S. under the International Banking Act of 1978, the Board must determine, for a foreign bank that presents a risk to the stability of the U.S. financial system, whether the home country of the foreign bank has adopted, or is making demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk (section 173). The Board also must take this factor into account in determining whether to terminate a U.S. office of a foreign bank.

2 One relatively large bank acquisition transaction that might have resulted in a more fulsome financial stability analysis, Bank of Montreal/Harris Bank's acquisition of M&I Corporation and its banking subsidiaries, was approved by the Board the month prior to the July 2011 effective date of the financial stability changes under Dodd-Frank Act section 604 to the BHCA.

3 For example, in an October 2011 approval of Australia-based Westpac Banking Corporation's acquisition of U.K./U.S. capital management firm J O Hambro Capital Management Limited, the Board addressed the financial stability aspects of this transaction in a short, one paragraph discussion. Federal Reserve Board, *Westpac Banking Corporation* (Oct. 24, 2011).

4 *Basel Committee on Banking Supervision, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement; Rules Text* (Nov. 2011).

5 The Office of the Comptroller of the Currency (OCC) subsequently approved COF's acquisition of HSBC Bank Nevada's $30 billion credit card portfolio. In its approval, the OCC's two-page analysis discussed the same financial stability metrics used by the Board, although the OCC approval did not appear to address these metrics in combination with one another. OCC, *Capital One, National Association* and *Capital One Bank (USA), National Association (*March 9, 2012).

6 Part of the difficulty in analyzing this term is that there is no clear consensus on the definition of "financial stability." Eric Rosengren, President of the Federal Reserve Bank of Boston, recently defined it as "the ability of the financial system to consistently supply the credit intermediation and payment services that are needed in the real economy if it is to continue on its current growth path." Rosengren, *Defining Financial Stability, and Some Policy Implications of Applying the Definition* (June 3, 2011), *available at* http://www.bostonfed.org/news/speeches/rosengren/2011/060311/060311.pdf. A different approach is taken in Schinasi, *Defining*

Financial Stability and a Framework for Safeguarding It, Central Bank of Chile Working Paper No. 550 (Dec. 2009), *available at* http://www.bcentral.cl/estudios/documentos-trabajo/pdf/dtbc550.pdf. A 2004 paper from the same author (Schinasi, *Defining Financial Stability*, IMF Working Paper WP/04/187 (Oct. 2004), *available at* http://cdi.mecon.gov.ar/biblio/docelec/fmi/wp/wp04187.pdf.), identified a dozen different definitions, including a definition of financial instability from Roger Ferguson, formerly a Governor of the Board.

[7] The product/service substitutability analysis is not new to the regulatory review process for financial institution business expansions, in that the availability of substitute providers of products or services has been a historic part of the required competitive analysis required in BHCA and Bank Merger Act applications. Unlike the competitive analysis, where the substitutability of products and services is examined primarily with a view towards its impact on the pricing of an applicant's products and services, in the financial stability context the analysis focuses upon potential financial system risks posed by a SIFI's involuntary withdrawal from the financial markets.

[8] Dodd-Frank Act sections 622 and 623.

[9] *See, Brookline Bancorp, Inc.* (Dec. 8, 2011) (acquisition of $1.6 billion banking organization, measured in total assets, by a $3.1 billion banking organization).

[10] 12 C.F.R. Parts 243 and 381 (2012), *adopted at* 76 *Fed.Reg.* 67340 (Nov. 1, 2011).

[11] 12 C.F.R. § 360.10 (2012), *adopted at* 76 *Fed.Reg*. 58389 (Sept. 21, 2011).