

Dodd-Frank Act: New Test for Bank Expansion

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On December 23, 2011, the Federal Reserve Board ("Board") issued a statement setting forth the rationale for its December 19 approval of a bank acquisition, subject to the newly added criteria under the Dodd-Frank Act ("Dodd-Frank") that the Board must provide in its analysis of bank expansion applications. Section 604(d) of Dodd-Frank amended Section 3(c) of the Bank Holding Company Act (12 U.S.C. 1842(c)) ("BHC Act") to require the Board to determine whether a proposed bank acquisition would lead to greater or more concentrated risks "to the stability of the United States banking or financial system." This new standard of weighing the risk to the financial stability of the U.S. banking or financial system applies to expansion by acquisition of banks and/or bank holding companies by banks, bank holding companies, financial holding companies and systematically important financial institutions ("SIFIs").

It should be noted that the "financial stability" factor is not confined to just bank acquisitions but also encompasses nonbank acquisitions. That is because the "financial stability" factor has been added to the public benefits balancing test in Section 4(j)(2)(A) of the BHC Act (12 U.S.C. 1843(j)(2)(A)) and to nonbank acquisitions of more than \$10 billion in consolidated assets by a financial holding company, which is found in Section 4(k)(6)(B) of the BHC Act (12 U.S.C. 1843(k)(6)(B)). The discussion in this memorandum is focused on Section 3(c) criteria and bank acquisitions.

Parties Involved

The application before the Board was the expansion proposal by The PNC Financial Services Group, headquartered in Pittsburgh, Pennsylvania, and its wholly owned bank holding company, PNC Bancorp (collectively, "PNC"), to acquire the U.S. retail banking operations of the Royal Bank of Canada, namely, RBC Bank (USA), Raleigh, North Carolina ("RBC Bank"), a state member bank. PNC has total consolidated assets of \$263 billion and is the seventh-largest depository organization in the United States, controlling deposits of \$180 billion. PNC is the

largest bank in Pennsylvania, with \$62 billion in deposits, and operates in 16 states and the District of Columbia (banking data are as of June 30, 2011).

RBC Bank has total consolidated assets of about \$27 billion and operates in six Southern states. In North Carolina, where RBC Bank is headquartered, it is the fifth-largest insured depository institution, with deposits of about \$10 billion. In its other states it has a considerably smaller market share.

The Board analyzed all the criteria it normally considers in reviewing a bank expansion application. Specifically, pursuant to Section 3(c) of the BHC Act, the Board considered competition; the financial and managerial resources of the involved organizations, which includes consideration of the competence, experience, and integrity of officers, directors and principal shareholder; the future prospects of the company and involved depository organizations; the effectiveness of the companies' anti-money laundering capabilities; the convenience and needs of the communities to be served; and the extent to which the proposal "would result in greater or more concentrated risks to the stability of the United States banking or financial system." Based upon its review of the complete record, the Board concluded that "all considerations are consistent with approval of the application."

New Criterion the Board Must Weigh in its Consideration of a Bank Acquisition: Financial Stability

Under the new statutory requirement in Section 3(c) of the BHC Act, the Board's analysis of the impact of a bank acquisition must now also include an assessment of the extent to which the proposal before it would result in greater or more concentrated risks to the stability of the U.S. banking or financial system. This new factor is a direct consequence of the financial crisis that the United States has been experiencing since the latter part of 2008. The Board's statement indicates it will issue a Notice of Proposed Rulemaking on how it should take financial stability into account when reviewing applications and notices (see footnote 18).

The Board indicated it will analyze six new criteria in its consideration of financial stability: (1) size, (2) substitutability, (3) interconnectedness, (4) complexity, (5) cross-border activity, and (6) financial stability factors in combination. An additional consideration to the Board was the

relative difficulty in resolving a combined firm were it to pose a material risk to the stability of the U.S. banking or financial system.

The Board's analysis included an assessment of these factors individually and in combination, applying a quantitative analysis of the individual and combined institutions relative to the U.S. financial system using public information, data collected through the supervisory process, direct queries of both institutions, and "qualitative judgments." In addition, the Board considered that PNC is a more than \$50 billion asset bank holding company, and is subject to the Enhanced Prudential Standards under Sections 165 and 166 of Dodd-Frank that the Board proposed for public comment December 20, 2011, but has not yet finalized.

Financial Stability Components

Size: The Board recognizes size as an important indicator of the risk an organization poses to the financial system. However, size alone is not determinative. Congress established 10 percent of nationwide deposits and liabilities as a macro measuring rod. The Board applied this national standard by looking at PNC's size relative to U.S. financial institutions, as well as PNC's total leverage ratio exposures. The Board's analysis concluded that while the post-expansion PNC would be large on an absolute basis, it competes with at least three financial organizations that are between six and eight times larger by asset size, and seven that are at least two times larger. As a result of PNC's focus on traditional commercial and retail banking, the Board found its deposit share is "relatively modest" - 2.2 percent of nationwide deposits and about 1.4 percent of liabilities. Moreover, PNC and RBC Bank's activities are focused on the more traditional commercial banking activities. Thus, any resulting risk to the stability of the U.S. banking or financial system could be resolved through the normal FDIC receivership process.

The Board concluded that PNC's absolute size alone is not sufficient to restrict its ability to acquire RBC Bank.

Substitutability: The Board considered the activities of the involved organizations to determine if they are "critical" to the functioning of the U.S. financial system and whether there are substitute providers. As the Board stated, both RBC Bank and PNC provide business and consumer credit

for which there are numerous other providers, and the resulting transaction does not raise an unacceptable risk to U.S. financial stability.

Interconnectedness: This factor concerns the speed and scope with which any financial distress at the resulting PNC might be transmitted to other institutions or markets within the U.S. financial or banking system. The Board also analyzed the impact of financial distress on counterparties. The Board found there was no evidence in the record that the pro forma combined entity would be so interconnected with markets and institutions in the U.S. financial or banking system as to make it likely that the resultant entity would transmit financial distress to other market participants or to the market generally, in a manner or to a degree that would cause material risks to the U.S. financial or banking system.

Complexity: The Board found that the pro forma entity's share of complex assets in the aggregate U.S. financial services market was consistent with its share of consolidated assets and, therefore, the combined entity's resolution, if necessary, would not cause a material increase in risks to the stability of the U.S. financial system.

Cross-Border Activity: In examining the cross-border activities of PNC and RBC Bank, the Board found the resulting combination would not engage in any additional or critical services whose disruption would impact the macroeconomic condition of the United States by disrupting trade or leading to increased difficulties for the FDIC resolution process. Thus, the cross border presence of the consolidated organization will not result in a material increase in financial liability risk.

Financial Stability Factors in Combination: The Board considered the foregoing factors in combination to determine whether interactions among them might mitigate or exacerbate risks. The Board considered whether the proposed transaction would present any stability benefits, and whether the proposed enhanced prudential standards would tend to offset any potential risks. The Board determined that the combined entity will not be highly interconnected, that its business is centered on commercial banking, and that the resolution process would be the traditional FDIC receivership. In light of the above and all the facts of record, the Board found that the proposal would not materially increase risks to the U.S. financial or banking system.

The traditional other factors the Board must consider in passing on a bank expansion proposal, namely competition, financial and managerial resources, and convenience and needs, were found by the Board to be consistent with approval.

Competitive Considerations

Upon consummation, PNC would become the fifth-largest depository organization in the United States with consolidated deposits of \$201 billion, representing approximately 2.2 percent of total insured deposits. In the 10 localized markets where there is direct competition, nine in Florida, and the Atlanta, Georgia market, the competitive consequences are all within the Department of Justice Guidelines, including the Herfindahl-Hirschman Index criteria. Accordingly, the Board found that overall the transaction would have no significant adverse competitive or concentration effects in any relevant banking market, and that competitive considerations are consistent with approval.

Financial and Managerial Considerations

The Board considered the organizations on both a parent-only and consolidated basis, as well as on a disaggregated basis. This included an assessment, most significantly, of capital adequacy, as well as a review of asset quality, earnings performance and how the transaction will be funded. This analysis also included the likely success of the integration. In this case, PNC Bank and its holding company are well capitalized and will remain so, even after PNC pays the \$3.6 billion purchase price through a combination of issuing noncumulative preferred stock, five-year subordinated debt and other available cash resources. After the transaction, PNC and PNC Bank would have capital ratios well above the regulatory minimums. The Board specifically pointed out that PNC has been performing capital stress testing since the second quarter of 2009, and that under the tested scenarios, PNC Bank's baseline Tier 1 common equity ratio would be at an acceptable level.

Management considerations included a review of risk-management systems and operations, supervisory experiences, and records of compliance with applicable banking law, including anti-money laundering laws. The Board also considered PNC's "demonstrated record" of successfully integrating over the years Riggs National Corporation, Mercantile Bancshares,

Sterling Financial, and National City. Also, PNC's plans for the integration and operation of the combined organization going forward leads the Board to conclude that managerial factors are consistent with approval.

Convenience and Needs Considerations

Under Section 3(c) of the BHC Act, the Board must also consider the convenience and needs of the communities to be served by the involved organizations, including the Community Reinvestment Act ("CRA") records of the relevant depository institutions. This requires an assessment by the insured depositories' federal financial supervisor of their record of meeting the credit needs of the entire served communities, including low- and moderate-income neighborhoods. This requires an evaluation of the depositories' most recent CRA records. PNC Bank's CRA rating was "Outstanding" and RBC Bank's was "Satisfactory," with no later decline in performance. Other evidence of PNC Bank's CRA performance was demonstrated affirmatively by the 121 supportive comments the Board received on the proposal, which included notably 104 from community groups. In addition, PNC explained how the transaction will benefit RBC's customers and local communities through a variety of new and enhanced products and services, drawing upon its existing capabilities and products that led to its "Outstanding" CRA rating. In addition, the Board noted that the increased geographic diversification could reduce the resulting company's exposure to regional economic downturns and could increase administrative efficiency.

— Implications

This decision is very important because it sets out the initial template the Board will apply going forward when it has to review a bank expansion application. In addition, this decision has important implications for how the Board will consider the effects of a bank acquisition where the acquirer is a SIFI.

— New Six-Point Test

In its analysis of the impact of the transaction upon U.S. financial stability, the Board undertakes a new six-point analysis that will probably be more refined over time and will likely reflect greater specificity following the Board's proposed rulemaking on the meaning of financial stability of the U.S. financial or banking system.

— Basel Criteria

The criteria or indicators the Board will analyze in its financial stability determination track the criteria established by the Basel Committee in its report submitted to the G-20 Finance Ministers and Central Bank Governors in 2009. The use of these indicators was reiterated by the Basel Committee in November 2011, when it established the framework to be used in determining the risk loss absorbency for global systemically important banks.

— Traditional Banking

The Board appears to be of the view that when the nature of the involved institutions' activities are the more traditional commercial banking activities, such as deposit-taking and providing business and consumer credit, the risk to U.S. financial stability is mitigated by the existing and often tested FDIC receivership process. That process, which does not entail the time and complexity of Dodd-Frank's Title II Orderly Liquidation Authority (found at Sections 201 to 217), does not appear to require the cost, time, or difficulty that would cause material increase in risks to the stability of the U.S. financial system. The Board appears to consider, for example, clearing and settlement as a complex activity that might complicate the traditional FDIC resolution process.

— Size Analysis

On the issue of size, the Board appears willing to tolerate a pro forma organization larger than that of PNC before its concern is raised. For example, the Board noted the presence of three much more significant competitors - each with at least six times more assets than PNC. Furthermore, the Board's proposed Enhanced Prudential Standards criterion at 12 C.F.R. 252.92(aa) and 252.93(b) indicate that a company with \$500 billion or more in consolidated asset size is a "major covered company," and thus its net credit exposure to any one customer is limited to 10 percent of its capital stock and surplus. For a bank below that major consolidated asset level, the aggregated net credit exposure to any one customer can be up to 25 percent of the covered company's capital stock and surplus. The Board will probably approve a resulting organization that is engaged in traditional commercial banking activities larger than the pro forma PNC, but below a \$500 billion consolidated asset threshold, assuming no out-of-the-ordinary risk. However, as the proposed transaction approaches that threshold, the Board will more carefully scrutinize the merits of the transaction, and will seek to ascertain whether it offers any benefits to the public.

- New Competitive Analytic Framework

While the Board's competitive analysis traditionally looks at impacts on carefully defined local banking markets within the United States, that analysis over time might in practice not be confined only to U.S. markets exclusively. Since the factors considered under financial stability include interconnected uses and cross-border activity impacts on the macro U.S. financial markets, and with the development of the Internet and the many transnational means of communicating, confining a competitive analysis to domestic markets only will likely be revised, depending on the activity, to becoming a more macro and multi-country analysis. One consequence might be a greater tolerance for size.

- Expanded Data Demands

The amount of data required by the Board for its analysis will become greater, more sophisticated, and require more in-depth analysis and consideration.

- Ramification of Enhanced Prudential Standards

Finalization of the Enhanced Prudential Standards under Title I of Dodd-Frank will likely have significant ramifications for the review of expansion applications. Title I of Dodd-Frank marks the first attempt at comprehensive financial stability regulation. How its rules are developed and implemented will determine the reality of the macro prudential oversight regime. These new standards will eventually address the specific details that will be applied to the covered firms. In turn, the core principles contained in the Financial Stability rules will form the basis for the financial stability reviews conducted in connection with expansion applications in the future. Therefore, while this initial application approval is important, it is very likely that the elements of a financial stability review will evolve over time as the broader Dodd-Frank rules are implemented. This is what happened with the initial understanding of the terms "financial and managerial resources" and "convenience and needs."

- Need for Heightened Pre-Filing Due Diligence

Bank expansion plans will need to be very carefully planned, analyzed and considered, and will require expanded and more detailed due diligence. The parties will need to have a clear understanding of the regulatory environment that will be much more involved and difficult than it has previously been under the pre-Dodd-Frank Section 3(c) of the BHC Act standards.



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