

Bank M&A Considerations Amid 2024's Regulatory Uncertainty

By **Robert Azarow and Amber Hay** (January 22, 2024, 6:36 PM EST)

Over the past decade, bank mergers and acquisitions have gone through peaks and valleys being driven by swings in macroeconomic conditions, alternative periods of enhanced regulatory supervision and regulatory relief, the COVID-19 pandemic, and, most recently, significant bank failures.

In particular, 2023 was marked by the lowest level of bank M&A activity in over a decade due to high interest rates, inflation and fears of a recession, low bank stock prices, and extensive rulemaking activity.

Despite significant regulatory uncertainty, community banks and midsize banks with total assets of less than \$50 billion will likely see increased deal-making opportunities in 2024.

This article will highlight considerations for bank M&A in 2024 by revisiting the industry's activity from 2018 through 2023.

2018-2023

Significant Midsize and Regional Bank Consolidation

The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, or the Economic Growth Act, opened the runway for mergers of regional banks to create super regional banks,[1] allowing for growth without the mandatory applicability of Dodd-Frank Act enhanced prudential standards until crossing over \$250 billion in total consolidated assets.

The COVID-19 pandemic significantly slowed down expansionary activities in 2020 due to uncertainties related to the economy and the resulting impact on bank stock prices.

However, the economic stimulus approved by Congress and accommodations made by the regulators allowed for continued growth efforts by banking organizations as stock prices rebounded later in 2020.

Mergers of large regional banks from 2018 through 2021 led to calls from Congress for changes in bank merger review, pushing for a closer look into the potential anti-competitive effects, and financial stability and consumer protection considerations, particularly in large bank mergers.[2]

Consistent with President Joe Biden's executive order on promoting competition in the American economy,[3] the U.S. Department of Justice, in consultation with the federal banking agencies, is evaluating the 1995 Bank Merger Guidelines.[4]

The DOJ's process predates the executive order and has been ongoing for three years. The DOJ along with the Federal Trade Commission recently adopted amendments to the Horizontal and Vertical Guidelines.[5]



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Therefore, it is expected that revisions to the bank merger guidelines are soon to follow. Relatedly, the federal banking agencies have not proposed amendments to bank merger regulations, but the FDIC did publish a request for comment on the bank merger review framework in March 2022.[6]

Concepts under the 2023 merger guidelines may be applicable to the nonbank parts of an acquisition,[7] and the ongoing review of the bank merger guidelines causes some uncertainty of how bank M&A will be evaluated.[8]

Once adopted, the new guidelines may introduce greater complexity to the competition analysis as well as a more stringent approach to approvals and divestiture requirements.

Over the past four years, the market has experienced a significant slowdown in the regulatory approval process, particularly for larger transactions.

The change in administration and turnover in leadership at the federal banking agencies in 2021 were significant factors in the delay of several large transactions announced close to each other, with many extending longer than 12 months following execution of the definitive agreements.[9]

We believe this had a chilling effect on other possible large bank M&A transactions. Further, core regulatory concerns regarding significant growth and whether resulting organizations have the systems and controls to manage the related risk and regulatory burden contributed to the longer review time frames.

The uncertainty created by the executive order and the failure of the federal banking agencies to issue new guidelines likely has further affected the approval process.

Impact of Market Forces

In 2023, bank M&A seemingly disappeared due to a variety of economic and regulatory factors. Particularly, 2023 has been marked with a significantly higher interest rate environment resulting from efforts of the Federal Open Market Committee, or FOMC, that began to address inflation in early 2022.

Over the past year, an environment of high interest rates has had a significant adverse impact on stock prices of financial institutions,[10] thereby affecting the ability of buyers to utilize equity as the primary component of merger consideration.

Additionally, most banks with significant investment securities portfolios have seen the fair market value of those portfolios decline dramatically.

Due to purchase accounting, many potential mergers have lost their financial attractiveness as the immediate realization of losses related to a target's portfolio upon completion of a merger would dramatically and adversely affect the pro forma financial impact of a deal.

Response to Large Regional Bank Failures

The sudden failure of three large regional banks in the spring of 2023 further negatively affected bank M&A activity. In March 2023, the banking industry was shaken by the unexpected failures of Silicon Valley Bank and Signature Bank,[11] which was followed by the failure of First Republic Bank in May 2023.[12]

The failures of the banks brought a sharp focus on the fragility of bank balance sheets in the prevailing interest rate environment and the lack of capital and liquidity options for those institutions most in need.

The regulators seem to be laser focused on shoring up bank balance sheets and preventing any future failures of large and regional banking organizations.[13] Further, there are growing fears of a brewing commercial real estate crisis as commercial real estate loans originated at low rates begin to mature in the high-rate environment, further increasing the fear of additional bank failures.[14]

The federal banking agencies have adopted and proposed several new regulations and guidance aimed at enhancing the supervision and regulatory requirements applicable to banking organizations above \$100 billion in assets, and to a lesser extent, for banking organizations with \$50 billion or more in assets, and \$10 billion or more in assets, respectively.[15]

2024 Outlook

Going into 2024, the macroeconomic conditions seem to be shifting in a more stable direction, though the possibility of a recession continues to loom.[16]

In December 2023, the FOMC announced it was not altering the federal funds rate and in public comments stated that 2024 would likely see three modest 25 basis point reductions.[17]

This news caused a rally in bank stocks and infused the market with some optimism, which could support an increase in bank merger and acquisition activity.[18]

Approval Process for Bank M&A

We expect that the vast majority of bank M&A will involve community banks, as has been the case historically.

Banks may be ready and willing to engage in M&A activity to resume strategic growth initiatives.

But large regional banks that have, or are growing toward, \$100 billion or more in total consolidated assets may remain on the sideline while the industry awaits changes to the regulatory framework for such organizations and any revisions to the bank merger guidelines and regulations.

We generally see regulatory receptiveness to community bank combinations.

Mergers and acquisitions involving banking organizations with \$50 billion or more in assets will likely continue to be subject to prolonged approval processes.

These processes are likely to include heightened scrutiny of business plans, governance and risk management, and an expectation that the resulting institution will be able to comply with any additional prudential standards within the specified timeframes.

Regulatory fear of resolving future large bank failures, particularly those of fast-growing institutions, seems to be a dominant theme.

All institutions will need to ensure that they are receiving a clean bill of health during examinations and appropriately addressing any regulatory concerns to avoid restrictions on growth and activities that would prevent the possibility of a merger or acquisition.

Enhanced risk management and compliance systems and processes will be essential to achieve growth objectives.

Proposed Regulations That Could Affect Bank M&A

The banking regulators will likely adopt final versions of the regulations and guidance proposed in 2021 through 2023 focused on enhanced prudential standards for banking organizations with \$100 billion in total consolidated assets.

To a lesser extent, the final versions are likely to focus on additional requirements for banking organizations with over \$50 billion in assets and over \$10 billion in assets focused on risk management and governance.

It is likely that the bank merger guidelines will be updated in 2024, which will impact the competitive analysis of bank mergers of all asset sizes.[19]

Supervisory Considerations

Banking regulators are clamping down on institutions through the examination process.[20]

We expect that regulators will continue to use the examination process to place growth and activity restrictions on institutions that are not meeting regulatory requirements and expectations.

Additionally, increased capital costs and regulatory requirements may lead acquirers to carefully parse where to place the acquired business units within their banking organizations to optimize permitted activities and regulatory requirements applicable to the businesses, affiliate transaction requirements, and the costs of funding the acquired businesses.

Institutions that will cross any significant asset threshold — \$10 billion, \$50 billion, \$100 billion, etc. — should be prepared to demonstrate the ability to comply with any additional requirements associated with the applicable asset threshold, and commit to resolving any supervisory issues of an acquired target.

What's Next

Macroeconomic factors will always be the first arbiter of the return of bank M&A.

But from a regulatory standpoint, we see a receptiveness to community bank combinations and the federal banking regulators appear to have a much better perspective on banks crossing the \$10 billion threshold than the large bank asset threshold of \$100 billion.

Regulatory fear of needing to resolve future large bank failures, particularly fast-growing institutions, and not having a strong cadre of larger — but not the largest — banks to come to the rescue seems to be a dominant theme.

Whether this fear will delay deals involving banks between — or looking to cross over — the \$50 billion and \$100 billion thresholds remains to be seen.

Heading into a presidential election year may increase the challenges.

However, it seems apparent that the federal banking agencies will need to allow banks to grow through M&A above the \$50 billion and \$100 billion thresholds if they ever hope to achieve a wider base of institutions to compete with the largest banks and to have that strong cadre of banks that can come to the rescue when weaker banks fail.

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[1] The Economic Growth Act raised the mandated applicability of enhanced prudential standards under the Dodd-Frank Act from US\$50 billion to US\$250 billion, and gave the Federal Reserve Board the discretion to apply any enhanced prudential standards on a tailored basis based on identified risk factors to banking organizations with US\$100 billion or more in total assets.

[2] See, e.g., Press Release, "Senator Warren and Rep. Chuy García Introduce the Bank Merger Review Modernization Act to End Rubber Stamping of Bank Merger Applications," (Sept. 30, 2021); Press Release, "Waters Calls on Fed, FDIC, and OCC to Halt Mergers and Acquisitions Over \$100 Billion," (Dec. 10, 2021). The increased Bank M&A among larger institutions also caused the FBAs to look more closely at the potential risks to the financial stability of the banking industry and the options available for resolving large banking organizations. In October 2022, the Federal Reserve Board and FDIC issued an advance notice of proposed rulemaking and request for comment (ANPR) on Resolution-Related Resource Requirements for Large Banking Organizations, 87 Fed. Reg. 64170 (Oct. 24, 2022). The release notes that "[d]uring the global financial crisis, there were limited and undesirable options available to the FDIC for resolving the largest failed IDIs including disruptive and costly liquidation strategies or the sale of large banks to even larger financial institutions. The challenges associated with the acquisition of a large, failed IDI continue to be significant, both operationally and financially; as a result, the universe of potential acquirers is limited ..." Id. 64171-64172.

[3] Executive Order No. 14036, 86 Fed. Reg. 36987 (Jul. 14, 2021).

[4] The Antitrust Division of the Department of Justice's review predates the Executive Order, as the DOJ first sought comments on proposed revision in September 2020. DOJ, Press Release, "Antitrust Division Seeks Public Comments on Updating Bank Merger Review Analysis" (Sept. 1, 2020).

[5] On December 18, 2023, the DOJ and FTC jointly issued its 2023 Merger Guidelines (horizontal and vertical guidance) after a two-year process of public engagement.

[6] The FDIC published a request for information (RFI) on the bank merger review framework in March 2022. See, FDIC Request for Information on Bank Merger Act, FIL -11-2022 (Mar. 25, 2022).

[7] The 2023 Merger Guidelines will impact Bank M&A that involves the acquisition of a nonbank subsidiary to the extent that review is required under the 2023 Merger Guidelines.

[8] The 2023 Merger Guidelines lower the threshold for a presumption that a particular transaction in a

concentrated market illegally lessens competition, returning to the threshold that existed prior to revisions to the Horizontal Merger Guidelines in 2010. It is not yet known whether any revision of the Bank Merger Guidelines would take a similar approach.

[9] See, David French, "White House delay on Fed regulation chief bodes badly for bank M&A," Reuters (Dec. 2, 2021).

[10] See, e.g., Carew, Sinéad, "Bank stocks rally to pre-crises levels after Fed meeting," Reuters (Dec. 14, 2023) ("The Fed left interest rates unchanged after its meeting on [Dec. 13, 2023]...While higher interest rates boost lenders' profits to an extent they also can result in weakening of loan demand and pressure for banks to raise deposit rates they pay customers.").

[11] See, "Silicon Valley Bank and Signature Bank Failures," Congressional Research Service (Mar. 21, 2023).

[12] First Republic collapse sparks regional bank shares sell-off
<https://www.reuters.com/business/finance/first-republic-collapse-sparks-sector-wide-regional-bank-shares-sell-off-2023-05-01/>.

[13] See, e.g., Speech of Vice Chair for Supervision Michael S. Barr at the ECB Forum on Banking Supervision, Frankfurt, Germany, "The Importance of Effective Liquidity Risk Management," (Dec. 1, 2023).

[14] See, e.g., McGahey, Richard, "Bank Failures, Devalued Commercial Real Estate, and Working from Home," Forbes (May 5, 2023).

[15] See, e.g., Guidelines Establishing Standards for Corporate Governance and Risk Management for Covered Institutions With Total Consolidated Assets of \$10 billion or More, 88 Fed. Reg. 70391 (Oct. 11, 2023).

[16] See, e.g., Wayne Duggan, "Recession Or Soft Landing: What's Next for the U.S. Economy?" Forbes Advisor (Oct. 17, 2023); "Common Causes of Economic Recession," Congressional Research Service (Mar. 21, 2023).

[17] Press release, "FOMC Decisions Regarding Monetary Policy Implementation," (Dec. 13, 2023).

[18] Supra fn. 23.

[19] See, Remarks by Chairman Martin J. Gruenberg on Oversight of Prudential Regulators before the Committee on Financial Services, United States House of Representatives (Nov. 15, 2023).

[20] See Pete Schroeder and Nupur Anand, "US regulators clamp down in bid to prevent more bank failures," Reuters (Dec. 6, 2023).