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Speeding up: What risk, compliance, and legal leaders can do to accelerate regulatory approval of bank mergers

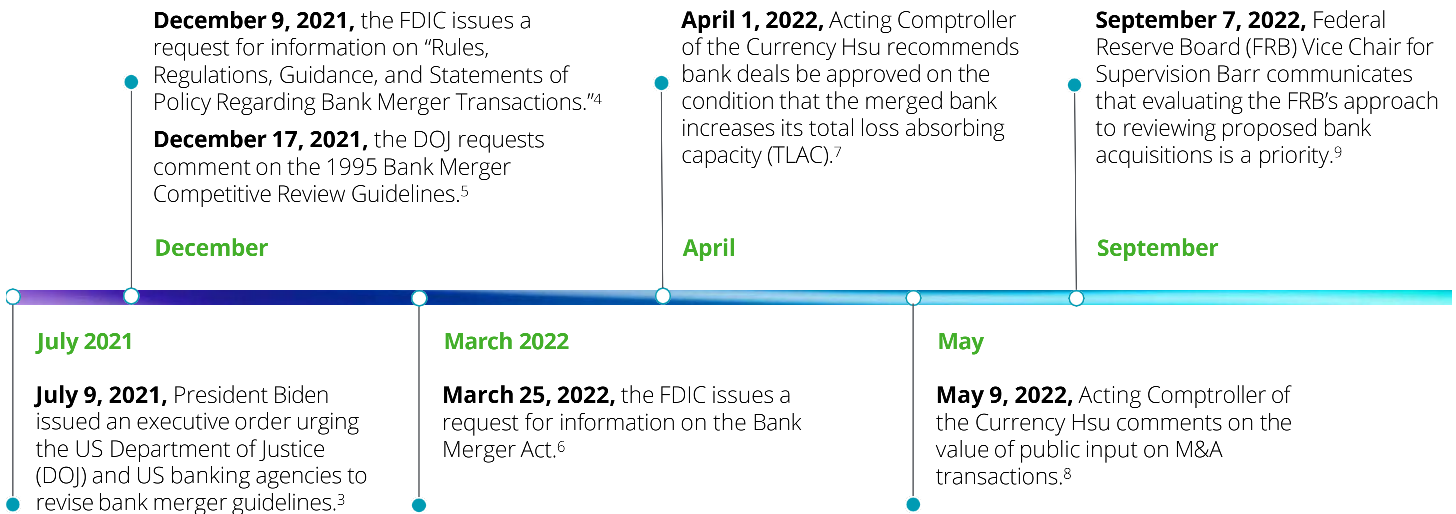
Introduction/background

Over the past decade there has been considerable consolidation in the US banking and capital markets industries fueled by an increase in merger and acquisition (M&A) activity. In 2021 alone, there were 208 total bank M&A deals with aggregate deal value of more than $77 billion, a 15-year high for the sector.[1] To manage the risks that may arise from this M&A activity, US banking regulators—the Federal Reserve (FRB), Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)—are evaluating the potential implications that bank mergers have on financial stability. For entities exceeding $100 billion in assets especially, this means greater scrutiny and a higher bar when seeking regulatory approval for merger activities (figure 1).[2]

Figure 1. Regulatory M&A developments timeline[3]

Regulatory review of bank merger guidelines

US banking agencies look to update long-standing M&A regulations, accounting for technological innovation in the banking sector and the potential threat to US financial stability posed by large bank transactions.



For financial entities looking to acquire, divest, or invest in another banking entity or its assets, this heightened challenge shift in focus means the second line, led by the chief risk officer (CRO) and chief compliance officer (CCO), must take a more visible and proactive role in examining the risks presented by a proposed transaction. The CRO and CCO alongside the typical Integration units/functions (e.g., Business Leads, CFOs, Technology, and Operations) must assess new activities, business processes, change management, and strategic and business planning, while also keeping in mind systemic risk implications. In addition, the second line must evaluate impacts of the M&A transaction to its own risk and compliance functions from end-to-end. This is especially true for larger banking organizations (with $100 billion or more in assets) whose regulatory requirements and supervisory expectations are more stringent.

Foundational activities for CROs and CCOs to consider at the start of any proposed transaction include the following:

- Complete an assessment of key material risks to the target entity or its integration into the acquiring bank to identify significant financial and nonfinancial risks and to ground prioritization of integration activities.

- Dedicate sufficient and knowledgeable resources with appropriate time to help coordinate the overall firm's assessment of the inherent, resultant, and emerging risks of the target and combined entities. Develop a plan to mitigate significant risks over time, outlining action steps, assigning responsibilities, and initiating a tracking mechanism.

- Ensure adequate risk and compliance representation at executive steering committees and other integration governance meetings with reporting and escalation to the board (likely the risk committee and full board, as appropriate).
- Ensure that the risk and compliance functions have the appropriate stature to influence organizational or functional change where needed.
- Validate the target entity's counterparties against core BSA/AML requirements—for example, Know Your Customer (KYC) requirements and Office of Foreign Assets Control (OFAC) sanctions.
- Conduct a current-state gap assessment of processes (following a risk-based approach) to ensure consistency with applicable rules, regulations, and expectations. Review new business process for target entity at appropriate timing, and prepare strategy changes to be approved by the board for the target entity.
- Perform a review of the regulatory risk/posture of the target entity. Understand the target entity's primary state and federal regulators and if they are subject to any public-facing enforcement actions or litigation that may negatively impact reputational or legal risk.
- Consider the new regulatory requirements that may apply after the transaction (especially those driven by changes in asset size). Determine if any newly applicable requirements (including regulations, supervisory guidance, and impact of tailoring regulations)[10] require proactive assessments such as a heightened standards review.
- Establish a model for managing integration decisions and regulatory communications across the first and second lines.
- Develop a process to enable information flow and transparency to the board and senior management around key decisions, key changes (e.g., product, risk appetite, organizational), and core integration activities (e.g., planning, risk management).
- Review the overall process for evaluating change risk, execution risk, and overall resourcing considerations (subject-matter expertise contention; balance between transaction, BAU, change, and organic growth).
- Set the tone at the top and liaise with regulators on behalf of the integration program by laying out how risk and compliance programs and processes will be merged at the resultant organization.

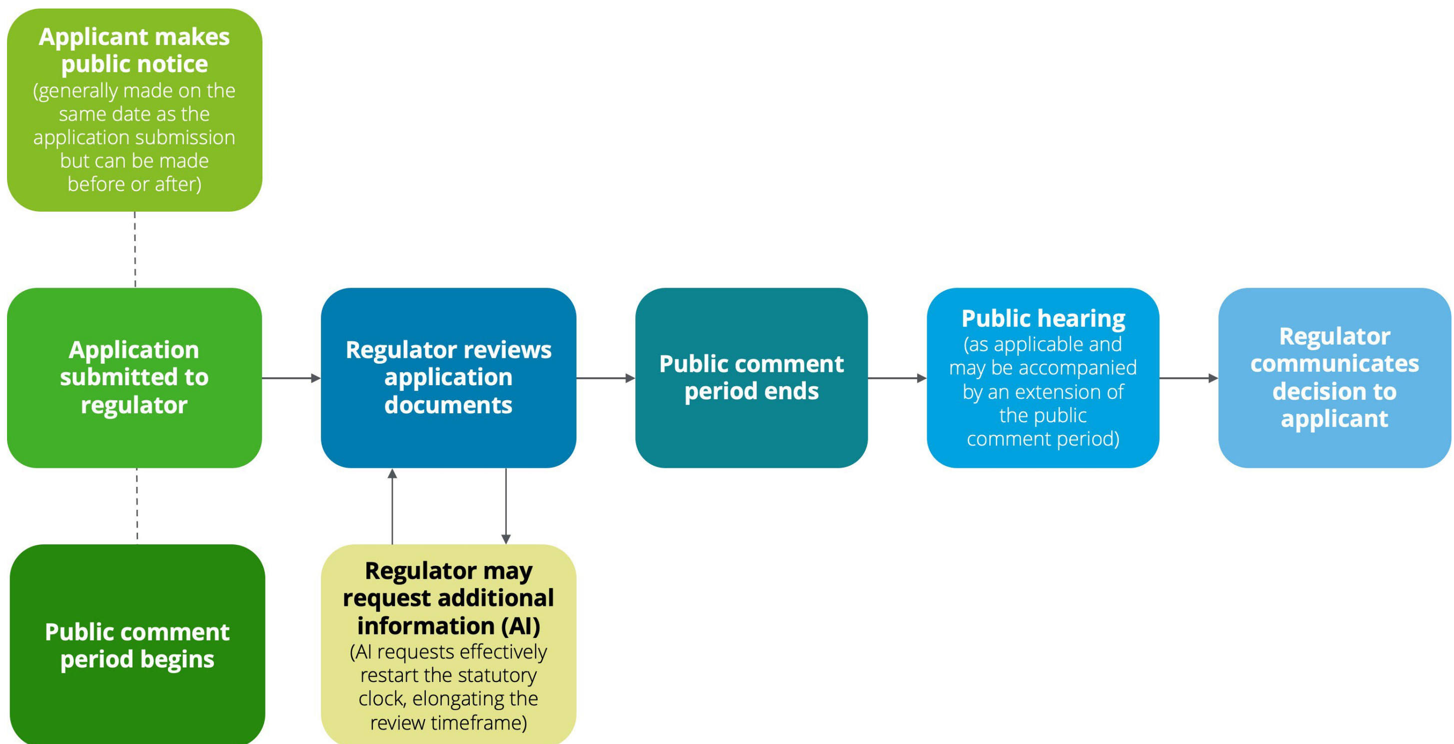
Ultimately the CRO and CCO are expected to challenge the impact of change to their respective functions and the firm as a whole, particularly the first line.

Against this backdrop, we expect the roles of the CRO, CCO, and other second-line leadership through the merger timeline, including their interactions with the board and risk committee, to become increasingly more important for attaining regulatory approval and closing the deal. In the remainder of this point of view, we expand on the CRO's and CCO's role in an integration, paying special attention to practices that may accelerate the process and mitigate associated risks and costs.

When and who: Timelines for the approval process, and which regulators approve which deals

The regulatory review and approval process under the Bank Merger Act (banks acquiring banks) and the Bank Holding Company (BHC) Act (BHCs acquiring banks, other BHCs, or their assets) are relatively similar.[11] Both begin with public notice of the deal and require actions on the part of the acquiring entity and the regulators, including preparing for potential public comments and/or hearings leading up to deal close. However, different deal types and sizes are overseen by different primary regulators, which will impact regulatory considerations. This process is outlined in the figure 2.

Figure 2. Bank and BHC merger illustrative timeline



There are also deal-specific nuances that drive the CRO and CCO responsibilities. For example, in larger mergers that include metropolitan markets, the CCO should expect the potential for an increased number of public comments. This can slow the regulatory approval process as commentor concerns get addressed and can add to the cost of a merger. A CCO should be sensitive to where the organization may need to do additional risk assessment based on past issues and product/geographic footprint. Similarly, depending on the applicable regulators and how the target entity has been supervised to date, the CRO and CCO will need to consider the potential impacts of regulations, such as OCC Heightened Standards and FRB Enhanced Prudential Standards, that may not have previously applied in the same manner and scrutiny to that target entity. For example, there are increased expectations of more formalized governance across lines of business and the lines of defense—and potentially a need for more, or more thorough, "horizontal" assessments and integrated views of risk across entities, as the bank increases in asset size.

The what: Regulatory review factors

While the regulators make progress on reviewing merger guidelines, the events of the previous months will likely not result in substantial changes to the factors regulators use to judge bank mergers in the near term. In the meantime, regulators are maintaining their focus on existing requirements. The following are some of the main factors regulators consider when reviewing a bank merger application:[12]

- **Competition** – This includes the extent of existing competition between and among the merging institutions, other depository institutions, and other providers of similar or equivalent services in the relevant product market(s) within the relevant geographic areas.

- **Prudential** – Regulators do not want to create larger, vulnerable institutions or debilitate existing institutions whose overall condition is currently satisfactory, so they will generally not approve a proposed merger where the resulting institution would fail to meet capital standards or have unsatisfactory management, or whose earnings prospects (both quality and quantity) are weak or doubtful.

- **Convenience and needs** – This factor largely focuses on the CRA and examines the extent to which the proposed merger transaction is likely to benefit the public along with each institution's CRA performance evaluation record.
- **Anti-money laundering (AML)** – The adequacy of each institutions programs, policies, and procedures for AML, relevant supervisory history, the effectiveness of any corrective programs, and information from other agencies (e.g., Department of the Treasury) all factor into whether the merged institution would have effective AML protections.

Figure 3. Merger application trends by bank size, 2015–2022

Bank size	Average aging time to regulatory approval[a]	Average aging time to deal approval[b]
Greater than $100 billion in assets	236 days	275 days
Less than $100 billion in assets	196 days	257 days
All banks	216 days	266 days

Source: S&P Capital IQ, Regulatory Approval Notices
Note: For open mergers that have not yet received regulatory approval or closed, number of days was calculated as of August 18, 2022.
[a] Number of days between regulatory approval filing and regulatory approval.
[b] Number of days between deal announcement and deal completion.

The focus for the CRO and CCO in concert with senior management and business leaders should be to acknowledge the regulatory review statutory windows and minimize the number of times the regulators request additional information on an application. When additional information is requested by the regulators, the timeline for regulatory approval is prolonged since the regulatory review period resets upon receipt of new information (figure 3). CROs and CCOs should focus on providing a thorough and complete application that specifically covers the previously mentioned factors that regulators consider, and they should be preparing the application in anticipation of the regulators' thorough review and challenge.

Figure 4. Merger application trends by public reaction, 2020

Public reaction	Average days for FRB to process application
Adverse public comments received	232 days
No adverse public comments received	64 days

Source: Congressional Research Service, "Bank Mergers and Acquisitions," October 2021

Getting these factors right when applying is important. When examiners and staff from the banking regulators identify substantive issues, concerns, or gaps within application materials, staff will typically request additional information from the applicant to "complete the record" by collecting all necessary information to inform a final decision.[13] This is where the importance of a comprehensive application package that speaks to the benefits, risks, and all other key aspects of a proposed transaction is critical. Multiple requests for information to complete the record could extend the overall application review timeline (figure 4). The CRO and CCO play key roles along with the legal and regulatory management functions.

Much attention has been paid to the fact that "federal banking agencies have not formally denied a bank merger application in more than 15 years."[14] However, if any identified issues cannot be resolved, the application is generally withdrawn by the applicant. From 2018 to 2020, the FRB, FDIC, and OCC reviewed a combined total of 336 bank merger applications, 22 (roughly 6.5%) of which were eventually withdrawn.[15] A withdrawn application is not an outright denial from a regulator; however, it could represent potential failure to meet regulatory standards, or the presence of some material flaw, and potentially results in a loss of investment in the deal. If there is a resubmission, the approval time will be extended even further. In addition, the financial, customer, and employee impact of a delayed regulatory approval cannot be understated.

Putting it all together: Legal day one themes

The business drivers of any merger will be top of mind for bank executives when working from deal announcement to deal close. But more than ever before, risk management and compliance need to be near the top of that list as well.

To say that gaining regulatory approval for a proposed bank or BHC merger deal is important would be stating the obvious; as the gatekeepers to whether a deal can proceed or not, it is a necessity that FRB, OCC, FDIC, and state regulators (as applicable) give their approval. Thus, the point is not whether a deal gets the approval of the regulators or not, but rather ***how*** acquiring banks can set themselves up for success through the application process and legal day one ("LD1") planning to avoiding significant delays and their consequences.

In terms of impact and expectations of the CRO, CCO, and legal and regulatory management, we recommend intense focus on the following LD1 considerations:

- **Understand the risks of the target and combined entity**
  - Follow an institution's new activities, business policies, and governance processes through the transaction timeline, as well as processes that are utilized to mitigate change management
  - Develop an early view of combined risk and compliance strategy grounded in a material risk assessment of the target entity and any additional subject-matter-specific assessments depending on what's identified in the material risk assessment (e.g., counterparty credit concentration risks, gaps in operational risk capabilities)
  - Focus on early alignment of risk appetite setting and limits, with analysis of new businesses, products, and risks that may be or become present and how they will be managed, as well as the integration of business planning/strategy, financial planning, and risk appetite setting
  - Maintain strong emphasis on consumer compliance and protection rooted in an analysis of the entities' capabilities and the applicable laws, rules, and regulations (potential supervisory guidance may need to be reviewed for applicability depending on the situation)
- **Proactive regulatory communication and management**
  - Consider submitting a "pre-filing" to the relevant banking regulators, for transactions subject to FRB and other approvals, to obtain the agency's preliminary reaction to a potential proposal in advance of submitting finalized application materials[16]
  - Develop clear approaches for resolving any existing regulatory issues impacted at both financial institutions, including the resources and plans to address those issues
  - Create detailed integration plans and playbooks not only to guide integration but also with a regulatory audience in mind as regulators will likely expect to review materials on a regular basis
  - Establish a feedback loop to share regulatory feedback on an ongoing basis with relevant stakeholders; centrally manage regulatory updates for consistency and minimum quality
  - Identify a "cornerstone" to anchor communications with regulators, such as a material risk assessment (discussed earlier), which can be an effective way to ensure consistent messaging and avoid time-consuming requests for more information
- **Pro forma risk capital, liquidity, estimates, and reporting**
  - Present conservative pro forma to demonstrate adequacy of capital and liquidity, and other risk data impacting the return on investment (ROI) of the deal
  - Understand the practical impacts of merging bank entities and holding companies on LD1 (data sharing, exposure calculations, aggregated reporting, etc.), and be prepared to produce consolidated regulatory reporting (e.g., FFIEC 102, FR Y-9C, FR 2052a, Call Reports)
  - Assess the extent to which the resultant entity would be subject to new or additional regulatory reports based on a change in size or complexity, and communicate preparedness to adhere to applicable reporting requirements

- **Consolidate an effective LD1 integration plan**
  - Establish clear governance structures to facilitate active board management or risk at the newly acquired entity on LD1, or as a fast follower, including the adoption of key top-of-house risk and compliance frameworks and policies
  - Outline an LD1 organizational model clearly identifying how the three lines of defense, including the CRO and CCO functions, will interact on LD1 and be integrated at the combined entity, with specific plans for how the second line of defense will execute its "check and challenge" mandate on the target's first-line activities and processes
  - Have a clear plan to align legal entity structure, board participation and responsibilities, governance processes, and core risk and regulatory reporting (across the three lines)
- **Provide a "check and challenge" process to business and other integrations**
  - Early in the integration process, CROs and CCOs should facilitate information sharing with internal audit to align on planning and documentation practices and expectations
  - Process for developing and socializing integration plans should have embedded checkpoints with internal audit to allow for timely and credible audit validation
  - Active board oversight, monitoring, and escalation by senior management

From both the acquiring entity and the target entity, CROs and CCOs must have a seat at the table and be active participants throughout the deal and integration process. What's more, regulators expect that CROs and CCOs have experienced managers to navigate deal closure and ensure proper risk and compliance functions are in place from LD1 onward as well as to provide a lens to the changing risk profile of the combined organization or resulting organization, both in their individual roles and in their reporting and escalation responsibilities to the board and risk committee.

As the regulatory scrutiny on these areas and bank mergers at large firms increases, so, too, does the importance of the above themes, and no one will be in a better position to understand and execute on these priorities than the CRO and CCO.

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Endnotes

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