



Updated March 28, 2024

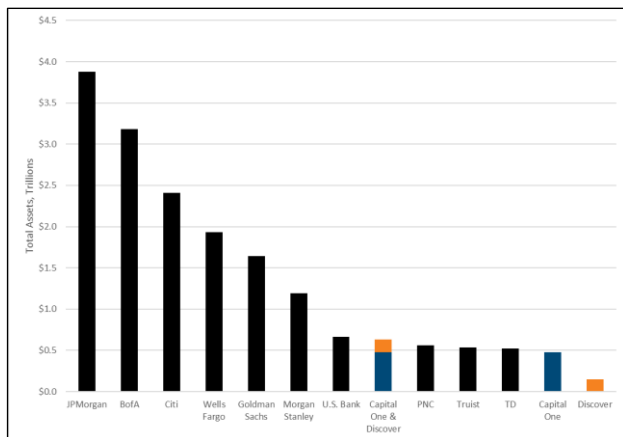
Capital One–Discover Proposed Merger: Systemic Risk and Market Competition Considerations

In February 2024, Capital One announced a merger deal with Discover. This In Focus explores the policy issues raised by the potential merger that may be of interest to Congress, with particular attention to the competition and systemic impacts on the banking system.

Capital One is the ninth largest depository institution in the country, with the 12th largest parent bank holding company (BHC) by assets (\$478 billion). It is also one of the largest issuers of Visa- and Mastercard-branded credit cards. Discover is the 27th largest depository, with the 33rd largest BHC (\$152 billion in assets). Discover also operates one of the four largest card payment networks in the country and is a major issuer of payment cards. If the banks do not divest any current assets, the merger would result in an insured depository institution with over \$600 billion in assets, making it the sixth largest depository and eighth largest BHC in the country. As shown in **Figure 1**, the institution would be significantly smaller than the six largest BHCs but comparable in size to four banking organizations currently in the next tier (over \$500 billion in assets). Additionally, it would combine two of the five largest card issuers and one of the largest card networks into one institution.

Figure 1. Comparing Capital One and Discover to the 10 Largest Banking Organizations

December 31, 2023



Source: CRS calculations based on data from Federal Reserve.
Note: TD is an intermediate holding company. Others are BHCs.

Regulatory Approval Process

Statute requires bank regulators to review merger applications for, among other things, their effects on competition and grants them authority to block mergers that do not meet certain standards. This merger is subject to the approval of the Federal Reserve (because both banks are

structured as BHCs) and the Office of the Comptroller of the Currency (because Capital One is a national bank). In addition, the Department of Justice has the authority to block any merger on antitrust grounds. It and the bank regulators review proposals for their effects on market power on the national and local levels. Bank mergers are also subject to numerical statutory concentration limits to curb market power—the merged entity may not hold more than 10% of total deposits nationally or 30% of deposits in any state, and for BHCs, the merged entity cannot hold over 10% of all financial company liabilities nationally. According to the application, the merged entity would hold 2.6% of national deposits and 2.3% of liabilities—not close to the national limits. However, their combined deposits in Delaware would be 65% of the state total. The merger application requests an exemption from the state limit, in part because they are largely online deposits.

Bank regulators must also consider other aspects of a merger, such as whether the merged institution would have adequate financial, capital, and managerial resources. Regulators consider the “convenience and needs of the community” and the banks’ Community Reinvestment Act (P.L. 95-128) ratings. As of the date of the latest rating, Discover held a *satisfactory* rating and Capital One held an *outstanding* rating. Regulators also consider the banks’ effectiveness in combatting money laundering. According to the Fed, “deficiencies that have resulted in the issuance of a formal or informal enforcement action generally are considered to be less than satisfactory.” In 2021, Capital One paid a \$390 million civil money penalty for violating anti-money laundering regulations. More broadly, issues resulting in enforcement actions or supervisory downgrades are expected to be resolved before a merger is approved. Both Discover and Capital One over the past several years were subject to enforcement actions in various areas, although this is not uncommon for large banks. While these specific actions were resolved, regulators do not make information about outstanding supervisory concerns at any bank publicly available. However, Discover noted in its recent Form 10K that it expects an enforcement action to result from a recent card product misclassification issue.

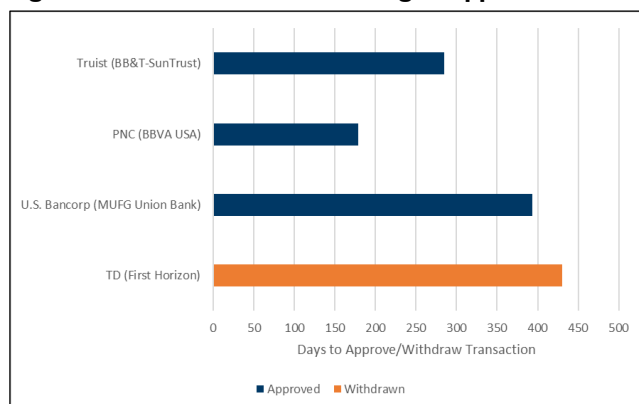
The time regulators take to review a particular merger varies, and it is not uncommon for several months to pass between a large merger announcement and approval, as shown in **Figure 2** for four recent proposed mergers by banks currently closest in size to a merged Capital One–Discover entity. Those review periods took between 179 and 430 days, with three approvals and, in the longest case, a withdrawn application (TD–First Horizon). To gain regulatory approval, applicants often make changes to their activities or holdings, such as divesting branches in

overlapping markets to allay concerns about market power, which creates uncertainty about how a merger will affect factors such as competition and systemic risk until approved.

Systemic Risk Issues

Regulators must also consider whether the merger poses systemic risk to the U.S. banking or financial systems. Although there does not seem to be a standard formula for determining this, the factors considered overlap with those used to classify *Globally Systemically Important Banks*, or G-SIBs. G-SIBs are classified on the basis of size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity. To mitigate systemic risk, large banks are subject to enhanced prudential regulation (EPR). Under EPR, banks are placed in four categories and subject to progressively more stringent regulations. Capital One is currently a *Category III* bank and Discover is a *Category IV* bank, and the EPR category of the merged entity is also likely to be *Category III*, so it would not be subject to more stringent EPR requirements than currently apply to Capital One (but more stringent requirements than currently apply to Discover). The merged entity is unlikely to meet the definition of a *Category I* (i.e., G-SIB) or *Category II* bank. The entity would not initially meet the asset or cross-jurisdictional activity threshold for *Category II* banks. The merged entity would also score relatively low on all of the metrics used to identify G-SIBs except size, intra-financial system assets, and securities outstanding. All of the other banks in **Figure 2** also remained *Category III* banks following their mergers.

Figure 2. Duration of Recent Merger Applications



Source: CRS calculations based on data from S&P Capital IQ.

Notes: The post-merger bank is not in parentheses. For TD–First Horizon’s merger proposal, figure shows length of time from announcement to withdrawal.

Retail Payment Issues

While making loans and accepting deposits are the core operations of a bank, there is a third critical function banks serve: payments. Banks are crucial in the facilitation of retail and wholesale payments. For example, banks are the institutions that issue payment cards (retail) and settle transactions (wholesale) at the Federal Reserve.

At the end of 2023, more than a quarter of Capital One’s total assets and nearly half of its loan portfolio were credit card loans. Credit card loans were 68% of Discover’s

assets. According to Capital One’s regulatory filings, it was the third largest issuer of Visa and Mastercard payment cards. Capital One credit card users purchased around \$587 billion in transaction value in 2022. Discover credit card holders purchased around \$224 billion, with an additional \$550 billion run through Discover proprietary and affiliated debit card networks. Absent changes, the merger would result in a depository institution with a retail card issuer that accounts for over \$1 trillion in annual transaction volume.

The competition consideration in merger reviews generally focuses on deposit concentration, but regulators also sometimes consider competition in product markets, notably for mergers involving specialty banks, such as credit card banks. Capital One and Discover are both among the largest credit card issuers in the country, and Discover operates a large card network that processes credit and debit cards. Further, Discover’s debit card network structure is currently not covered by certain provisions of Regulation II, which regulates debit card transaction fees. (Regulation II implemented the “Durbin Amendment.”)

According to the application, Capital One plans to integrate its card issuance with Discover’s network. It is uncertain whether this would drive prices (i.e., “swipe fees”) down, by creating economies of scale and helping the Discover network better compete with Mastercard and Visa in retail payments, or drive prices up by reducing competition through the vertical integration of two major actors in the different parts of the market. Competition in this market has perennially drawn congressional attention, and promoting competition in the credit card market is one of the primary goals of legislation such as the Credit Card Competition Act of 2023 (S. 1838/H.R. 3881). Regulation II caps permissible debit transaction fees. Currently, Capital One does not have a large debit card business, but its debit card issuance is covered by the regulation, meaning the revenue it can generate from a transaction (i.e., “interchange”) is limited by the price cap. In its February 2024 8-K securities filing, Capital One noted that it would benefit from moving its debit portfolio to Discover networks, which are not covered by Regulation II price caps.

CRS Resources

CRS In Focus IF11956, *Bank Mergers and Acquisitions*, by Marc Labonte and Andrew P. Scott

CRS In Focus IF11893, *Merchant Discount, Interchange, and Other Transaction Fees in the Retail Electronic Payment System*, by Andrew P. Scott

CRS In Focus IF12548, *How the Credit Card Competition Act of 2023 Could Affect Consumers, Merchants, and Banks*, by Andrew P. Scott

CRS Report R47876, *Enhanced Prudential Regulation of Large Banks*, by Marc Labonte

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