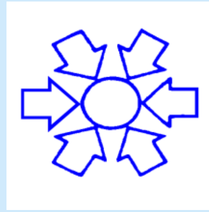

Financial Services Management

Holding-Company Powers, M&A

Corporate Planning	Strategic Action Item

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Dodd-Frank Act

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Title VI

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Overview

In this report, FedFin turns to Title VI of the Dodd-Frank Act, examining provisions that rewrite how large financial holding companies (FHCs) are regulated and who can own insured depositories under what terms. This title also includes the "Volcker rule" on proprietary trading and non-traditional investments, but this is not covered in depth here.[1] This title also ends the barrier to paying interest on business demand deposits.[2]

The provisions assessed in this report – while often overlooked due to the furor over the Volcker Rule – are also very significant strategic concerns, redefining as they do the degree to which an FHC can benefit from the funding advantages and other market benefits of owning an insured depository institution. This is accomplished through tough new inter-affiliate transaction restrictions that expand the scope of limits on the use of bank funds for non-traditional banking purposes. New lending limits also cover national banks and certain state-bank activities, creating both limits on national-bank non-traditional activities (e.g., securities lending, derivatives)

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[1] See Client Report PROPTRADE5, July 6, 2010.

[2] See Client Report INTEREST, *Financial Services Management*, July 20, 2010.

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and incentives to house them in a state-chartered bank. The law also brings the FRB far more strongly into regulating all FHC and bank holding company subsidiaries, creating the prospect for strict new rules for them not otherwise mandated by "functional regulators" (e.g., the SEC and state insurance regulators). Certain subsidiaries will also be regulated as if an activity were conducted in a bank, significantly limiting the perceived and real benefits of housing entities outside all of the rules – most notably ongoing examination. This creates a new strategic framework for integrating banking and non-bank financial services.

Significant new limits on size are mandated and, while these do not break up the biggest banks, they will limit growth going forward outside of emergency or other exempted transactions. Indeed, the overall criteria governing large M&A deals are so changed that new strategic considerations are required in any contemplated transaction. Tough new capital rules that build on others mandated in law[3] will also constrain M&A activity going forward in the financial sector if an insured depository is involved. A forthcoming strategic analysis of CEO decision points will highlight many of the issues raised in this part of the Dodd-Frank Act.

Analysis

A. Non-Bank Banks

1. *Intermediate Holding Companies*

The Dodd-Frank Act imposes new conditions on commercial firms that control insured depositories, including allowing the FRB to mandate "intermediate holding companies" in certain circumstances.[4] A "commercial firm" must have less than fifteen percent of its annual gross revenues from activities that are financial in nature and, if applicable, from the ownership or control of one or more insured depository institutions.

This title also allows this intermediate holding company structure for parents of savings associations that do not pose systemic risk, with the FRB authorized to mandate it for unitary thrifts or other S&L parents engaged in non-financial activities. The Board could mandate this ninety days after the transfer date (see below), but rules on it are required (without a deadline). In general, grandfathered unitary firms may continue prior internal financial activities outside the intermediate entity, but the Board could bar this if desired on grounds detailed in law. Colloquies on the law suggested that only one intermediate holding company would be required if a firm fell under numerous provisions in this arena.

[3] See Client Report SYSTEMIC29, *Financial Services Management*, July 13, 2010.
[4] See Client Report SYSTEMIC29, *Financial Services Management*, July 8, 2010.

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2. *Moratorium and Study*

The FDIC is barred from approving an application for deposit insurance received after November 23, 2009 for a credit-card, industrial or trust bank controlled directly or indirectly by a commercial firm. This will sunset three years after enactment. Changes in control for them are similarly barred during the moratorium unless regulators approve them under permitted exceptions (e.g., to forestall failure, ordinary M&A of a parent concern).

During this moratorium, GAO is to study non-bank banks, reporting in eighteen months on whether these entities pose risk or other problems, as well as on the adequacy of the regulatory regime governing savings associations. In the past, GAO has urged significant restrictions on non-bank banks. However, even if it does so again – as seems likely – the moratorium will end absent Congressional action, permitting new non-bank banks, albeit under all the restrictions now applicable to them.

3. *Small-Business Lending*

Credit-card banks will not lose their unique status now if they engage in small-business lending.

B. Holding Companies

The transfer date referred to below is the one established in Title III for the transfer of current supervisory duties among the bank regulatory agencies and the end of the Office of thrift Supervision. It is one year after enactment (i.e., July 21, 2011), although it could be extended an additional six months.

1. *FRB Authority*

The FRB is given broad authority upon the transfer date to examine functionally-regulated FHC subsidiaries (e.g., broker-dealers, insurers) other than insured depositories, repealing limits imposed here in the Gramm-Leach-Bliley Act.[5] It is also expressly authorized to examine bank holding company (BHC) subsidiaries, clarifying the degree to which the FRB may examine entities such as mortgage banks or finance companies housed in a BHC outside an insured depository. The BHC powers focus on examination to prevent a BHC or FHC from posing risk to affiliated banks or the U.S. financial system, but the FRB could also intervene if it believes consumer-protection concerns arise (although these would more likely be addressed by the Bureau of Consumer Financial Protection established elsewhere in the Dodd-Frank Act).[6]

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[5] See *Financial Services Management*, November 15, 1999.

[6] See Client Report CONSUMER13, June 3, 2010.

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In addition, Dodd-Frank repeals limits in the Gramm-Leach-Bliley Act on the Board's ability to issue rules or take enforcement action against non-bank subsidiaries in BHCs and/or FHCs. Although examination requires coordination with functional regulators, issuing rules for these entities or taking enforcement action against them does not unless systemic concerns are involved.[7]

In setting rules for non-bank subsidiaries of BHCs and FHCs that are not functionally regulated or insured depositories, the FRB is to ensure these are comparable to those governing the lead bank in the holding company and hold these firms to the same standards in its examinations. Coordination with state functional regulators is required and sharing with them is permitted under certain circumstances. If the Board does not supervise the non-bank subsidiary to the satisfaction of the lead-bank regulator, a process for resolving disputes and, then, intervention by the banking agency (including with enforcement actions penalizing the subsidiary as if it were an insured depository) may proceed.

2. *S&LHCs*

All of these powers are also granted to the FRB for savings-and-loan holding companies (S&LHCs) and their day-to-day regulation is conformed to reflect the new savings-association framework required elsewhere in the law.[8] However, the rules do not apply to S&LHCs where the thrift subsidiary operates solely in a trust or fiduciary fashion or if it is the parent of an intermediate holding company (see above).

3. *Acquisitions*

Effective on the transfer date, all holding companies associated with an insured-depository interstate acquisition must be well-capitalized and well managed, with the law elsewhere requiring that the insured depository meet these criteria both before and after acquisition. New rules are also established when an FHC acquires a non-bank with assets over $10 billion, with prior approval now generally required (although exceptions may be permitted depending on the activities in which the acquired firm engages). Elsewhere in the law, BHCs with over $50 billion in assets are also required to obtain prior approval for non-bank acquisitions over $10 billion.[9] Otherwise, prior approval remains inapplicable for FHC entry into permissible activities or most acquisitions.

The criteria the FRB must review in considering all applications for acquisitions now include the degree to which the transaction affects risk to the U.S. banking or financial system.

[7] See Client Report SYSTEMIC29, *Financial Services Management*, July 8, 2010.
[8] See client Report REFORM39, April 1, 2010.
[9] See Client Report SYSTEMIC29, *Financial Services Management*, July 8, 2010.

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4. *Capital*

As noted, acquisition-related capital standards are tightened. In addition, the FRB is directed to make BHC and S&LHC capital as counter-cyclical as possible. The law also dictates similar rules for insured depositories.

5. *Source of Strength*

BHCs and S&LHCs (including the intermediate ones described above) are now required to serve as a source of strength to insured-depository subsidiaries, which regulators must also mandate when control of an insured depository vests directly or indirectly outside a holding company. Regulators may require reports under oath from these persons to ensure their ability to serve as a source of strength. Rules here are due one year after the transfer date, with the source-of-strength duty effective at the transfer date. This would appear to allow a regulator to enforce a source-of-strength call even if rules have yet to be issued.

C. Bank Operations

1. *Inter-Affiliate Transactions*

This section of the Dodd-Frank Act significantly revises current requirements in this area,[10] with the new restrictions effective one year after the transfer date.

Going forward, any investment fund advised by the bank or an affiliate is considered an "affiliate" for purpose of these restrictions, which limit the total amount of "covered transactions" between a bank and affiliates and require that these be conducted on an arm's-length basis.

In addition, repurchase agreements are now considered "extensions of credit" for purposes of the collateral rules governing inter-affiliate transactions and other transactions and financial structures are also brought under the full range of inter-affiliate transaction restrictions. Of particular note here is coverage of any securities financing transaction and derivatives in which a bank has a "credit exposure" to an affiliate. Credit exposures are not defined in the law, giving the FRB some rulemaking scope here.

Collateral rules related to inter-affiliate transactions now must be met over the life of the transaction, not just at its outset and the overall collateral standards are tightened. The inter-affiliate transaction rules are also tightened for financial subsidiaries.

In implementing these restrictions, the FRB may take netting into account and exempt transactions that are fully secured in accordance with standards in the law. However, any relaxations of the inter-affiliate transaction rules

[10] See Client Reports in the REGW series.

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related to a specific institution must be issued jointly by the FRB and appropriate regulator. The OCC, FRB or FDIC may exempt transactions from inter-affiliate restrictions under a process detailed in law, but the FDIC is required to approve any such exemptions if it is not the lead agency granting them. If it is, then the FRB must approve the exemption.

2. Lending Limits

Rules here are also significantly tightened, with national banks and savings associations now required to apply loan-to-one-borrower limits also to direct or indirect credit exposures related to repurchase agreements, securities financing or derivatives. These rules must be effective one year after the transfer date.

These lending limits do not apply to state-chartered banks, but they may only engage in derivatives transactions if their state loan limits apply to them. This provision is effective eighteen months after enactment.

3. Conversions

The law generally bars charter conversions if a bank is subject to sanction by its federal regulator related to a "significant" supervisory matter or similar action by a state attorney general, although conversions may proceed if regulators permit them and various requirements are met.

4. De Novo Branching

This is now permitted for national and out-of-state banks in states that otherwise bar it.

D. Securities Operations

Although the SEC no longer allows "consolidated supervised entity" charters,[11] the law bars them going forward. Instead, it allows a new "securities holding company," which could be established under Federal Reserve regulation by broker-dealers facing demands in the European Union or elsewhere for consolidated regulation. This structure may be of particular use to asset managers and investment banks, as the rules governing a securities holding company could be less onerous even though the FRB is likely to seek parallel treatment to the greatest extent possible. The Board is given considerable authority to set capital and related standards for these securities companies, although it is required to tailor these to individual firms and/or business models.

The final version of the law bars this charter to any firm deemed a non-bank financial company subject to FRB systemic regulation, meaning that any current BHC seeking to exit this charter under the "Hotel California" provisions in the law[12] could not use it if still subject to systemic regulation. Any company controlling a bank or thrift (other than a non-bank bank) or most

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[11] See Client Report CHARTER7, *Financial Services Management*, July 8, 2004.

[12] See Client Report SYSTEMIC29, *Financial Services Management*, July 13, 2010.

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foreign banks could not make use of this charter. In general, the FRB's authority over the securities company parallels that for BHCs, although activity restrictions would not apply.

E. Concentration Limits

1. Large Firms

Subject to recommendations of the Financial Stability Oversight Council, a financial company may not merge with or otherwise consolidate with another if the total consolidated liabilities of the resulting company would exceed ten percent of total liabilities in U.S. financial companies in the prior year, although exceptions may be made if the FRB finds this necessary in the event of a failing bank or similar situations. The law covers all financial companies (including those that control insured depositories even if not otherwise regulated) and foreign banking organizations active in the U.S. Liabilities are defined generally as assets minus regulatory capital, with the FRB told to define this more precisely for insurance companies.

The FRB is to issue rules here based on FSOC recommendations, with the Council recommendations due six months after enactment. Importantly, the recommendations may modify the otherwise-express statutory requirements noted above. FRB rules are due nine months after receipt of this study, with the rules "reflecting" FSOC recommendations and thus governed by apparent limits on FRB discretion in this strategic area.

2. All Mergers

Going forward, no entity may control more than ten percent of total U.S. deposits following an acquisition or merger. This does not, however, bar organic growth or emergency transactions. Prior law imposed a similar requirement on bank deposits, but large acquisitions were possible due to the exclusion of thrift deposits.

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