FedFin Client Report

Monday, April 29, 2024

FedFin Assessment: Index-Fund Passivity Debate Could Touch Broader Control Questions

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Executive Summary

As we noted, the FDIC board late last week faced the unusual and perhaps unprecedented situation of a staff resolution supported by its Chair and one Democratic Director that was countered by a different proposal from Republican Directors, with both options finally tabled due to objections from the Acting Comptroller. Both proposals address the extent to which index-fund managers can hold what would otherwise be controlling stakes in banking organizations exempted by virtue of passivity commitments that have come under fire from all sides. We expect the next move will be an inter-agency RFI launched by Mr. Hsu and accepted by the FRB as an interim step to a possible inter-agency rule about which the Fed appears to have considerable qualms. Should this falter, Mr. Hsu also said that he is open to the kind of rulemaking CFPB Director Chopra proposed should the Fed prove unwilling to work with the FDIC on next steps. This report analyzes these competing proposals; final action or even interim examiner intervention in this arena has considerable impact not only on asset managers, but also on bank corporate governance and market capitalization. Changes are also possible to the liberal standards set by the FRB in 2020 defining when a controlling interest or even certain seemingly-controlling conditions such as a board seat do not constitute the legal control forcing BHC designation (see FSM Report **TAKEOVER10**).

Analysis

Staff/CFPB Proposal

Notably, Director Chopra's statement makes it clear that this approach is intended not only to capture unduly-active fund managers, but also nominally-passive owners such as FTX when it came to a small Washington State bank. This was made possible via the FRB's 2020 rule, which as noted considerably loosened the criteria that could lead those with ownership stakes to come under BHC designation. Mr. Chopra links this rule not only to direct bank control but also to asset managers who are, for example, allowed to sit on a bank's board without waiving their passivity commitment.

The proposal thus takes the form of a draft rule that gives the FDIC a chance to object to

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

Fed agreements to change in control if the banking organization involves an FDIC-supervised bank. This would of course have no impact on filings involving a national bank, the reason Mr. Hsu pressed for an inter-agency approach. The NPR also asks about the advisability of monitoring passivity commitments, thus also indirectly considering Mr. McKernan's approach.

GOP Option

Proposed by Director McKernan and supported by Vice Chair Hill, this alternative is strictly limited to asset managers, taking the form of a resolution stating that, if the Federal Reserve does not provide the FDIC with notice regarding a Change-in-Bank-control involving an FDIC-supervised institution, the FDIC will require notice also to be made to it. The FDIC would also enhance passivity-agreement compliance monitoring and the FDIC's comfort with the resulting ownership structure. The FDIC would then evaluate the facts and circumstances related to a fund manager's passivity commitment. This monitoring would be on an annual basis when fund companies or "complexes" control more than five percent of an FDIC-supervised institution.

In his statement at the FDIC meeting, Mr. McKernan noted that he proposed this approach to examining self-certification after there was no agreement on the board regarding sending letters to large fund managers asking about their ownership status and, in the absence of a compelling response, establishing a presumption of control. Blanket passivity commitments would then be monitored as detailed above.

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E-mail: info@fedfin.com www.fedfin.com