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Financial Holding Company (FHC) Issues

CONFERENCE OF STATE BANK SUPERVISORS
& INSTITUTE OF INTERNATIONAL BANKERS
US Regulatory/Compliance Orientation Program

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DEFINITION OF A FINANCIAL HOLDING COMPANY (FHC)

Bank holding company that:

- Controls one or more depository institutions that meet Federal Reserve Board (FRB) requirements for FHC status
- Makes an effective election to become an FHC

A foreign banking organization (FBO) that also is a bank holding company for purposes of the Bank Holding Company Act can become an FHC

An FBO that maintains direct branches or agencies, but does not control a U.S. depository institution, can elect to be treated as an FHC

FHC status is available as well to a company that controls an FBO

FHC authority is in addition to the authority available to FBOs under Regulation K

WHY BECOME AN FHC?

Authority to engage in the US in nonbank activities that are "financial in nature" or incidental or complementary to a financial activity -- a significantly broader list than those permissible for a bank holding company or FBO that has not elected FHC status/treatment

Except for "complementary" activities, no need to obtain prior approval from the Federal Reserve Board to commence any such activity *de novo* or to acquire a company engaged in any such activity

HOW AN FBO BECOMES AN FHC

FBO files a written declaration stating that it elects to become an FHC or to be treated as an FHC

- Declaration must certify that "well capitalized" and "well managed" requirements are met
- Provide risk-based capital ratios and amount of tier 1 capital and total assets (as of end of prior quarter)
- Provide risk-based capital ratios for each US depository institution subsidiary

FBO that has not been found to be subject to "comprehensive supervision on a consolidated basis" (CCS) and is from a country from which no bank has been found to be subject to CCS is required to use the "pre-clearance" procedure

If FBO does not meet the CCS standard, then

- Home country must have made "significant progress" toward CCS
- FBO's capital levels "significantly exceed" minimum levels required to meet the "well capitalized" standard

HOW AN FBO BECOMES AN FHC (CONT'D)

- Applicable standards
  - If the FBO has a US branch or agency, the FBO is "well capitalized" and "well managed"
  - Each FBO-controlled non-US bank that has a US branch or agency is "well capitalized" and "well managed"
  - Each US depository institution subsidiary is "well capitalized" and "well managed"
  - Each US insured depository institution subsidiary (and, where applicable, each FDIC-insured US branch) has received a rating of at least "Satisfactory" in connection with its most recent examination under the Community Reinvestment Act of 1977("CRA")

HOW AN FBO BECOMES AN FHC (CONT'D)

"Well capitalized" standards

- *The FBO (and each non-US bank subsidiary that has a US branch or agency)*
  - If covered by the Basel Accord, must have minimum tier 1 and total risk-based capital ratios of 6% and 10%, respectively, as calculated under home country standards
  - In addition, capital must be comparable to capital required for FHC-controlled US bank
  - Alternative: determination under the "pre-clearance" procedure
- *US depository institution subsidiaries*
  - Minimum tier 1 and total risk-based capital ratios of 6% and 10%, respectively
  - Minimum leverage ratio (tier 1 capital to average total consolidated assets) of 5%

HOW AN FBO BECOMES AN FHC (CONT'D)

"Well managed" standards

- *The FBO (and each non-US bank subsidiary that has a US branch or agency)*
  - Composite examination rating of at least "Satisfactory" for US branches/agencies (on a combined basis)
  - Consent of home country supervisor
  - The FBO's management "meets standards comparable to those required of a US bank owned by [an FHC]."
- *US depository institution subsidiaries*
  - At least a "Satisfactory" composite examination rating
  - At least a "Satisfactory" rating for management

PERMISSIBLE ACTIVITIES OF AN FBO - FINANCIAL ACTIVITIES

- Regulation Y "laundry list" activities and other activities determined by FRB to be "closely related to banking" under Section 4(c)(8) prior to enactment of Gramm-Leach-Bliley Act (GLB)
- Activities determined by FRB to be usual in connection with the transaction of banking outside the US under Regulation K
- Underwriting and dealing in securities without pre-GLB revenue restrictions and operating conditions
- Insurance underwriting -- property, casualty, health, disability, life -- and annuities
- Insurance company portfolio investments

PERMISSIBLE ACTIVITIES OF AN FBO - FINANCIAL ACTIVITIES (CONT'D)

- Merchant banking investments
  - Securities or insurance adviser affiliate
  - Bona fide merchant banking purpose
  - Holding periods
  - No involvement in routine management or operations of portfolio companies, except in workout situations
  - Cannot be held by a depository institution or depository institution subsidiary

PERMISSIBLE ACTIVITIES OF AN FBO "INCIDENTAL" TO FINANCIAL ACTIVITIES

- Activities determined to be "financial in nature or incidental to such financial activity" by FRB in consultation with the Treasury Department
  - "Finder" activities (e.g., hosting an electronic marketplace on the FHC's web site)
  - Citigroup permitted to acquire, operate and manage a third party, fully funded, "hard-frozen" pension plan in the UK - an activity deemed to involve investment advisory and investment management skills and the types of operational and investment risks that financial institutions routinely incur and manage (Citigroup Inc., 94 Fed. Res. Bull. C16 (2008))
- In determining whether an activity is financial or incidental to a financial activity, must take into account:
  - Statutory purposes of BHCA and GLB
  - Changes or reasonably expected changes in the marketplace in which FHCs compete
  - Changes or reasonably expected changes in technology for delivering financial services
  - Whether activity is necessary or appropriate to allow FHC to--
    - (i) Compete effectively with companies seeking to provide financial services in the US
    - (ii) Efficiently deliver financial information and services through technological means
    - (iii) Offer customers available or emerging technology for using financial services or for document imaging of data

PERMISSIBLE ACTIVITIES OF AN FBO "COMPLEMENTARY" TO FINANCIAL ACTIVITIES

- Activities that FRB determines by regulation or order are "complementary" to financial activities, do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally and could be expected to produce benefits to the public that outweigh possible adverse effects.
  - FRB policy objective is to avoid FHC's becoming disadvantaged by market developments if commercial activities evolve into financial activities or competitors find innovative ways to combine financial and nonfinancial activities
  - Examples of approved activities to date by specific order:
    - **Trading physical commodities as principal and taking delivery of physical commodities in connection with certain derivatives contracts (E.g., Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008))**
    - **Disease management and mail order pharmacy activities in connection with underwriting health insurance (WellPoint, Inc., 93 Fed. Res. Bull. C133 (2007))**
    - **Energy management services to owners of power generation facilities in connection with acting as a principal in commodity derivatives and providing financial and investment advisory services, physically settled energy tolling (E.g., Royal Bank of Scotland Group plc, 94 Fed. Res. Bull. C60 (2008))**

PERMISSIBLE ACTIVITIES OF AN FBO "COMPLEMENTARY" TO FINANCIAL ACTIVITIES (CONT'D)

- In requesting FRB determination that an activity is "complementary" to a financial activity, requestor should
  - Identify the financial activity for which the proposed activity would be complementary and provide detailed information sufficient to support a finding that the proposed activity should be considered complementary to the identified financial activity
  - Describe the scope and relative size of the proposed activity as measure of the projected FHC revenues
  - Describe the potential risks of conducting the activity to the safety and soundness of the FHC's subsidiary depository institutions and to the financial system generally
  - Describe the potential adverse effects that conducting the activity could raise, and explain the measures the FHC proposes to take to address those potential effects
  - Describe the potential benefits to the public that the proposal reasonably can be expected to produce, such as greater convenience, increased competition, or gains in efficiency

ONCE AN FHC . . .

- Provide 30-day, after-the-fact notice on Form FR Y-10 of:
  - Nonbank acquisitions and commencement of *de novo* activities
  - Merchant banking investment when total costs exceed the lesser of (i) 5% of tier 1 capital or (ii) $200 million
- Prior regulatory approval is still required for the establishment, or acquisition of 5% or more of the voting shares, of a bank or thrift
- Approval from appropriate functional regulator still required (*e.g.*, acquisition of securities broker-dealer or insurance company)
- FBO US branch or agency transactions with US affiliates engaged in insurance underwriting, securities underwriting or dealing, merchant banking or insurance company portfolio investment activities are subject to restrictions on transactions with affiliates

DEMANDS ON FHC STATUS

- To remain an FHC, FBO must meet on an ongoing basis each of the "well capitalized" and "well managed" standards applicable to the original determination of its FHC status
- FHC status is contingent not only on the condition of the FBO, but also on the condition of each of its US depository institution subsidiaries, and of any non-US bank subsidiary that has a US branch or agency
- Within 45 days of notice by FRB that it is no longer in compliance with FHC standards, an FHC is required to enter into an agreement with the FRB explaining how the deficiencies will be corrected and providing a schedule for completing the necessary remedial action

DEMANDS ON FHC STATUS (CONT'D)

- Until capital and/or management deficiencies have been remedied, FRB may limit FHC's US activities
- FHC is prohibited from commencing any additional expanded financial activity, or acquiring any company engaged in such activities, without prior FRB approval
- If deficiencies are not corrected within 180 days of the notice, FRB could force FHC to choose between terminating all US banking activities (including divesting any US depository institution subsidiaries) or ceasing to engage in the expanded financial activities permissible for FHC's

DEMANDS ON FHC STATUS (CONT'D)

- Applicable CRA standards also must be satisfied on an ongoing basis
  - If out of compliance, prohibited from commencing any additional activity or acquiring control of a company engaged in FHC activity
  - Prohibition remains in effect until come back into compliance
  - May continue to make merchant banking investments if such activity had commenced at a time when the FHC was in compliance with the CRA standards

LEGAL DEVELOPMENTS

- Obama Administration's Proposed Financial Regulatory Reform
  - Financial firms whose failure could pose a threat to financial stability due to a combination of their size, leverage and interconnectedness will be considered as Tier 1 FHCs
  - As Tier 1 FHCs, such FHCs will be subject to Tier 1 FHC supervision and regulation even though they are not presently being regulated or supervised as BHCs
  - FRB would have responsibility for consolidated supervision and regulation of Tier 1 FHCs
    - FRB would have greater authority than under GLB to require reports, impose prudential requirements or restrict activities of functionally regulated subsidiaries (including depository institution subsidiaries) of Tier 1 FHCs
  - Tier 1 FHCs would have stricter capital, liquidity and risk management standards than other FHCs
  - October 1, 2009 report date for FRB regarding changes to Federal Reserve structure to handle expanded role