Do Banks Need Holding Companies?

COMMENTARY

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IN SHORT

Situation: Most banks have bank holding companies ("BHCs"). BHCs, including thrift holding companies, are most useful for organizations (i) under $1 billion in assets that are "Small BHCs" under the Federal Reserve's Small BHC Policy and (ii) those engaged in nonbanking activities.

Opportunities: Bank of the Ozarks ("Ozarks") garnered significant industry interest by merging its BHC into its bank on June 26, 2017 ("Merger"). The Merger was effected to realize managerial, operational, and administrative savings and efficiencies, and eliminate redundancies, including consolidated financial reporting, Federal Reserve oversight, and SEC fees.

What to Do: BHCs' benefits have been reduced by the Dodd-Frank Act, the Basel III capital rules, and the stagnation of BHC activities and powers. Banks should consider these and their own situation in evaluating the usefulness of a BHC.

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BHCs versus Banks

Activities
BHCs, especially BHCs that exercise financial holding company ("FHC") powers, can conduct more activities than banks. Many BHCs have not exercised these nonbanking powers, including Ozarks, which was a FHC.

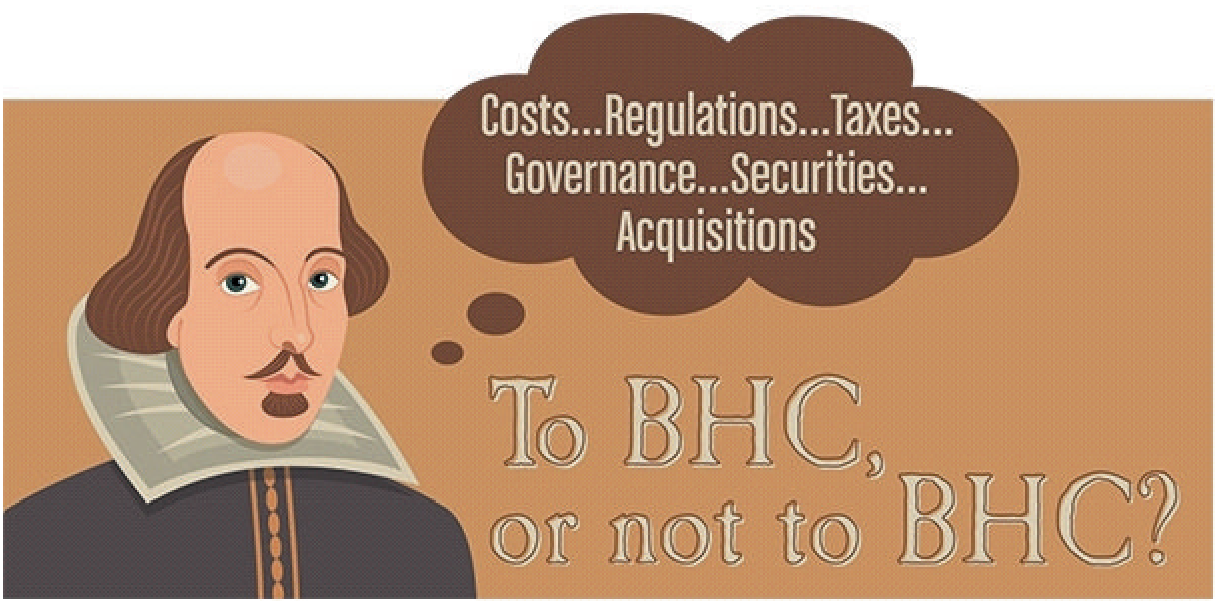
Capital
BHCs can no longer issue capital instruments different from bank capital instruments. BHC debt to equity ratios above 30 percent are discouraged, except for Small BHCs.

Small BHCs
Small BHCs may incur up to 300 percent debt to equity, and capital adequacy is evaluated only at the depository institution. This enables Small BHCs to use debt proceeds for bank capital.

Investments
BHCs may invest in up to five percent of any class voting securities of any entity, without prior regulatory approval.

Source of Strength and Affiliates
BHCs must be a source of strength for their banks. Federal Reserve Regulation W limits transactions between a bank and its BHC affiliates.

Capital Actions
Bank capital actions, including repurchases and redemptions of capital and dividends are limited by law. Federal Reserve policy and most BHCs' reliance on dividends from bank subsidiaries limit BHCs' capital actions.



What Banks Should Consider

The largest and smallest organizations likely will find BHCs necessary and desirable. BHCs conducting nonbanking and FHC activities need a BHC. Small BHCs will find holding companies extremely useful in meeting capital requirements.

Numerous other organizations should consider:

Costs
The net cost and time savings from eliminating the BHC, including state taxes, personnel, accounting, and audit.

Reduced Regulation
Elimination of BHC regulation, although most BHC regulation focuses on depository institution subsidiaries.

Activities, Assets, and Capital
Can the BHC's activities and assets be conducted and held by the bank? Will grandfathered activities or capital be lost in a reorganization?

Funding
BHC funding costs are likely higher than bank costs. Bank deposits are cheaper and BHC debt is rated lower than bank subsidiary debt. Ozarks' assumed its BHC's debt, which was upgraded upon the Merger.

Governance
Bank governing documents require updating consistent with the bank becoming a public institution. Authorized bank shares will be increased to accommodate conversion of its BHC's outstanding shares and options. Sufficient bank common shares and blank preferred stock should be authorized for future needs. Governance matters should be updated to meet the needs of a public entity. Differences in shareholder rights between the BHC and the bank require disclosure.

Acquisitions
Eliminating the BHC should not adversely affect acquisitions.

Taxes
A reorganization should be structured as a nontaxable transaction, which preserves existing tax benefits and facilitates future tax savings.

Securities
Bank securities are exempt from registration under federal and most state securities laws. Although the Comptroller of the Currency has securities registration and offering rules, bank offerings may be simpler than BHC offerings, and will avoid SEC registration and fees. Securities Exchange Act of 1934 requirements governing public banks are supervised by the bank's primary federal bank regulator.

Charter Selection
Selecting the bank's appropriate charter is essential when the organization's regulatory relations depend on one federal regulator. Thrifts should consider converting to commercial banks (state or national) to broaden their lending powers, increase their market prices and avoid the "qualified thrift lender" test.

Timing
Eliminating a BHC will require shareholder and regulatory approvals. A Federal Reserve waiver is needed for BHC transfers of low quality assets to the bank. A shareholders' meeting must be held.

Conclusions

BHCs that (i) are Small BHCs or (ii) engage in nonbanking or FHC activities will find BHCs most important. The large number of other organizations may not need a BHC. Reviews of BHCs should be forward-looking, and consider the organization's activities, markets, future opportunities and plans, and legislative and regulatory changes. This process is useful for identifying potential opportunities, efficiencies, cost and tax savings and corporate housecleaning and modernization.

THREE KEY TAKEAWAYS

1. The Dodd-Frank Act and the Basel III capital rules have curbed many of the benefits of a BHC.
2. The BHC structure is most advantageous and necessary for the largest and smallest organizations. Other institutions should consider the usefulness of their BHCs.
3. A number of factors should be considered—and a long-term, prospective view should be taken—when contemplating eliminating a BHC.

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