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WHITE PAPER

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Do Banks Need Holding Companies?

Bank holding companies, including thrift holding companies, are most useful for organizations under $1 billion in assets that are Small BHCs under the Federal Reserve's Small BHC Policy and those engaged in nonbanking activities. Bank of the Ozarks garnered significant industry interest by merging its BHC into its bank on June 26, 2017. 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. 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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Most banks have bank holding companies ("BHCs"). BHCs have been formed primarily to facilitate additional nonbanking activities, issue capital instruments not deemed capital for banks, and/or greater corporate, financial, and operational flexibility. BHCs have been especially useful for small BHCs under the Federal Reserve's Small Bank Holding Company Policy Statement ("Small BHC Policy Statement"), which originally was adopted in 1980. The Small BHC Policy Statement allows small BHCs to incur various kinds of debt, including senior debt and secured debt, in greater amounts than BHCs, generally. Such debt could be used for acquisitions or stock repurchases, or the proceeds from such debt can be contributed to the bank subsidiary as capital to support growth.

A handful of BHCs have been merged or liquidated into their bank subsidiaries in recent years to eliminate their holding companies. Most recently, Bank of the Ozarks ("Ozarks") garnered significant industry interest when it eliminated its BHC by merging it into the bank on June 26, 2017 ("Merger"). Ozarks' May 5, 2017, proxy statement provided these reasons for the Merger:

> "The reorganization is expected to lead to managerial, operational and administrative cost savings and efficiencies associated with the elimination of redundant activities, including but not limited to:
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> - Simplified financial reporting (consolidated accounting),
> - Elimination of regulatory oversight by the [Federal Reserve of] BHC activities,
> - Decreased SEC registration fees as the Bank's stock is exempt from registration under the Securities Act of 1933 ("Securities Act"), and
> - Consolidation of governance and organizational structure, including Company/Bank policies and procedures, risk management, and the elimination of dual boards of directors and joint board meetings."

Various BHC benefits have been reduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the Basel III capital rules, and industry and regulatory reluctance in the last 10 years to expand activities and powers as a result of the financial crisis. Since the beginning of the financial crisis, BHC powers have been relatively static, few BHCs or banks have sought Federal Reserve approval of new activities, and no new activities have been added to the list of permissible BHC and financial holding company ("FHC") activities. The Dodd-Frank Act and Basel III also eliminated the most significant advantages that BHCs had compared to banks when issuing capital instruments.

This *White Paper* focuses on the advantages and disadvantages of BHCs, but many of the same considerations are applicable to savings and loan holding companies ("SLHCs"), which, on July 21, 2011, became subject to Federal Reserve supervision and regulation.

SLHCs with less than $1 billion in consolidated assets may now be treated like small BHCs under the Federal Reserve's Small BHC Policy Statement (*See* Federal Reserve SR 11-11/CA 11-5 (July 21, 2011) and SR 14-9 (Nov. 7, 2014); Public Law 113-250 and Reg. Y, App. C "Small BHC Policy Statement," as revised effective May 15, 2015. Only 800 thrifts remain and many have converted in recent years to commercial banks. At year end 2016, approximately 84 percent of all thrifts had less than $1 billion in assets). Depository institutions, including savings and loans or thrifts, should consider the usefulness of holding companies in light of these changes, and their own size, activities, and situation.

PRINCIPAL DIFFERENCES BETWEEN BHCS AND BANKS

Permissible Activities

BHCs can conduct a wider range of activities than banks, and unitary SLHCs may have grandfathered activities that are not permitted generally under current law. Permissible BHC nonbanking activities are those activities that are "so closely related to banking or managing or controlling banks as to be a necessary incident thereto" (BHC Act Section 4(c)(8), and Federal Reserve Reg. Y §§ 225.21 and 225.28 (list of permissible nonbanking activities)). BHCs with well-capitalized and well-managed bank subsidiaries may elect to become FHCs, *provided that* all insured depository institution subsidiaries of the BHCs have "satisfactory" or better Community Reinvestment Act ("CRA") ratings as of their most recent CRA examination (BHC Act Section 4(h) and Federal Reserve Reg. Y §§ 225.81 and 225.82). A FHC may engage in any activity that the Federal Reserve determines, in consultation with the Secretary of the

Treasury, to be "financial in nature or incidental to such financial activity" or is "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally" (BHC Act Section 4(k) and Reg. Y § 225,86 list permissible FHC activities. Reg. Y § 225.88 specifies how to request Federal Reserve determinations that nonlisted activities are financial in nature or incidental to such activities). Many BHCs and FHCs have not engaged in the permissible BHC or FHC activities. For example, Ozarks was a FHC, but conducted most business through its bank and bank subsidiaries.

Investments

Unlike banks that are limited by law to investments primarily in high quality U.S., U.S. agency, and state, county, and municipal debt, BHCs may invest in up to five percent of any class voting securities of any entity, without prior regulatory approval and without regard to the target's activities (BHC Act, Section 4(c)(6)). Such nonbank investments may provide the means to invest in fintech and other companies, which offer the BHC opportunities for potential financial and operational gains.

Source of Strength

BHCs must serve as a source of financial and managerial strength for their subsidiary banks under Federal Reserve policy and Reg. Y, § 225.4(a). Federal Deposit Insurance Act, Section 38A(a) was added by the Dodd-Frank Act, and requires that any company controlling a FDIC-insured depository institution serve as a source of financial strength to that depository institution. In contrast, banks have no source of strength obligations to their subsidiaries, and Federal Reserve Regulation W ("Reg. W") limits transactions between a bank and its holding company and holding company subsidiaries.

Financial Flexibility

Until the Dodd-Frank Act and the adoption of the Basel III capital rules, effective January 1, 2014, all BHCs had greater flexibility in issuing capital instruments different from those permitted to banks and downstreaming capital to their bank and nonbank subsidiaries. (Dodd-Frank Act Section 171 requires BHC capital instruments to be identical to those counted as regulatory capital and eliminated trust preferred as regulatory capital, generally. Trust preferred securities issued before May 19, 2010, by depository institutions with less than $15 billion of consolidated assets were grandfathered until the institution had $15 billion or more of consolidated assets. Certain exceptions are made for banks under $500 million in assets subject to the Federal Reserve's Small BHC Policy Statement as in effect on May 19, 2010.) Federal Reserve, Reg. Q, § 217.20(e)(2) now requires the Federal Reserve to consult with the Office of the Comptroller of the Currency ("OCC") and the FDIC before including a new type of instrument as capital. Transitional and grandfather rules governing BHC capital instruments, such as trust preferred securities, need to be taken into account, if these will be assumed by a bank in a reorganization with its BHC. For example, prior to the Merger, Ozarks had $118 million of outstanding Tier 2 trust preferred securities. Since Ozarks had exceeded $15 billion in assets prior to the Merger, it already had lost the grandfathered Tier 1 capital status for its outstanding trust preferred securities, before the bank assumed these in the Merger.

Unlike banks, BHCs are not subject to loan and derivative-limitations with respect to each borrower/counterparty. Reg. W does not apply to BHCs' transactions with nonbank affiliates.

Except for BHCs and SLHCs with less than $1 billion in consolidated assets ("Small BHCs") that qualify under the Federal Reserve's Small BHC Policy Statement, BHC capital is evaluated on a consolidated basis, and BHCs' subsidiary depository institutions' capital is evaluated separately, as well. The Small BHC Policy Statement permits small BHCs to incur up to 300 percent debt to equity, subject to certain conditions. Generally, except in temporary or other special situations, BHC debt to equity ratios above 30 percent are discouraged. The Small BHC Policy Statement permits capital adequacy to be evaluated at the depository institution, and without considering a BHC's or SLHC's consolidated capital. Small BHCs are permitted to use debt to raise capital for their depository subsidiaries to avoid the extra costs and dilution of issuing stock, and deduct the interest on such debt on their consolidated income tax returns.

Capital Actions

Capital actions include dividends and repurchases and redemptions of capital instruments Federal Reserve SR 09-4 (Revised Dec. 21, 2015) ("SR 09-4"), SR 15-18 (Dec. 18, 2015) and SR 15-19 (Dec. 18, 2015).

Bank dividends are limited by law. For example, see National Bank Act, Sections 56 and 60 and OCC Regs. §§ 5.63 – 5.65 applicable to national banks. Generally, national banks that are not "undercapitalized" are limited to net income for the current year plus net income, plus retained net income for the previous two years. State banks often have similar limitations under state law.

Federal Reserve policy, including SR 09-4, provides that dividends are to be paid from the past four quarters of net income. BHCs that pay larger dividends without the Federal Reserve's consent may be subject to safety and soundness violations.

Banks' stock repurchases are governed and constrained by state and national bank statutes that require prior regulatory approval of any reductions in capital. In contrast, Reg. Y § 225.4(b) requires BHCs to provide prior notice of any repurchase or redemption of equity securities in an amount often taking into account equity issues, that is in excess of 10 percent of the BHC's consolidated net worth in the preceding 12 months. Exceptions are made under the Small BHC Policy Statement and where the BHC is well-capitalized, well-managed, and not subject to any unresolved supervisory issues. The largest banks, which are subject to the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR"), require prior Federal Reserve approval of their capital plans, including any capital actions.

Lastly, the Basel III capital rules require prior regulatory approval of the redemption or repurchase of any capital instruments by BHCs and banks (*See* 78 FRI. 62046). The Small BHC Policy Statement permits Small BHCs to use holding company debt to repurchase stock and thereby increase the liquidity of their shares by "making a market" in shares.

Governance and State Law

National banks and federal thrifts are subject to governance and other corporate requirements of federal banking law and OCC regulation. The OCC has extensive governance and corporate practices regulations, but allows national banks to fashion certain governance provisions, such as director and officer indemnification, in accordance with OCC rules, the bank's home state, or another state such as Delaware.

BHCs are subject to state business corporation laws, and may be organized in any state offering attractive corporate laws and tax treatment. State banks are subject to the banking laws of their home state, which may incorporate much of that state's business corporation laws. State banking laws may set the percentage of votes required for bank mergers, qualifications of bank directors, and other items differently from state business corporation laws. BHCs, therefore, offer additional flexibility in determining their state of incorporation, governing state law, and indemnifying and exculpating directors and officers.

As entities distinct from their bank subsidiaries, BHCs likely will have separate expenses, state franchise taxes, and in some states, may not be able to file consolidated state income tax returns. Although BHCs require a board of directors, BHCs and their subsidiary bank boards often are comprised of the same persons and meet jointly. Therefore, these expenses and savings may already be limited, especially where the BHC conducts few, if any, activities other than controlling the bank.

WHAT BANKS SHOULD CONSIDER

BHCs offer various advantages not available to stand-alone banks. The largest BHCs, and FHCs conducting securities and underwriting, merchant banking, and insurance activities permitted only to FHCs or which operate internationally, and those with numerous nonbank subsidiaries and activities likely will find their holding companies necessary and desirable. Small BHCs operating under the Small BHC Policy Statement also will find holding companies extremely useful. Foreign banking organizations with $50 billion or more in nonbranch assets operating in the United States are required to have a U.S. intermediate holding company.

A large number of other banking organizations may benefit by not having a holding company and should consider the following, among other factors specific to their organizations, to determine the usefulness of a holding company:

Costs. Cost savings from not maintaining a separate BHC, including state franchise and similar taxes, personnel, accounting and audit, and legal costs, as well as separate Dodd-Frank Act stress tests, where the organizations exceed $10 billion in assets.

Regulatory Simplification. Elimination of the time and costs of separate BHC or SLHC regulation, although most BHC regulation focuses on the depository institution subsidiaries, especially in the case of shell BHCs and SLHCs (*See*, e.g. Federal Reserve SR 16-4 (Mar. 3, 2016)).

Activities and Assets. Will any grandfathered BHC or SLHC activities be lost following a reorganization of the holding company into the bank or thrift? Can the BHC's current or contemplated activities be conducted by the depository institution or its subsidiaries? Are the BHC's assets permissible for the depository institution or its subsidiaries? Although Reg. W is generally inapplicable to transactions between banks and their subsidiaries, credit from, and derivative transactions between, banks and their subsidiaries may be limited by loan-to-one borrower rules. Banks also cannot take low-quality assets from their affiliates.

Funding. Banks are funded primarily by deposits. These are the cheapest and most stable sources of funding. Banks also have access to federal funds lines, and Federal Home Loan Bank borrowings, as well as loan sales and securitizations. Organizations are ineligible under the Small BHC Policy Statement.

BHCs or SLHCs fund themselves from dividends received from their bank subsidiaries and public and private stock and debt offerings. Their funding costs may be higher than their banks in part due to the structural subordination of holding company debt to creditors of their subsidiaries, which usually results in holding company debt being rated a notch lower than their bank subsidiaries' debt. For example, Ozarks' outstanding BHC debt was upgraded by the Kroll rating agency when such debt was assumed by the bank as a result of the Merger.

Capital. Subject to applicable state banking and business corporation laws, and in certain states, legal limitations on preferred stock and bonded indebtedness, banks can now use the same capital instruments as BHCs, including preferred stock issued in series and as depository shares, and subordinated debt. The federal bank regulators, and state regulators in certain states, must approve the issuance and redemption or repurchase of any capital instruments.

Trust preferred securities issued before May 19, 2010, by BHCs with less than $15 billion in assets are being phased out of Tier 1 capital through January 1, 2024, and thereafter will be included in Tier 2 capital without limitation. Banking organizations should consider whether outstanding BHC trust preferred securities would be capital in the bank, and if so, what element of bank capital, if such securities are assumed by a depository institution in a reorganization that eliminated its parent BHC. Debt instruments will need to be reviewed, and may require amendment to facilitate the bank's assumption of the debt.

Charter, By-Laws, and Governance. The bank's governing documents should be reviewed and amended prior to any reorganization to make any necessary changes to meet the needs of a public or widely held institution, instead of a wholly-owned subsidiary of a BHC. At a minimum, prior to any reorganization, a bank's charter should increase the bank's authorized shares to accommodate conversion of its BHC's outstanding shares, options, and warrants with sufficient authorized but unissued shares left available for future needs.

Bank charter changes also may be needed, such as where the BHC has outstanding preferred stock, but the bank charter has no authorized preferred stock. Authorized preferred stock issuable in one or more series should be included in the bank's charter. Indemnity or similar agreements between the BHC and its directors should be reviewed in light of laws applicable to banks. Governance matters should be reviewed generally as part of the process. Differences in shareholder rights and regulations between the holding company and the bank will need to be discussed in any reorganization proxy materials.

Mergers and Acquisitions. Operating with a depository institution without a holding company should not affect growth through acquisitions, although interstate bank laws in likely target states should be evaluated to ensure these permit mergers of out-of-state banks without holding companies.

Tax Planning. How much tax savings can be achieved by eliminating the holding company? Can the resulting bank's capital structure and charter be improved from a state tax standpoint? What are the total anticipated net tax savings from a reorganization eliminating the holding company? Any reorganization should be structured to be a tax-free transaction to the participating entities and their security holders. Consideration of tax bases and the preservation of any tax assets are elements of reorganization planning, generally.

Securities Law Compliance. Bank securities are "exempt securities" under Section 3(a)(2) of the Securities Act and under most state securities and "blue sky" laws. However, the OCC has extensive securities offering rules in OCC Regs. Part 16, and may charge securities offering filing fees. All federal bank regulators have regulations under the Securities Exchange Act of 1934 ("Exchange Act"), Section 12(i), and a bank subject to Exchange Act reporting will file reports under that Act with its primary federal bank regulator instead of the SEC. The transition from SEC to bank reporting should be planned carefully, and the availability of regulatory interpretative advice under the Exchange Act considered. Ozarks' BHC used its existing SEC shelf registration statement to make a $300 million SEC-registered common stock offering on May 24, 2017, and paid a $42,000 filing fee to the SEC. It did, however, raise capital in a favorable market, and avoided any capital concerns or transaction delays in connection with the elimination of its BHC.

BHC and Employee Plans. The bank will become the sponsor and employer under any employee benefit and incentive plans and these should be reviewed, changed, and updated, as needed.

Regulatory Concentration. A stand-alone bank's regulatory relations and risks are focused in the bank's primary federal bank regulator and its state bank regulator. National banks and federal thrifts are regulated solely by the OCC. Fewer regulators may reduce regulatory costs and time, but will increase the risks if the relationship between a bank and its regulators deteriorates. It is difficult to change bank regulators when this occurs, especially where the bank's regulatory ratings have declined or it is subject to regulatory enforcement.

Charter Selection. As a result, selecting the right charter and regulator for the bank is essential when there is no holding company. Even though bank activities are generally the same across most commercial banks (See Federal Deposit Insurance Act, Section 24(a)), differences in regulatory expertise and processes, as well as the working relationships with regulators are important considerations. The cost of regulation will differ among bank regulators and states. Thrifts considering whether to drop their SLHCs also should consider converting to commercial banks (state or national) to broaden their range of commercial lending powers and avoid the "qualified thrift lender" test under banking and tax laws.

Approvals and Timing. Eliminating a BHC can be done most inexpensively and quickly when the bank is in excellent condition. A bank's federal and state regulators may have to approve a combination of the holding company into the bank. BHCs may hold assets not permitted to banks, which will necessitate divestiture or bank regulatory waivers or approvals. A Federal Reserve waiver may be needed under Reg. W, if the BHC has low quality assets. The elimination of a BHC or SLHC likely requires shareholder approval at a special or annual meeting. In some states, such as Arkansas, where Ozarks' holding company was organized, holding company shareholders may have dissenters' rights of appraisal in reorganization. Reorganization proposals submitted at an annual shareholders' meeting will reduce transaction costs associated with a separate special meeting. Advance planning will facilitate a faster transaction.

CONCLUSIONS

Eliminating a BHC or SLHC parent should be most valuable to the broad range of (i) organizations that are ineligible for the Small BHC Policy Statement or (ii) holding companies are not actively engaged in nonbanking, FHC or grandfathered unitary SLHC activities. Except for small BHCs and SLHCs, activities rather than asset size are most important. For example, First Republic Bank has successfully operated without a BHC and currently has over $76 billion in assets, and has been able to support such growth with periodic capital offerings.

A banking organization should consider and quantify the net cost savings and consequences of a reorganization that eliminates its holding company, together with any qualitative benefits or losses. The analysis should be forward-looking, and include reviews of the organization's future plans and opportunities, as well as likely market, legislative, and regulatory changes that could make a BHC more useful or desirable.

This process is an opportunity to evaluate not only the usefulness of a holding company, but also the organization's activities, powers, capital structure, governing law, strategic goals and opportunities, and potential tax savings strategies. The choices of the resulting bank charter and the bank's primary regulators are extremely important to the overall process. The evaluation of the holding company is also a good opportunity for "housecleaning," including reviewing charters, by-laws, governance, benefit plans, and other contracts and instruments. Planning should begin now, if these changes are to be presented at the annual shareholders' meeting in 2018 to avoid the costs of a special shareholders' meeting.

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