JONES DAY

COMMENTARY

AUGUST 2017

The Fed's Small BHC Policy Statement—Regulatory Relief for Bank Growth and Acquisitions

IN SHORT

The Situation: The current Small Bank Holding Company Policy Statement provides significant regulatory benefits and relief for small, non-complex banks and thrifts but could be improved.

The Opportunities: The Policy Statement is a compelling reason to have a bank or thrift holding company. A BHC facilitates expansion and improves capital structures for qualifying organizations under $1 billion in assets. Such BHCs benefit from no consolidated capital requirements, increased levels of BHC debt, and simplified Federal Reserve applications, notices, and reporting.

What to Do: The Policy Statement, and the tax benefits of a capital structure that includes debt, facilitate growth, acquisitions, stock repurchases, and ownership transfers. BHCs failing a qualitative factor should consider eliminating the disqualification. BHCs approaching a disqualification should plan their capital structures without the Policy Statement. BHCs should support further relief for quantitative and qualitative factors.

The Small Bank Holding Company ("BHC") Policy Statement ("Policy Statement") was adopted by the Federal Reserve in 1980 to facilitate transfers of small banking organizations, including BHCs formed to assume individuals' bank stock acquisition debt. It allowed BHCs with total assets up to $150 million and no leveraged nonbanking activities to use up to 75 percent debt for acquisitions, *provided* the BHC demonstrated it could reduce the debt to 30 percent of equity or less in 12 years and retire it in 25 years. BHC debt generally is limited to 30 percent of equity.

Changes to the Policy Statement

The Policy Statement was revised as part of the 1997 Regulation Y overhaul. The asset limitation was increased in 2006 to "less than $500 million of pro forma consolidated assets," which covered an estimated 85 percent of all banks, subject to new qualitative factors that the Federal Reserve would evaluate on an individual basis.

Section 171 of the Dodd-Frank Act constrains regulatory changes to the Policy Statement. In 2014, Public Law 113-250 amended Section 171 to include savings and loan holding companies within the Policy Statement and directed the Federal Reserve to increase the Policy Statement's permissible size to up to $1 billion of assets. This law also codified these Policy Statement qualitative factors:

- No significant nonbanking activities (excluding ownership of thrifts) through nonbanking subsidiaries;
- No significant off-balance sheet activities, including securitization and asset management or administration; and
- No material amount of outstanding SEC-registered securities, other than trust- preferred securities.

The Federal Reserve amended the Policy Statement accordingly and retained discretion to require consolidated risk-based capital requirements.

> The Policy Statement is one of the most important reasons to have a BHC and a powerful tool for expansion, but the limitation on SEC-registered securities may be the Policy Statement's most limiting factor for small institutions.

Current Policy Statement

The Policy Statement continues the 75 percent debt-to-equity limit, subject to the qualitative factors. Other requirements include:

- Each insured depository institution subsidiary should be well capitalized;
- BHC dividends generally cannot be paid until debt to equity is 1:1 or less and debt service is not adversely affected; and
- Federal Reserve applications and notices are considered in light of a BHC's debt levels, growth, earnings stability and trend, debt service, and management's record.

Small BHCs should consider Basel III's capital requirements, including their bank subsidiaries' capital conservation buffers and dividend limits, when calculating their debt service capacity.

Recent Proposals

In 2016, H.R. 3791 proposed increasing the maximum size of "small" BHCs to $5 billion, which would have encompassed an estimated 400 additional banks by size. The Financial CHOICE bill (H.R. 10) increases the size to $10 billion. The Treasury's June 2017 Report recommends a $2 billion limit. Size increases are meaningful, but many institutions at these levels may not meet the qualitative factors set by law, especially the SEC-registered securities factor, and the qualitative factors also should be addressed.

Conclusions

The Policy Statement is one of the most important reasons to have a BHC and a powerful tool for expansion:

- The Policy Statement includes almost 88 percent of all banks and thrifts by size;
- The Policy Statement facilitates small BHC growth, acquisitions, share liquidity, and prices, and it reduces capital costs and dilution;
- Increased regulation and compliance costs, as well as accommodative monetary policies, make it essential for small organizations to use the Policy Statement to optimize their asset sizes and capital structures;
- The Policy Statement facilitates mergers among small banks, which improves their value and competitive position; and
- BHC debt is currently available privately, and positive earnings and earnings trends exist. Now may be the best time since the onset of the credit crisis to obtain and use the BHC debt under the Policy Statement.

Although a further increase in the Policy Statement's asset size would be helpful, the limitation on SEC-registered securities may be the Policy Statement's most limiting factor for small institutions:

- SEC registration under the Exchange Act is an "all or none" in the case of common stock;
- Mergers may require or result in Exchange Act registration without correlation to the resulting BHC's complexity or access to public securities markets;
- Many small SEC-registered companies do not have ready access to the capital markets and are not complex;
- SEC registration may, however, increase BHCs' options to raise capital and support capital adequacy and debt repayment;
- Bank market valuations have increased small traded banks' market capitalizations beyond the "smaller reporting company" standard under SEC rules and which the Federal Reserve has referenced as a "small" characteristic, and this may not be a useful test; and
- FDIC Regs. Part 363 may impose various audit and other complexities similar to SEC registration upon banking organizations with $500 million or more in assets, without any benefits of SEC registration.

A change to this qualitative factor is appropriate to further the Policy Statement's objectives.

The no-nonbanking-activity qualitative factor also should be revisited. This factor was added in 2006 to take into account the legal, operational, and reputational risks potentially resulting from the Gramm-Leach-Bliley Act's expansion of permissible nonbanking activities. More than 18 years of experience with these powers should permit this factor to be refined and restored to the original Policy Statement formulation of "no leveraged nonbanking activity." The Federal Reserve has reserved the authority to prevent abuses by requiring consolidated capital treatment where warranted.

THREE KEY TAKEAWAYS

1. The Policy Statement is a compelling reason to have a small BHC.
2. Banks can use the Policy Statement to optimize their size, capital structure, and share values, including through acquisitions, while reducing capital costs and potential shareholder dilution.
3. Approximately 88 percent of banks and thrifts already meet the Policy Statement's size requirement, but as size increases, the SEC registration qualitative factor becomes more of a limiting factor. Increases in the Policy Statement's size limit would be most useful when combined with eliminating the qualitative SEC registration restriction on small BHCs' stock and with changing the nonbanking activity qualitative factor to "leveraged nonbanking activities" consistent with earlier versions of the Policy Statement.

AUTHOR

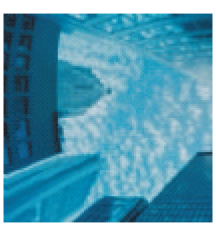
Chip MacDonald
Atlanta

All Contacts >>>

Holly M. Boggs, a summer Associate in the Atlanta Office, assisted in the preparation of this Commentary.

YOU MIGHT BE INTERESTED IN: Go To All Recommendations >>

Do Banks Need Holding Companies?



The Department of the Treasury Issues Recommendations on the Regulation of U.S. Depository Institutions

Volcker Rule Reform Begins

Controversial Rule by CFPB Limits Class Action Waivers in Arbitration Agreements

SUBSCRIBE   SUBSCRIBE TO RSS