Dodd-Frank and Reconsidering Financial Holding Company Status

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Section 606 of the Dodd-Frank Act adds a new standard for a bank holding company (BHC) which elects to become, or already is, a financial holding company (FHC). Now, in order for a BHC to elect or maintain FHC status, not only must a BHC certify that its bank subsidiaries are well capitalized and well managed and have satisfactory CRA ratings, but the BHC itself must be deemed well capitalized and well managed.

The Federal Reserve lists over 500 BHCs across the country whose elections to become or be treated as FHCs are effective. In the current enforcement environment, many community BHC Boards of Directors would be well advised to re-examine the decision to elect FHC status.

Why did so many community BHCs rush to elect FHC status after the Gramm-Leach-Bliley Act (GLBA), which was enacted in 1999? GLBA, which was enacted primarily to allow the cross ownership of banking, securities and insurance companies through FHCs, also allowed FHCs to engage without prior approval in new activities to be indentified as "financial in nature" or incidental or complementary activities. Several years after GLBA was enacted a Federal Reserve report found that other than acquisitions of insurance agencies, few of the over 450 BHCs with assets under $1 billion which elected FHC status had used any new GLBA powers. That appears to remain true today, in part perhaps because few new activities (e.g. acting as a finder) have been determined to be financial in nature.

FHC status was initially viewed as validating a BHC as a strong competitor and suggested regulatory blessing as well, even though few community BHCs had a plan for exercising any new GLBA

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powers when they elected FHC status. This same motivation was apparent when many community BHCs, which now seek to repay TARP capital as soon as possible and be released from its constraints, initially sought TARP capital without specific plans for lending the TARP funds.

What is the harm of having elected FHC status? The downside of unnecessarily electing FHC status first appeared when banks saw their composite and management CAMELS ratings slide to less than satisfactory as asset quality and other problems were identified by the banking regulators in the early days of what became a tsunami of enforcement actions. When an FHC falls out of status, it is required by Section 225.83 of Federal Reserve Regulation Y to enter into a "cure agreement" with the Federal Reserve within 45 days and to regain well capitalized and well managed status within 180 days thereafter unless an extension is obtained.

There are draconian potential consequences in Regulation Y if an FHC cannot return to well capitalized and well managed status within 180 days. The FHC must cease or divest any activities engaged in or acquisitions made based on FHC authority or the Federal Reserve can order the BHC to divest its bank subsidiary. Since raising new capital in the current environment has proven to be a slow and difficult process for many BHCs and since it generally takes at least 1 or 2 examination cycles before a bank enforcement action can be terminated and 3 and 4 CAMELS ratings can be upgraded, cure agreements often cannot be satisfied as quickly as Regulation Y contemplates. Thus, in practice, cure agreements usually require extensions and become little more than an additional supervisory burden which can distract management and directors from tending to the subsidiary bank's core problems.

While new Section 606 reflects the intent of Dodd-Frank to mitigate risks to financial stability and impose heightened capital and other prudential standards, its requirements are somewhat ironic. BHCs tend to mirror their subsidiary bank's capital and supervisory ratings. Furthermore, commonly soon after a community bank receives downgraded composite and management ratings, is deemed to be in "troubled condition" or receives an enforcement action, the Federal Reserve will notify the BHC that its ratings are accordingly being dropped and therefore the BHC is also considered in troubled condition and a parallel enforcement order would be issued. Dodd-Frank Section 606 is therefore principally important as a reminder for many community BHCs to consider whether there is any reason to be an FHC.

There was no decertification process when the Federal Reserve first observed that FHC status was often unnecessary for many community BHCs and presented a supervisory challenge when examination ratings began to decline. However, if an FHC has not used any GLBA authority, it may submit a letter electing to forego FHC status in the future. It may also be possible to restructure certain subsidiaries or financial activities which required FHC status over a longer time period with Federal Reserve concurrence.

Nonbanking activity authority previously approved for BHCs by the Federal Reserve remains available to BHCs with or without FHC status. Additionally, state and national banks may also engage in most financial activities through finance subsidiaries if the bank is and remains well capitalized and well managed.

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T.J. Mick Grasmick practice focuses on mergers and acquisitions, non-banking activities, formation of new banks, interstate and other expansion by banks, bank holding companies and other financial institutions and the requirements and restrictions on expansion of state and federal bank regulatory agencies; bank supervision and examination, and general banking corporate matters and regulatory and legislative developments.