ALERTS AND UPDATES

U.S. Financial Reform: Capital Requirements for Financial Institutions

August 24, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

Title I of the Act, designated the "Financial Stability Act of 2010" (the "Financial Stability Act") creates the Financial Stability Oversight Council (the "Council") and gives broad authority to the appropriate federal banking agencies to mandate minimum leverage capital requirements and risk-based capital requirements for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (the "Board").

Title VI of the Act, designated the "Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010" (the "Improvements Act"), mandates stronger capitalization for all insured depository institutions, depository institution holding companies and any company that controls an insured depository institution, and provides that any company in control of an insured depository institution be accountable for the financial strength of that entity.

Financial Stability Act

The Financial Stability Act implements increased oversight of the capital requirements applicable to insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board. The Council has been tasked with identifying risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies. The Financial Stability Act gives the Council broad authority to make recommendations to the Board regarding heightened prudential standards for, among other things, risk-based capital, leverage capital and contingent capital.

Minimum Leverage and Risk-Based Capital Requirements

The Financial Stability Act mandates that each federal banking agency set appropriate minimum leverage capital and risk-based capital levels, on a consolidated basis, for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board. It also mandates that the Board establish prudential standards for nonbank financial companies supervised by the Board and bank holding companies with total assets of $50 billion or greater that, subject to certain exceptions, include risk-based capital requirements and leverage limits. In addition, the Financial Stability Act sets the floor for both leverage and risk-based capital requirements based on the minimum capital requirements established by the appropriate federal banking agencies under section 38 of the Federal Deposit Insurance Act. Subject to the recommendations of the Council, each federal banking agency must develop capital requirements applicable to insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board that address, at a minimum, risks arising from (i) significant volumes of activity in derivatives, securitized products purchased and sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase agreements and reverse purchase agreements; (ii) concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid two-way markets; and (iii) concentrations in market share for any activity that would substantially disrupt financial markets if the institution is forced to unexpectedly cease the activity. In developing these capital requirements, each federal banking agency is required to take into consideration the risks posed by the activities of each institution on not only the institution itself but also to public and private stakeholders in the event of adverse performance, disruption or failure of the institution.

The minimum leverage and risk-based capital requirements discussed above will be applicable as follows:

- Debt or equity instruments issued on or after May 19, 2010, by insured depository institution holding companies or nonbank financial companies supervised by the Board will be deemed to have become subject to the requirements as of May 19, 2010;
- For debt or equity instruments issued before May 19, 2010, by depository institution holding companies or nonbank financial companies supervised by the Board, any regulatory capital deductions imposed by the requirements will be phased-in over a period of three years commencing on January 1, 2013, provided that capital deductions that would be required for other institutions will not be required for depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009, or organizations that were mutual holding companies as of May 19, 2010; and
- Depository institution holding companies that were not supervised by the Board as of May 19, 2010, will (other than as described in (i) and (ii) above) become subject to the requirements on July 21, 2015; and certain foreign bank holding company subsidiaries of foreign banking organizations will (other than as described in (i) above) become subject to the requirements on July 21, 2015.

Investments in financial subsidiaries that insured depository institutions are required to deduct from regulatory capital pursuant to the Federal Deposit Insurance Act do not have to be deducted from regulatory capital by depository institution holding companies or nonbank financial companies supervised by the Board, unless required by the Board or the primary regulatory agency in the case of nonbank financial companies supervised by the Board.

The minimum leverage and risk-based capital requirements imposed by the Financial Stability Act will not be applicable to:

- Debt or equity instruments issued to the United States or any agency or instrumentality thereof pursuant to the Emergency Economic Stabilization Act of 2008, and prior to October 4, 2010;
- Any federal home loan bank; or
- Any small bank holding company that is subject to the Small Bank Holding Company Policy Statement of the Board of Governors, as in effect on May 19, 2010.

Off-Balance-Sheet Activities

Each bank holding company with $50 billion or greater in total consolidated assets and each nonbank financial company supervised by the Board must include off-balance-sheet activities[1] in its computation of capital for purposes of meeting its applicable capital requirements.

Contingent Capital Requirement

The Council is required to conduct a study, and submit a report to Congress no later than July 21, 2012, relating to the feasibility, benefits, costs and structure of a contingent capital requirement for nonbank financial companies supervised by the Board and large, interconnected bank holding companies. Subsequent to submitting the Council's report to Congress, the Board is authorized to issue regulations, and the Council is authorized to make recommendations to the Board, to require any of the aforementioned entities to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.

Stress Tests

The Board, in coordination with the appropriate primary financial regulatory agencies and the Federal Insurance Office, is required to conduct annual analyses that evaluate whether nonbank financial companies supervised by the Board and bank holding companies with total consolidated assets equal to or greater than $50 billion have the capital, on a consolidated basis, necessary to absorb losses as a result of adverse economic conditions. In addition, each nonbank financial company supervised by the Board and bank holding company with $50 billion or more in total consolidated assets will be required to conduct semiannual stress tests. Any other financial company that has total consolidated assets of more than $10 billion and is regulated by a primary federal financial regulatory agency will be required to conduct annual stress tests, in accordance with regulations to be prescribed by its primary financial regulatory agency in coordination with the Board and the Federal Insurance Office.

Hybrid Capital Study

The Financial Stability Act requires that the Comptroller General, in consultation with the Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation, conduct a study to determine whether hybrid capital instruments, such as trust preferred securities, should be included as a component of Tier 1 capital for banking institutions and bank holding companies when determining their compliance with minimum capital requirements. The study is also to examine the differences between the components of capital permitted for insured depository institutions versus those permitted for companies that control insured depository institutions. A report on the findings from this study is due by January 21, 2012.

Currently, the U.S. Federal Reserve allows bank holding companies to count trust preferred securities as Tier 1 capital. Under this structure, the trust's common securities are held by the bank holding company. The trust preferred securities are issued to investors for cash. The trust then lends this cash to the bank holding company, taking in return a long-term, junior subordinated note. The junior subordinated note typically provides for interest deferral of at least five years. Trust preferred securities permit the bank holding company to deduct interest on the subordinated note in an amount equal to distributions on the trust preferred securities, resulting in tax deductible equity.

Improvements Act

The Improvements Act is intended to ensure that all insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board are financially stable, and places responsibility on their controlling entities.

The Improvements Act amends both the Bank Holding Company Act and the Home Owners' Loan Act to require that bank holding companies and savings and loan holding companies that wish to expand the financial services of their bank subsidiaries are well capitalized and well managed. Previously, only the subsidiary banks were required to be well capitalized and well managed.

In addition, the Improvements Act imposes a heightened standard of review regarding the capitalization of a bank resulting from a merger or acquisition. Previously, the reviewing agency required the resulting bank to be *adequately* capitalized and *adequately* managed, but the standard has been increased to require that a *well* capitalized and *well* managed bank will result from the merger or acquisition. The effect of this heightened standard is that insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board will now be required to maintain capital levels that exceed the current minimum capital levels set by the appropriate federal agencies to effectuate a merger or acquisition.

In an attempt to mitigate the financial stress on financial institutions caused by an economic downturn, the Improvements Act requires the applicable federal regulatory agencies to adjust the minimum capital requirements for insured depository institutions, bank holding companies and savings and loan holding companies, so that they are countercyclical, requiring less capital during periods of economic contraction and more capital during periods of economic expansion.

Perhaps one of the most significant changes to the regulation of capital requirements under the Improvements Act is that bank holding companies, savings and loan holding companies and any other companies that directly or indirectly control an insured depository institution will now be held accountable for the financial stability of their subsidiaries. The Improvements Act requires that the applicable federal banking agencies require bank holding companies and savings and loan holding companies to serve as a source of financial strength for their subsidiaries that are depository institutions. If an insured depository institution is not the subsidiary of a bank holding company or a savings and loan holding company, the appropriate federal banking agency for the insured depository institution must require any entity that directly or indirectly controls the insured depository institution to serve as a source of financial strength for the depository institution. The phrase "source of financial strength" is defined to mean the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution. The appropriate federal banking agencies are required to implement rules to this effect no later than July 21, 2012.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Howell J. Reeves, Kathleen A. Johnson, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

As required by United States Treasury Regulations, you should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.

Notes

1. Section 165(k)(3) of the Financial Stability Act defines off-balance-sheet activities as an existing liability of a company that is not currently a balance-sheet liability, but may become one upon the happening of some future event, including the following transactions, to the extent they may create a liability:

   (i) direct credit substitutes in which a bank substitutes its own credit for a third party, including standby letters of credit,
   (ii) irrevocable letters of credit that guarantee repayment of commercial paper or tax-exempt securities,
   (iii) risk participations in bankers' acceptances,
   (iv) sale and repurchase agreements,
   (v) asset sales with recourse against the seller,
   (vi) interest rate swaps,
   (vii) credit swaps,
   (viii) commodities contracts,
   (ix) forward contracts,
   (x) securities contracts, and
   (xi) such other activities or transactions as the federal banking agencies may, by rule, define.