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Bank Strategy Briefing

Ideas and analysis for community bank executives

Bank holding companies – the case for not firing the Federal Reserve

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In recent months, we have received a flurry of questions regarding whether banks need holding companies. Last year, a handful of financial institutions, including Bank of the Ozarks, Bancorp South and Zions Bancorp, elected to merge their holding companies into their subsidiary banks, eliminating the Federal Reserve as a regulator. While the specific reasons vary from institution to institution, some of the common themes include reduced regulatory oversight, simplified financial reporting and reduced administrative burdens and costs. Financial and legal advisors have picked up on the bandwagon and some are now pushing the concept as a way to simplify operations – and collect fees.

We tend to be much more skeptical regarding whether jettisoning a holding company is in the best long-term strategic interests of many of our clients. The question you need to ask is what is the problem that you are trying to solve? You have heard of the old adage, "if it's not broke, don't fix it." We are concerned that financial institutions unwittingly may give up the flexibility of a holding company structure in an effort to solve a problem that simply does not exist.

To be clear, for some financial institutions, there may be some important benefits to eliminating a holding company, such as the elimination of Fed-administered stress tests. However, these are largely reserved for large and mid-sized regional banks. On balance, we believe that this is more hype than substance and do not see any significant benefits for bank holding companies that are subject to the Federal Reserve's Small Bank Holding Company Policy Statement (the threshold annually is less than $1 billion in consolidated assets, which will increase to less than $3 billion in consolidated assets under the pending bipartisan regulatory relief bill).

Advantages of eliminating a holding company

Historically, holding companies were used to engage in non-banking activities, to facilitate interstate banking and branching, and to issue capital instruments that were not eligible for capital treatment by banks. Many of these traditional advantages have been watered down or eliminated over the years, including, notably, the elimination of trust preferred securities from regulatory capital (subject to certain grandfather provisions) under the *Dodd-Frank Act*. Against this backdrop, proponents point to the following benefits of eliminating the holding company structure:

- *Regulatory consolidation.* With no holding company, the Federal Reserve's supervisory role is terminated (unless you are a Fed member bank). Clearly one less regulator is not a bad thing and there will be incremental cost savings in this regard.
- *Securities laws.* For SEC-registered holding companies, oversight and reporting will transition from the SEC to the primary federal bank regulator. As a general matter, securities offerings still will be subject to securities offering rules; however, since bank stock is exempt from registration under the securities laws, there are no SEC registration fees.

- *Administrative.* With no holding company, there is simplified financial reporting and a streamlined corporation governance structure. Duplicative processes and procedures, such as separate holding company policies and procedures, dual board of directors, and joint board and committee meetings can be eliminated.

Disadvantages of eliminating a holding company

In general, we believe that there is a tendency to overstate some of the costs and burdens of regulatory oversight and regulatory reporting for small bank holding companies. For example, the Federal Reserve often takes a light touch on its examinations of holding companies. More importantly, even if there are some incremental benefits, these need to be carefully weighed against the disadvantages, several of which could be potentially significant depending on future events.

- *Capital instruments.* If a holding company is eliminated, consideration will need to be made regarding whether outstanding capital instruments will continue to be capital at the bank and how, from a documentation perspective, the bank can assume the securities.
- *Leveraging debt.* Most financial institutions with less than $1 billion in consolidated assets are subject to the Federal Reserve's Small Bank Holding Company Policy Statement. This Policy Statement permits capital adequacy to be evaluated at the bank level, without considering a holding company's consolidated capital. Small bank holding companies are permitted to use debt to raise capital for subsidiary banks to avoid the extra costs and dilution of issuing stock, and deduct the interest on such debt on their consolidated income tax returns.
- *Dividends.* Bank dividends are limited by statute, which varies among the various types of charters. Holding companies are subject to the Federal Reserve's policy statement SR-09-4, which generally provides a little more flexibility on the payment of dividends.
- *Stock repurchases.* Stock repurchase are subject to state and federal law, which require prior regulatory approval of any reductions in capital. Holding companies, on the other hand, generally only have to provide prior notice and small bank holding companies subject to the Policy Statement have additional flexibility if they are well capitalized and well managed.
- *Mergers and acquisitions*. Small bank holding companies can hold a higher level of debt than banks, which can be an important consideration in merger transactions. A holding company structure can also provide additional flexibility in structuring transactions. For example, multiple bank charters can be retained and core processing platforms do not need to be immediately converted.
- *Permissible activities and investments*. Most of the expanded powers for holding companies have been curtailed as a result of the *Dodd-Frank Act*, and in reality, very few holding companies have utilized these expanded powers. The one exception is with respect to investments. Holding companies may invest in up to 5% of voting securities in any entity without prior regulatory approval. Moreover, although the Volcker Rule has curtailed some of the merchant banking authority, holding companies still can engage in a wider range of investment activities than banks.

Conclusion

For most financial institutions with less than $1 billion in assets, there continue to be important advantages in retaining a holding company structure. When you take into account the upfront costs and expenses related to the elimination of a holding company, including the shareholder vote, regulatory applications, advisor fees and restructuring of contracts and policies, any perceived cost saves may take years to recoup. Ultimately, however, perhaps the most persuasive case against making a change is the loss of flexibility and the potential for unknown or unintended consequences.

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