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Fed Consolidated Regulation Poses New Challenges for Savings and Loan Holding Companies

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) transfers supervisory functions related to savings and loan holding companies (“SLHCs”) and their non-depository subsidiaries to the Board of Governors of the Federal Reserve System (“Board”) on July 21, 2011 (“Transfer Date”). On April 15, 2011, the Board proposed for comment a notice (“Notice”) of its intention to apply its consolidated supervisory program currently applicable to bank holding companies (“BHCs”), as enhanced by the Dodd-Frank Act, to SLHCs effective on the Transfer Date.¹ Public comments on the Notice are due by May 23, 2011.

The implications of the Notice should not be underestimated by SLHCs, because it contemplates an immediate integration of SLHCs into the Board’s BHC consolidated supervision program, including virtually all aspects of BHC--like regulation and supervision. As a result, SLHCs will be subject to new capital, source of strength, holding company exam rating system, and other existing (and new) BHC regulatory requirements.

Background

Elimination of OTS and Transfer of Jurisdiction over SLHCs the Board

Title III of the Dodd-Frank Act abolishes the Office of Thrift Supervision (“OTS”) effective on the Transfer Date, and transfers OTS supervisory functions (including rulemaking) related to SLHCs and their non-bank subsidiaries to the Board on the Transfer Date.

The Board’s Notice of Intent to Regulate SLHCs as BHCs

The Notice clearly states that the Board believes that it is important that any company that owns and operates a depository institution be held to “appropriate standards of capitalization, liquidity, and risk management consistent with the principles of safety and soundness.” As a result, Board intends to assess the condition, performance, and activities of SLHCs on a consolidated, risk-based basis “in a manner that is consistent with the Board’s established approach regarding [BHC] supervision.” The Board’s clearly stated objective will be to ensure that SLHCs and their nondepository subsidiaries “are effectively supervised and can serve as a source of strength for, and do not threaten the soundness of, its subsidiary depository institutions.”

The Notice indicates that after the Transfer Date, the Board will issue rates or other formal guidance, as appropriate, taking into consideration any comments received on the Notice, to apply the

supervisory program in place for BHCs to SLHCs “to the fullest extent possible,” taking into account the unique characteristics of SLHCs and the requirements of the Home Owners’ Loan Act (“HOLA”).

The Notice identifies at least four major elements of the Board’s current BHC supervisory program that will apply to SLHCs: (i) the Board’s consolidated supervision program; (ii) the Board’s holding company rating system; (iii) BHC capital adequacy standards; (iv) the Board’s supervisory program for small, noncomplex bank holding companies.

1. Consolidated Supervision Program

General

The Notice highlights that the Board supervises BHCs on a consolidated and enterprise-wide basis.² The Board’s supervision program is aimed at understanding and assessing each BHC on a consolidated basis. The program is applied in a risk-focused manner, and supervisory activities (continuous monitoring,³ discovery reviews,⁴ and testing) vary across portfolios of institutions based on size, complexity, and risk. The framework provides for coordination by the Federal Reserve System with, and reliance on the assessments by, bank and functional regulators of BHC subsidiaries. The Notice emphasizes that the consolidated supervision program is not only central to the Board’s assessment of risk to individual banking organizations and their depositor institution subsidiaries, but also to the Board’s assessment of the stability of the broader financial system.

More Intense Oversight

While the Board’s BHC consolidated supervision program has similarities to the current supervisory program employed by the OTS, the Notice unmistakably highlights the Board’s view that its consolidated supervision program will entail more intensive supervisory oversight than under current OTS practice, at least for some SLHCs. The Notice describes, for example, the Board’s program may entail more rigorous review of internal control functions and consolidated liquidity, as well as the conduct of discovery reviews of specific activities. In addition, the Board’s supervisory program may entail heightened review of the activities of nonbank subsidiaries (consistent with applicable law and regulation) and involve greater continuous supervisory monitoring of large SLHCs.

The Notice states that the Board plans to integrate each SLHC into supervisory oversight programs that align institutions with various supervisory portfolios (e.g., community banking organizations, regional banking organizations, and large banking organizations) based on their size and complexity, with a supervisory program tailored to the type of institution supervised.

2. New Holding Company Rating System for SLHCs

As discussed in the Notice, the Board and OTS have developed rating systems for supervised institutions to provide an assessment of financial and nonfinancial factors based on findings from examination and inspection activities, as well as to ensure uniform treatment across institutions. Both agencies use a 1-to-5 rating scale, with 1 indicating the highest rating and least degree of supervisory concern, and 5 indicating the lowest rating and highest degree of supervisory concern. These ratings are nonpublic supervisory information and, as such, are shared only with the institution being rated but are otherwise generally confidential.

The OTS rating system for SLHCs is known as “CORE.”⁵ The Board’s rating system for BHCs is known as “RFI/C(D),”⁶ commonly referred to as “RFI”. “Given the similarities between the CORE and RFI

rating systems, and the general goal of rationalizing supervisory processes for all institutions," the Notice notes the Board is considering transitioning SLHCs to the RFI rating system as the Board conducts its own independent supervisory assessment of the condition of each SLHC after the Transfer Date. The Board does not anticipate that any existing CORE ratings will be converted to RFI ratings until such a review is conducted. The bottom line is that SLHCs will at some point will be subject to the RFI/C(D) BHC rating system and the CORE system will be eliminated.

Notwithstanding substantial overlap between the two rating systems, including for risk management and financial condition, an important difference is that the CORE rating system does not explicitly take into account asset quality.⁷ Asset quality is one of a number of elements under the RFI system taken into account in assigning a composite BHC rating. The Notice states that the Board does not believe that assigning a rating for asset quality is likely to result in material changes to composite ratings because, under CORE, a review of asset quality is subsumed into other rating elements (it is taken into account indirectly in assessing the capital and earnings components).

Additionally, in contrast to BHCs, SLHCs currently are not subject to regulatory capital requirements. According to the Notice, until such time as consolidated capital standards for SLHCs are finalized by the Board, the Board anticipates that it will assess SLHC capital using supervisory quantitative and qualitative methods similar to those currently employed by the OTS. Noting that changes to the RFI system may be needed to address differences with SLHCs, the Board is continuing to review the two rating systems to determine where adjustments may be required.

3. New SLHC Capital Adequacy Requirements

The assessment of capital adequacy is one material difference between the OTS and Board supervisory programs for holding companies. In particular, SLHCs are not subject to quantitative BHC-type minimum regulatory capital ratio requirements. Instead, the OTS applies both a qualitative and quantitative supervisory capital assessment to SLHCs.

Pursuant to section 171 of the Dodd-Frank Act, BHCs and SLHCs are subject to minimum leverage and risk-based capital requirements that are not less than the generally applicable leverage and risk-based requirements applied to depository institutions.⁸ As highlighted in the Notice, small BHCs that are subject to the Small Bank Holding Company Policy Statement⁹ are exempt from these requirements. Notably, Section 171 of the Act did not expressly provide a similar exemption for small SLHCs.

Pursuant to the Dodd-Frank Act and the Basel III Report ("Basel III"),¹⁰ the Board, together with the other Federal banking agencies, is reviewing consolidated capital requirements for all depository institutions and their holding companies. According to the Notice, the Board is considering applying to SLHCs the same consolidated risk-based and leverage capital requirements applicable to as BHCs taking into account the unique characteristics of SLHCs and the requirements of HOLA.¹¹ The Board expects final rules establishing Basel III capital requirements to be finalized in 2012 and implemented starting in 2013, in accordance with the international agreement.

Recognizing that SLHCs have historically been permitted to engage in a broad array of nonbanking activities, the Board anticipates providing additional notice or issuing specific format guidance or rules with regard to supervisory capital assessment after the Transfer Date and providing further opportunity for comment.

4. Small Holding Company Regulation -- \$1-10 Billion in Total Consolidated Assets

The Board and OTS have specific supervisory programs for holding companies viewed as posing a relatively low level of risk to depository institution subsidiaries and to the financial system. Consistent with this risk-based focus, the OTS currently classifies low-risk or noncomplex SLHCs as “Category I” and subjects these SLHCs to abbreviated, limited-scope onsite examinations. The Board has a similar program for BHCs with total consolidated assets of \$1 billion or less (“small shell BHCs”).¹²

Under the Board’s program for noncomplex¹³ small shell BHCs, provided all subsidiary depository institutions have satisfactory composite and management ratings and there are no material outstanding holding company or consolidated issues, the Board generally assigns only a composite rating and a management rating to the BHC. Typically those ratings are based on the ratings of the lead depository institution. For complex small shell BHCs and noncomplex small shell BHCs that do not satisfy the additional conditions noted above), the Board generally conducts an offsite review, with targeted onsite reviews as necessary.¹⁴

As stated in the Notice for a noncomplex BHC with total consolidated assets between \$1 - \$10 billion and a satisfactory composite rating, a limited-scope¹⁵ onsite inspection is required every two years.¹⁶ For a complex BHC with total consolidated assets between \$5 - \$10 billion and a satisfactory composite rating, a full-scope onsite inspection is required annually.¹⁷

For a noncomplex BHC with total consolidated assets between \$1 - \$10 billion and a less-than-satisfactory composite rating, irrespective of complexity, at least one full-scope onsite inspection and one limited-scope or targeted inspection are required annually.

For all BHCs with total consolidated assets greater than \$1 billion (i.e., those that are not considered small shell BHCs), as discussed in the Notice, complete ratings are assigned in conjunction with inspection activities. Moreover, additional limited-scope or targeted inspection activities may be conducted as needed.¹⁸

As Board supervisory staff become familiar with the structure and financial condition of SLHCs, the Board expects to apply the program for small shell BHCs as set forth in SR 02-1 and supporting documents to SLHCs that meet the same criteria. The Board will determine whether SLHC with assets of \$1 billion or less is complex or noncomplex, and will tailor its supervision as appropriate. For a number of small, noncomplex SLHCs, this may have the effect of reducing burden as onsite examinations/inspections will no longer be required.

Action Plan for SLHCs

- Generally, plan for new and more intense holding company regulation and additional regulatory compliance burdens – and proactively plan how to comply with these new standards.
- In the case of a BHC with assets between \$1 - \$5 billion, the requirement for an annual full-scope inspection may be satisfied with a limited-scope or targeted inspection for the onsite portion, supplemented by other inspection sources.
- Understand the specific differences between OTS and the Board’s regulation of holding companies, and assess what your SLHC’s new supervisory oversight and compliance responsibilities will include.

- Review capital adequacy to ensure compliance under the new rules, and as appropriate, come up with a capital plan.
- Revise SLHC compliance policy and procedures to reflect the Board's BHC regulation, including for non-bank subsidiaries of the SLHC as well as bank subsidiaries.
- Consider commenting on the Notice regarding your concerns about BHC regulation. In this regard, the Board is seeking comment, by May 23, 2011, on all aspects of the Notice, and specifically requests public comment on the following:
 1. The burden of these potential modifications to supervisory activities on SLHCs.
 2. Whether there are any unique characteristics, risks, or specific activities of SLHCs that should be taken into account when evaluating which supervisory program should be applied to SLHCs and what changes would be required to accommodate these unique characteristics.
 3. What instruments that are currently includable in SLHCs' regulatory capital would be either excluded from regulatory capital or more strictly limited under Basel III? 3(a) How prevalent is the issuance of such instruments? Please comment on the appropriateness of the Basel III transitional arrangements for non-qualifying regulatory capital instruments. Provide specific examples and data to support any proposed alternative treatment.
 4. Are the proposed Basel III-based capital transition periods appropriate for SLHCs and, if not, what alternative transition periods would be appropriate and why?
 5. What methods the Board should consider implementing for assessing capital adequacy for SLHCs during the period between the transfer date and implementation of consolidated capital standards for SLHCs.
 6. Although the Board believes it is important for SLHCs generally to be subject to the same consolidated leverage and risk-based capital requirements as BHCs, it recognizes that SLHCs have traditionally been permitted to engage in a broad range of nonbanking activities that were not contemplated when the general leverage and risk-based capital requirements for BHCs were developed. The Board is seeking specific comment with respect to any unique characteristics, risks, or specific activities of SLHCs the Board should take into consideration when developing consolidated capital requirements for SLHCs based on Basel III. What specific provisions, consistent with the Dodd-Frank Act, should be incorporated in the proposed rule in order to address such unique characteristics, risks, and/or specific activities?

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ 76 FEDERAL REGISTER c2662 (April 22, 2011)—<http://edocket.access.gpo.gov/2011>.

² The Board's consolidated supervision program is set forth in SR letter 08-9/CA letter 08-12, "Consolidated Supervision of Banking Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" (SR 08-9). This Guidance is currently being reviewed pursuant to changes in the Board's supervisory responsibilities as set forth in the Dodd-Frank Act, including those that apply to the supervision of SLHCs.

³ "Continuous monitoring activities" are supervisory activities primarily designed to develop and maintain an understanding of the organization, its risk profile, and associated policies and practices. These activities also provide information that is used to assess inherent risks and internal control processes. Such activities include meetings with banking organization management; analysis of management information systems and other efforts to coordinate with, and utilize the work of, other relevant supervisors and functional regulators (including analysis of reports filed with or prepared by these supervisors or regulators, or appropriate self-regulatory organizations, as well as related surveillance results).

⁴ A discovery review is an examination/inspection activity designed to improve the understanding of a particular business activity or control process, for purposes such as addressing a knowledge gap that was identified during the risk assessment process.

⁵ See *Holding Companies Handbook*, Office of Thrift Supervision, March 2009. See also OTS CEO letter 266 (December 20, 2007) and 72 FEDERAL REGISTER 72442 (2007).

⁶ See Board Supervision and Regulation (SR) letter 04-18, "Bank Holding Company Rating System," and 69 FEDERAL REGISTER 70444 (2004).

⁷ Although liquidity is not rated separately under the CORE system, it is nevertheless taken into account in both the organizational structure and earnings components.

⁸ Under Section 171 of the Dodd-Frank Act, the "generally applicable" leverage and risk-based capital requirements are those established by the appropriate Federal banking agencies to apply to insured depository institutions under prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act.

⁹ 12 CFR Part 225, Appendix C.

¹⁰ Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee on Bank Supervision; see <http://www.bis.org/publ/bcbs189.htm>.

¹¹ The Board, together with the other Federal banking agencies, expects to issue a notice of proposed rulemaking in 2011 that will outline how Basel III-based requirements will be implemented for all institutions, including any relevant provisions needed to comply with the Dodd-Frank Act. It is expected that the Basel III notice of proposed rulemaking also would address any proposed application of Basel III-based requirements to SLHCs.

¹² See SR letter 02-1, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or less" (SR 02-1). See also Federal Reserve Regulatory Service (FRRS) 3-1531 (S-2483, October 7, 1985, as revised by S-2563, May 20, 1994) and FSSR 3-1532.5 (S-2587, November 3, 1997). SR 02-1 also sets forth procedures for BHCs with total consolidated assets of between \$1 - \$5 billion, but these institutions are not considered to be small shell BHCs.

- ¹³ The determination of whether a holding company is “complex” versus “noncomplex” is made at least annually on a case-by-case basis taking into account and weighing a number of considerations, such as: the size and structure of the holding company; the extent of intercompany transactions between insured depository institution subsidiaries and the holding company or uninsured subsidiaries of the holding company; the nature and scale of any nonbank activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley authorized activities (e.g., insurance, securities, merchant banking); whether risk management processes for the holding company are consolidated; and whether the holding company has material debt outstanding to the public.
- ¹⁴ Targeted inspection activities typically focus intensively on one or two activities.
- ¹⁵ A limited-scope inspection typically reviews all areas of activity covered by a full-scope inspection, but less intensively.
- ¹⁶ In the case of BHCs with assets between \$1 - \$5 billion, a targeted inspection is acceptable as well.
- ¹⁷ In the case of BHCs with assets between \$1 - \$5 billion, this requirement may be satisfied with a limited-scope or targeted review for the onsite portion of the inspection, supplemented by other information sources.
- ¹⁸ Requirements for BHCs with special characteristics (e.g., those that are formed to acquire an existing bank, have undergone a change in control, or are de novo and have been organized to acquire a de novo bank) may differ from the guidelines described here. See section 5000 of the Federal Reserve Board's *Bank Holding Company Supervision Manual*.