



Alerts

Federal Reserve Revises its Small Bank Holding Company Policy Statement by Increasing the Asset Limit to \$3 Billion

September 6, 2018

Hinshaw Alert

Summary

In 1980, the Federal Reserve Board (the "FRB") issued a Small Bank Holding Company Policy Statement (the "Policy Statement") which applied to bank holding companies ("BHCs") with pro forma consolidated assets of less than \$150 million. The Policy Statement was designed to permit the creation of small BHCs and to allow for their expansion by allowing them to have debt levels in excess of what is otherwise allowed for larger BHCs.

The Policy Statement has been revised twice since 1980. The consolidated asset limit was increased to \$500 million in 2006, and then in 2015, the consolidated asset limit was increased to \$1 billion and savings and loan holding companies ("SLHCs") were covered by the Policy Statement.

On May 24, 2018, President Trump signed legislation, which among other things, directed the FRB to increase the consolidated asset limit to \$3 billion. On August 28, 2018, the FRB issued an interim rule revising the Policy Statement increasing the consolidated asset limit to \$3 billion.

Under the Policy Statement, a BHC or SLHC (that meets the Qualitative Requirements discussed below)

- is exempt from the FRB's risk-based capital and leverage rules (Appendixes A and D of Regulation Y); and
- may use debt to finance up to 75% of the purchase price of an acquisition allowing (in theory) a BHC or SLHC to have a debt-to-equity ratio of up to 3:1.

As discussed below, the Policy Statement also applies to expedited processing by the FRB of applications filed by a Qualifying BHC (as defined below) and the payment of dividends and the completion of stock redemptions by a Qualifying BHC.

The remainder of this alert reviews the terms of the Policy Statement as revised by the new consolidated asset limit. For convenience purposes, the term "BHC" will mean either a BHC or an SLHC, and the term "subsidiary bank" means either the subsidiary bank of a BHC or the subsidiary savings association of a

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Service Areas

Securities



SLHC.

Small Bank Holding Company Policy Statement

Qualitative Requirements. The Policy Statement now applies to a BHC with consolidated assets of less than \$3 billion that meets the following Qualitative Requirements: (i) it is not engaged in significant non-banking activities either directly or through a non-bank subsidiary; (ii) it does not conduct significant off-balance sheet activities, including securitizations or asset management or administration, either directly or through a non-bank subsidiary; or (iii) it does not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the SEC (a "Qualifying BHC").

Capital Adequacy. A Qualifying BHC is exempt from the FRB's risk-based capital and leverage rules. As a consequence, it does not have to comply with the Basel III Capital Adequacy rules.

Each subsidiary bank of a Qualifying BHC must comply with the Basel III Capital Adequacy rules and must be well-capitalized. If any subsidiary bank is not, the FRB expects it to become well-capitalized within a brief period of time.

Acquisitions. A Qualifying BHC may use debt to finance up to 75% of the purchase price of an acquisition, thereby allowing the BHC (in theory) to have a debt-to-equity ratio of up to 3:1. As a consequence, a Qualifying BHC may incur a substantial amount of debt when making an acquisition. In addition, it does not have to comply with the FRB's risk-based capital and leverage rules, meaning that its acquisition pro forma consolidated balance sheet does not need to demonstrate that it complies with the Basel III Capital Adequacy rules.

Maximum Acquisition Debt. The amount of acquisition debt may not exceed 75% of the purchase price of the entity to be acquired.

Parent Company Leverage Requirements. A Qualifying BHC must reduce its parent company debt so that it is retired within 25 years of being incurred. It must also achieve a debt-to-equity ratio of .30:1, or less, within 12 years of the incurrence of the debt and comply with any debt servicing and other requirements imposed by its creditors.

"Debt," as used in the debt-to-equity ratio, is defined to mean borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions), and any securities issued by, or obligations of, the Qualifying BHC that are the functional equivalent of borrowed funds.

"Equity," as used in the debt-to-equity ratio, is defined to mean the total stockholders' equity of the Qualifying BHC as defined in accordance with GAAP. In determining the total amount of stockholders' equity, it must account for its investments in the common stock of subsidiaries by the equity method of accounting.

Generally, redeemable preferred stock will be treated as equity only if: (1) the preferred stock is redeemable at the option of the Qualifying BHC and (2) the debt-to-equity ratio of the Qualifying BHC would be at or remain below .30:1 following the redemption or retirement of the preferred stock. Preferred stock that is convertible into common stock of the BHC may be treated as equity.

Trust Preferred Related Subordinated Debt. The Policy Statement provides that trust preferred related subordinated debt will be considered debt for most purposes. For example, such debt would be included when determining whether (i) a Qualifying BHC's acquisition debt is 75% or less of the purchase price; or (ii) its debt-to-equity ratio is greater than 1.0:1 (the ratio above which it is subject to dividend restrictions and is not permitted to use the expedited applications processing procedures or obtain a waiver of stock redemption filing requirements under Regulation Y as discussed below).

When calculating its debt-to-equity ratio, a Qualifying BHC would be permitted to exclude an amount of trust preferred related subordinated debt totalling not more than 25% of its equity (as defined above), less parent company goodwill.



Trust preferred related subordinated debt is not included as debt when determining compliance with the Policy Statement's 12-year debt reduction and 25-year debt retirement requirements discussed above.

A Qualifying BHC that is organized in mutual form or a Qualifying BHC that has made an election to be taxed under Subchapter S of the Internal Revenue Code, when calculating its debt, may exclude the subordinated debentures issued to the U.S. Treasury under (i) the Troubled Asset Relief Program, and (ii) the Small Business Lending Fund.

Dividend Restrictions. A Qualifying BHC whose debt-to-equity ratio is greater than 1.0:1 is not allowed to pay corporate dividends until such time as it reduces its debt-to-equity ratio to 1.0:1 or less and otherwise meets the following criteria:

- its lead subsidiary bank must be well capitalized; subsidiary banks controlling at least 80% of the parent's total risk-weighted assets must be well capitalized; and no subsidiary bank may be undercapitalized (§225.14(c)(1)(ii) of Regulation Y);
- its lead subsidiary bank and its other subsidiary banks that control at least 80% of the parent's total risk-weighted assets must be well managed and have received at least a satisfactory compliance rating and no subsidiary bank has received one of the two lowest composite ratings (§225.14(c)(2) of Regulation Y); and
- during the previous 12 months, no formal order (including a written agreement, cease and desist order, prompt corrective action or similar order) or other formal enforcement action is or was outstanding against the Qualifying BHC or any of its subsidiary banks and no formal administrative enforcement proceeding is or was pending against the Qualifying BHC or any of its subsidiary banks (§225.14(c)(7) of Regulation Y).

Dividends may be paid by a Qualifying BHC when its debt-to-equity is at or below 1.0:1 and it otherwise meets the requirements in the three bullet points set forth above provided the dividends (i) are reasonable in amount; (ii) do not adversely affect the ability of the Qualifying BHC to service its debt in an orderly manner; and (iii) do not adversely affect the ability of the subsidiary banks to be well-capitalized.

Dividends must be eliminated if the Qualifying BHC (i) is not reducing its debt consistent with the requirement that the debt-to-equity ratio be reduced to .30:1 within 12 years of consummation of the proposal or (ii) is not meeting the requirements of any loan agreement(s).

Requirements for Expedited Processing - Expedited notices under Regulation Y. A Qualifying BHC desiring to make an acquisition will be eligible for the expedited processing procedures set forth in §225.14 (expedited treatment for banking acquisitions) and §225.23 (expedited treatment for non-banking acquisitions) of Regulation Y if: (i) it is in compliance with the ongoing requirements of the Policy Statement; and (ii) the following requirements are met:

- the parent BHC has a pro forma debt-to-equity ratio of 1.0:1 or less;
- the BHC meets all of the criteria for expedited action set forth in §§225.14 or 225.23 of Regulation Y, as the case may be;
- the lead subsidiary bank is well capitalized; 80% of the parent's total risk-weighted assets must be controlled by subsidiary banks which are well capitalized; and no subsidiary bank is undercapitalized (§225.14(c)(1)(ii) of Regulation Y);
- the lead subsidiary bank and the parent's subsidiary banks that control at least 80% of the parent's total risk-weighted assets must be well managed and have received at least a satisfactory compliance rating and no subsidiary bank has received one of the two lowest composite ratings (§225.14(c)(2) of Regulation Y); and
- during the previous 12 months, no formal order (including a written agreement, cease and desist order, prompt corrective action or similar order) or other formal enforcement action is or was outstanding against the Qualifying BHC or any of its subsidiary banks and no formal administrative enforcement proceeding is or was pending against it or any of its subsidiary banks (§225.14(c)(7) of Regulation Y).

Requirements for Expedited/Waived Processing - Stock redemptions. A Qualifying BHC will be eligible for the stock redemption filing exception for well-capitalized BHCs contained in §225.4(b)(6) of Regulation Y (which grants an exemption from the redemption pre-approval requirements for larger BHCs) if the following requirements are met:



- the parent BHC has a pro forma debt-to-equity ratio of 1.0:1 or less.
- the BHC is in compliance with the ongoing requirements of the Policy Statement.
- its lead subsidiary bank is well capitalized; 80% of the parent's total risk-weighted assets must be controlled by subsidiary banks which are well capitalized; and no subsidiary bank is undercapitalized (§225.14(c)(1)(ii) of Regulation Y);
- the lead subsidiary bank and the parent's subsidiary banks that control at least 80% of the parent's total risk-weighted assets must be well managed and have received at least a satisfactory compliance rating and no subsidiary bank has received one of the two lowest composite ratings (§225.14(c)(2) of Regulation Y); and
- during the previous 12 months, no formal order (including a written agreement, cease and desist order, prompt corrective action or similar order) or other formal enforcement action is or was outstanding against the Qualifying BHC or any of its subsidiary banks and no formal administrative enforcement proceeding is or was pending against it or any of its subsidiary banks (§225.14(c)(7) of Regulation Y).

For further information on the revised Policy Statement, please contact Tim Sullivan, Mike Morehead or your regular Hinshaw attorney.

Tax advice disclosure: To ensure compliance with the Internal Service Regulations governing the issuance of advice on Federal Tax issues, we advise you that any tax advice in this communication (and any attachments) is not written with the intent that it be used, and cannot be used, to avoid penalties that may be imposed under the Internal Revenue Code.