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Enhanced Opportunities for Community Banks: The Federal Reserve's Proposal to Raise the Threshold for Qualifying as a "Small" Holding Company from $500 million to $1 billion in Consolidated Assets

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The Bankers' Statement – Spring 2015

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Background:

In December 2014, Congress modified portions of Dodd-Frank to provide additional opportunities to reduce the regulatory burden on community banks. In response to this legislation, on January 29, 2015 the Federal Reserve Board (FRB) requested comment on several related proposals (and an interim rule) focused primarily on increasing the number of holding companies eligible for the reduced reporting and other requirements under the "small" holding company exclusion. The proposal includes, importantly, a change which would result in additional opportunities for small bank holding companies (SBHCs) to raise debt levels consistent with the FRB's Small Bank Holding Company Policy Statement by redefining the cap on qualifying as a "small bank holding company" from $500 million in consolidated assets to $1 billion on a pro forma basis.

The cap was last raised in 2006 when it went from $150 million in pro forma consolidated assets to $500 million.

The January 29 proposals would also provide parity for capital and debt rules for small savings and loan holding companies in a number of areas, again by increasing the size qualifying as "small" from $500 million to $1 billion.

In the same proposal, the FRB has reduced reporting requirements for certain bank and savings and loan holding companies.

In a nutshell, the proposals will make it easier for more holding companies to incur debt in order to expand and avoid some of the capital requirements otherwise applicable to larger holding companies under Basel III.

Highlights of the proposals:

Highlights of the FRB's announcement and request for comments include:

1. **Increased Permissible Holding Company Debt Levels**: The increase in permissible debt levels would enable more bank holding companies to qualify for the SBHC exemption from the FRB policy on holding company debt in Reg Y, thereby enabling SBHCs to carry additional long-term debt in excess of that typically permitted for larger bank holding companies (BHCs). The proposal would enable SBHCs to incur further debt for such things as acquisitions. The proposal would also level the playing field for BHCs and savings and loan holding companies (S&LHCs) to enable both to expand to the $1 billion pro forma threshold and still qualify as "small."
2. **Exempting Small S&LHCs from Capital Rules**: An interim final rule would exclude qualifying S&LHCs with less than $500 million in consolidated assets from the new FRB's regulatory requirements. As a result, both SBHCs and small S&LHCs, as newly defined, would be exempt from the FRB's minimum capital requirement and capital adequacy guidelines under Dodd-Frank, placing both on an equal footing with regard to those requirements. If the SBHC threshold is increased to $1 billion, it will exempt both BHCs and S&LHCs from the FRB's capital requirements up to the new $1 billion aggregate asset level.
3. **Reduce Filing Requirements**: The proposal would include relief from certain regulatory reporting burdens by providing that qualifying BHCs and S&LHCs with less than $1 billion in consolidated assets will no longer be required to file quarterly (but will continue to file parent-only FR Y-9SP reports) and regulatory capital reporting for S&LHCs with less than $500 million in assets will be eliminated.

For purposes of the proposals, "qualifying" BHCs and S&LHCs are non-complex organizations that:

1. Are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary;
2. Do not engage in significant off-balance sheet activities (including but not limited to securitization and asset management or administration) either directly or through a non-bank subsidiary; and
3. Do not have a material amount of debt or equity securities (other than TRUPs) that are registered with the Securities and Exchange Commission.

Assuming that the qualifying BHC or S&LHC meets the foregoing qualitative requirements, it may use debt to finance up to 75% of the purchase price of an acquisition (a debt/equity ratio of up to 3:1), providing that it:

1. Reduces parent debt to zero within 25 years of it being incurred;
2. Reduces its debt/equity ratio to 0.30:1 or less within 12 years of incurring the debt;
3. Ascertains that each insured depository subsidiary is and remains "well capitalized"; and
4. Refrains from dividends until the debt/equity ratio is 1.0:1 or less.

Other regulatory reporting, application and related matters under, for example, Regs LL, Q and Y, are also impacted by raising the threshold from $500 million to $1 billion in pro forma consolidated assets.

Increasing the threshold for qualifying as “small” would provide welcome benefits to institutions between $500 million and $1 billion in consolidated pro forma assets, and would provide additional opportunities for using debt to finance small acquisitions rather than diluting small holding company shareholders.

Conclusions:

The upshot is that the proposals help to carry out the referenced Congressional revisions intended to ease restrictions on smaller BHCs and S&LHCs in order to enable them to compete and to combine, if appropriate, using debt. This will also ease some regulatory capital and reporting requirements that may not make sense given the limited risk associated with smaller institutions that fit within the referenced qualifying operating criteria.

The requirements set forth in the proposal are complex and subject to additional issues if, for instance, a BHC controls a savings and loan association. In each instance, BHCs and S&LHCs should always review any proposed debt issue or other significant action with the FRB and banking regulators prior to taking such action as a matter of due diligence, to ascertain that the institution is in fact qualified and eligible, and for good general regulatory relations.