Why Have a Holding Company?

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AUTHORED ARTICLE | Summer 2019

By Jeffery E. Smith and Kimberly J. Schaefer
(Published in the Summer 2019 issue of *The Bankers' Statement*)

One of the "issues du jure" for the bank and thrift industry involves the benefit, or possibly lack thereof, of having a holding company.

Industry publications have cited certain instances where banking organizations, including some larger institutions, have eliminated or are considering eliminating their holding company parent for a variety of reasons, including the additional regulatory burden resulting from the holding company structure.

For large institutions, expenses related to regulatory oversight at the holding company level may be a factor to consider. However, for smaller, non-complex institutions with little to no real holding company regulatory involvement in the normal course, such as one-bank holding companies, having a holding company can provide both opportunities for expanded non-bank income as well as an entity for which securities matters can be much simpler than those of a bank or thrift.

Each institution should undertake a review of the issues based on their particular circumstances and long-term strategic plans. For the most part, however, absent unusual circumstances or particular unique holding company issues, it can be very advantageous to have a holding company in place as the primary vehicle for dealing with shareholder and capital issues, engaging in non-bank activities, and providing for separation of risk activities from the underlying institution.

Here are some examples:

1. Capital Issues. Holding companies are state corporations (with the exception of Federally-chartered mutual holding companies or MHCs), formed for the purpose of holding bank or thrift shares, that can take advantage of corporate opportunities available to other corporations, subject to limitations contained in state law and Federal Reserve regulations, which apply because the holding company is qualified as a bank or savings and loan holding company. Governance, securities,

director protections, and other important aspects of state corporate law generally apply (again with some impact by virtue of being a BHC); however, the relative ease of addressing state securities and governance laws for issuing capital and for stock buybacks are generally much more direct and straightforward than the rules applicable to banks directly. There are questions as to whether the "market" understands and is more accepting of BHC stock as a result, and/or whether as a result it is easier to raise capital using BHC stock as opposed to bank stock. Likewise, MHCs can be a vehicle to raise capital through affiliated entities in the MHC structure.

The same applies to other capital and capital-like instruments. For most purposes, it is generally easier and more straightforward to issue stock and debt under state general corporate law than the laws and regulations pertaining directly to banks and thrifts, despite the general relief from SEC regulation for banking institutions. This, combined in some instances with tax-related issues, was the underlying incentive for formation of BHCs in the first place and still generally applies.

2. Non-Bank Activities. Section 4 of the Bank Holding Company Act (BHCA) recognizes a number of non-bank activities in which BHCs can engage and which can provide non-bank income revenue sources to the overall organization. These revenue sources can also be down-streamed to provide capital to subsidiary banks and thrifts when appropriate. Conducting those activities through a separate subsidiary can provide protection for the institution from liabilities generated as a result of the activities as well as sources of income that are not subject to the types of economic changes that impact banks and thrifts. While some of these activities can also be conducted by banks and thrifts directly, not all of them can and, again, the off-balance sheet liabilities generated by the activities are typically best separated from the insured depository institution.

As noted previously, banks and thrifts are permitted to engage indirectly, through a holding company subsidiary, in a variety of activities in which the institution itself may or may not otherwise be permitted to participate. That spectrum of permissible non-bank activities is expanded if the holding company qualifies as a "financial holding company" under relevant Federal Reserve guidelines. The option to expand business lines through affiliated non-bank entities provides not only the obvious opportunity to increase and diversify revenue, but also to help provide liability protection for the institution itself.

3. Buy-Backs and Debt. Once again under the rubric of greater capital flexibility, BHCs are much better suited to react quickly to market situations and opportunities through stock buy-backs and the ability to issue debt and equity instruments. BHC lines of credit can be established to assist in those situations and in order to have a ready source of funds for a variety of strategic uses without the necessity of extensive regulatory pre-approvals like those required for banks and thrifts. BHCs considering redemptions should contact their Reserve Bank prior to proceeding to obtain guidance as to any potential capital issues with their particular institution and be prepared to provide the Reserve Bank with appropriate projections of the anticipated impact on the organization.

4. Regulatory Oversight. As noted, large complex holding companies are the subject of much more Federal Reserve regulatory involvement than smaller, non-complex holding companies that are more typical for community banks and thrifts. So long as the organization remains well-capitalized and well-managed, there is little likelihood of much Federal Reserve involvement in the normal course. There are, of course, limited Federal Reserve reporting requirements for holding companies, but agency movement has been to further limit the Federal Reserve's involvement in small holding company oversight in recent years,

recognizing the limited risk to the financial system. However, should the underlying bank or thrift become "troubled" in any way, the Federal Reserve will become more involved primarily to ascertain that there is appropriate funding available on an ongoing basis to enable the holding company to serve as a "source of strength" to the subsidiary institution or institutions. Troubled institutions can expect enhanced oversight by the Federal Reserve should significant issues arise. Likewise, if "control" issues arise, the Federal Reserve will be involved to ascertain that BHCA and related laws and regulations relating to "control" are appropriately enforced. Even without a holding company, however, institutions remain subject to state and federal "control" oversight through relevant state laws as well as the federal Change in Bank Control Act and related regulations (the CIBCA). Holding companies remain subject to state anti-takeover and related laws and regulations as well which, combined with the BHCA and CIBCA, can provide tricky traps for the unwary with regard to concentrations of ownership. Additional regulatory considerations for transactions between multi-entity holding company affiliates under Federal Reserve Regulation W is also a consideration for holding company, non-bank and bank affiliate transactions.

5. Tax Issues. Some states tax depository institutions differently than their holding companies and, as a result, there may or may not be tax advantages to maintaining a holding company. In addition, the liquidation of the holding company itself may have a variety of tax consequences. Tax issues arising from elimination of a holding company should be carefully reviewed with appropriate tax professionals as part of any assessment of the value of the holding company structure.

Conclusions:

While elimination of existing holding companies may be something boards should explore at the present time as a part of their general oversight responsibilities, institutions should take care to examine not only the benefits of the holding company structure but the expense and potential reduction in current and future business and economic opportunities involved in eliminating an existing holding company as compared to retaining the current structure.

New bank and thrift formations may not need a holding company at the beginning, but may wish to consider holding company issues and opportunities as they grow.