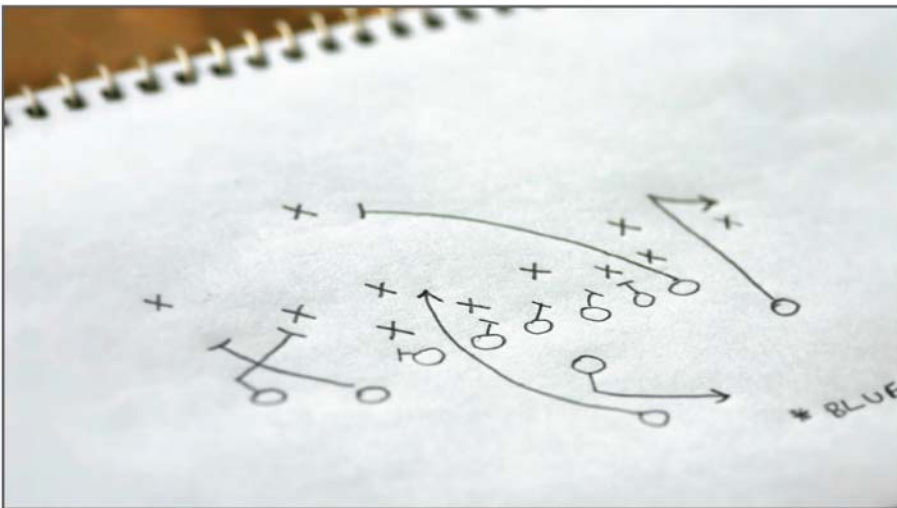


Dodd-Frank Wall Street Reform and Consumer Protection Act

Future for Thrift Institutions



This is the fifth of a series of user guides that will be published by Morrison & Foerster. The user guides provide an in depth discussion on specific topics raised by the Dodd-Frank Act. For our Dodd-Frank overview and brief alerts, please see our dedicated website at:

<http://www.mofo.com/resources/regulatory-reform/>.

With just under four months to go before the transfer of the authority of the Office of Thrift Supervision (“OTS”) to the other federal banking agencies, savings institutions should be prepared for some important changes to the regulatory framework to which they are accustomed. The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Act”) and the new international capital standards will, over time, result in several new requirements for the institutional operations of savings and loan holding companies and their subsidiary thrifts. For the most part, the changes will bring the thrift and bank charters closer together, and thrift holding companies are likely to be treated nearly the same as bank holding companies. At the same time, however, the existing restrictions on thrift institutions, such as the qualified thrift lender test, remain in effect.

For some savings and loan holding companies, especially those with significant nonbank businesses, the coming changes may have far-reaching effects. In some cases, management of a savings institution may want to consider the relative merits of the thrift charter in light of particular operations and business plans. Certain thrift organizations probably should retain the charter, including mutual savings associations, grandfathered unitary thrift holding companies, any thrift institutions that engage in real estate development or brokerage, and, possibly, those with relatively greater concentrations of commercial real estate loans.

This memorandum identifies and discusses the time-sensitive issues that Dodd-Frank presents for thrift institutions, longer-term capital issues, and the array of other important consequences for these organizations.

We do not address here the consumer protection and mortgage-related provisions of the Act, which are the subject of several User Guides that we have published.¹ This bulletin covers pertinent parts of Dodd-Frank that deal with federal preemption, but a comprehensive discussion appears in our Federal Preemption User Guide.²

Executive Summary

Because many changes will take effect on July 21, 2011, several items stand out for immediate attention by savings associations and their holding companies:

- ***Does the holding company engage in nonbank financial activities? If so, will it meet bank holding company capital requirements? Does it have a composite CORE rating of 1 or 2 and a component risk management rating of 1 or 2?***

On July 21, thrift holding companies engaged in activities permissible only for financial holding companies will be required to be well-capitalized and well-managed.³ Savings and loan holding companies are today examined by OTS on a qualitative basis for capital adequacy. Now, however, Dodd-Frank requires that thrift holding companies be treated identically to bank holding companies, which are subject to industry-wide quantitative standards.

- ***Is the holding company capable of serving as a source of strength? What is the likelihood that it could be called upon to support the thrift?***

On the same date, all savings and loan holding companies—regardless of the nature of their activities, if any, beyond control of a thrift—will be subject to the source-of-strength doctrine. Regulations implementing the doctrine are due a year later, on July 21, 2012, but the Federal Reserve arguably has authority to enforce the doctrine after July 21 of this year. Assessing the practical consequences of the doctrine is complex.

- ***For a federal thrift, does it have operating subsidiaries or agents that avoid state restrictions through federal preemption? Does the thrift have operations that rely on the OTS preemption regulations, 12 C.F.R. 545.2 and 560.2 or on OTS preemption opinions?***

Dodd-Frank makes some important changes to federal preemption that also will take effect on July 21, 2011. Most importantly, the Act eliminates preemption for operating subsidiaries and agents on a going-forward basis. The Act also effectively repeals sections 545.2 and 560.2 of the OTS regulations through a provision eliminating “occupation of the field” as a basis for preemption.

- ***Is the organization prepared for increased enforcement efforts by the states?***

State attorneys general have authority to enforce federal regulations against thrift (and other) financial institutions, in addition to the power to bring civil suits against federal savings associations.

¹ See Residential Mortgage User Guide (<http://www.mofo.com/files/Uploads/Images/ResidentialMortgage.pdf>); Mortgage Servicing User Guide (http://www.mofo.com/files/Uploads/Images/100830User_Guide_Mortgage_Servicing.pdf); Consumer Financial Protection User Guide (<http://www.mofo.com/files/Uploads/Images/101111-Dodd-Frank-Consumer-Financial-Protection.pdf>).

² This User Guide is available at <http://www.mofo.com/files/Uploads/Images/100723UserGuide.pdf>.

³ This requirement does not apply to grandfathered unitary thrift holding companies.

- ***Is the organization prepared for a new examination and supervision regime?***

Thrift organizations will take on two new regulators in place of OTS: the Federal Reserve Board (the “Federal Reserve”) for holding companies and either the Office of the Comptroller of the Currency (“OCC”) or the Federal Deposit Insurance Corporation (“FDIC”) at the depository level (depending on whether the charter is federal or state). The basic examination and supervision goals remain unchanged, but the day-to-day functions will be different—and likely more intense.

- ***Will the subsidiary thrift continue to meet the QTL Test?***

The Act imposes new sanctions for the failure by a savings association to comply with the qualified thrift lender test (the “QTL Test”). The principal change may be that the one-year remedial period is eliminated. These sanctions appear already to be in place, having taken effect the day after the enactment of Dodd-Frank.

- ***For a grandfathered unitary thrift holding company, is it prepared to establish an intermediate holding company?***

The Act contains a specific provision for the regulation of these grandfathered companies: under certain circumstances, these companies may be required to form intermediate holding companies that will control all of the financial activities of the institution. There is no specified time period, but the Federal Reserve could require the formation of these companies as early as October 19 of this year.

- ***Are policies on insider transactions up to date?***

Dodd-Frank imposes new limitations both on extensions of credit to insiders and on asset sales and purchases with insiders. The new asset sale and purchase requirements take effect on July 21.

Other dramatic changes will be coming after July 21. All thrift holding companies (including but not limited to those that must maintain well-capitalized status) must engage continuously in capital planning. Dodd-Frank sets the stage for the implementation in the U.S. over the next several years of the international capital rules known as Basel II and III. It is difficult to predict which rules will reach down to the vast majority of thrift institutions, but changes appear likely in several areas:

- ***Composition of capital.*** Dodd-Frank requires that savings and loan holding companies adhere to the same capital requirements that now exist for their subsidiary savings associations—a provision that governs capital composition by excluding trust-preferred and other hybrid securities from Tier 1 capital. Basel III introduces a range of other requirements on the composition of Tier 1 capital.
- ***New capital ratios.*** The Act does not provide for new capital ratios other than to require that capital rules incorporate a countercyclical element. However, Basel III provides a more robust set of ratios that U.S. regulators could apply in whole or in part on an industry-wide basis.
- ***Liquidity.*** Dodd-Frank requires that the Federal Reserve adopt liquidity standards for the largest banks and systemically important nonbank financial institutions. Basel III offers two liquidity ratios that U.S. regulators easily could implement throughout the U.S. banking system. The regulators already have statutory authority to do so.

Finally, important provisions of the Home Owners’ Loan Act (“HOLA”) warrant review. Some provisions remain unchanged by Dodd-Frank but, in light of the other changes imposed by the Act, may take on increased consequence. Certain provisions of HOLA have been amended, and while the changes have not been sweeping, they may have an impact on particular operations.

- **Commercial real estate lending.** Dodd-Frank does not amend the commercial lending authority of a federal thrift, and this authority is broader than that available to national banks. As of July 21, 2011, however, when the OCC inherits OTS's examination and supervision function, federal thrifts may encounter a new and more skeptical supervisory approach to CRE lending.
- **Service corporations.** This form of thrift subsidiary may engage in the broadest range of financial activities—residential real estate development and real estate brokerage among them—of any affiliate of an insured depository institution. Although this type of subsidiary has never qualified for federal preemption, it may be worth re-considering as a vehicle for new and broader business operations.
- **Lending limits.** The Act extends the limits on loans to one borrower and to insiders to capture credit exposures arising from various transactions, including derivatives and repurchase agreements.
- **Transactions with affiliates.** The Act also expands sections 23A and 23B to cover new arrangements or transactions that create credit risk. For example, any fund for which a bank (or an affiliate) serves as an investment adviser is now deemed to be an affiliate of the bank. The definition of a covered transaction is broadened to include derivatives and the borrowing and lending of securities. Repurchase agreements with affiliates are now subject to collateralization requirements.

Analysis

We discuss below these regulatory changes in greater detail, highlighting the practical implications for thrift institutions.

I. Matters Requiring Immediate Attention

On July 21, 2011, the Federal Reserve will assume responsibility for the regulation of savings and loan holding companies, and the OCC and the FDIC will take over the supervision of federal and state savings associations, respectively. At least equally importantly, changes to the substance of the new regulatory regime—including well-capitalized and well-managed status, source of strength, federal preemption, a new examination framework, and a new requirement for grandfathered unitaries—will take effect.

A. Well-capitalized and well-managed status

Section 606(b) of Dodd-Frank requires that, beginning on July 21, 2011, any thrift holding company (other than a grandfathered unitary) that is engaged in activities otherwise permissible only for financial holding companies must maintain well-capitalized and well-managed status. The activities available to a financial holding company include nearly all insurance- or securities-related work and certain limited investments in non-financial entities or assets.⁴ Well-capitalized and well-managed status is to be measured “as if the savings and loan holding company was a bank holding company.”

Well-capitalized status. The bank holding company capital requirements in Regulation Y are new in their entirety to thrift holding companies. Of course, savings and loan holding companies have some experience with capital requirements at the savings association level, which are virtually the same as those for banks. The bank holding company rules are not dissimilar from these depository-level requirements. Certain of the capital requirements warrant some attention because, while they have applied at the savings association level, they would not have been remarkable there.

- **Deductions of nonfinancial equity investments.** Bank holding companies are permitted to make investments in nonbanking entities through their merchant banking authority and a handful of other statutory provisions. These investments must, however, be deducted from the core capital elements

⁴ A few activities that arguably have a financial nexus are not permitted, including real estate brokerage.

of Tier 1 in certain amounts, ranging from 8 to 25% of the value of the investments. The particular percentage depends on the amount of the total nonfinancial investment relative to Tier 1 capital. (Amounts that are not deducted are risk-weighted at 100%.)⁵ The same rule will apply to savings and loan holding companies engaged in nonfinancial activities. For those thrift holding companies that have permissible nonfinancial investments, material deductions from Tier 1 could be required. Indeed, if the amount of nonfinancial equity investments equals the amount of Tier 1 capital, the thrift holding company could lose 25% of its core capital.

- **Limitations on the inclusion of “restricted core capital elements” in Tier 1 capital.** The Federal Reserve has imposed restrictions on what can be included in Tier 1 capital other than common stock and noncumulative perpetual preferred stock. These restrictions often are not a concern at the depository institution level but could well affect the capital planning at the holding company level.

There are five restricted core capital elements: (i) qualifying cumulative perpetual preferred stock; (ii) minority interests relating to certain preferred stock issued by a bank subsidiary; (iii) minority interests relating to common or certain preferred stock issued by a subsidiary that is not a bank; (iv) qualifying trust preferred securities; and (v) subordinated debentures issued to the Treasury Department as part of the TARP program by a subchapter S corporation or a mutual holding company. The rules are complex, but, as a starting point, these five elements may not constitute more than 25% of Tier 1 capital. (There is some greater leniency for the TARP subdebt.) Under different parts of Dodd-Frank and Basel III, eventually there will be significantly greater limits on the inclusion of these elements in Tier 1.

- **Leverage ratio/goodwill.** A relatively small point, but in calculating its leverage ratio, a bank or thrift must deduct goodwill. The Federal Reserve has not imposed this requirement on bank holding companies, but both Dodd-Frank and Basel III will require the deduction.

Well-Managed Status. Any savings and loan holding company (other than a grandfathered unitary) that engages in a financial activity will be required to be “well managed.” Presumably this rule will mean that the most recent report of examination of a thrift holding company shows a composite CORE rating and a risk management component rating of 1 or 2.

An interesting question for savings and loan holding companies is whether, if well-managed (or well-capitalized) status is difficult to maintain, any financial activities at the holding company level should be transferred into service corporation subsidiaries. These subsidiaries do not appear to trigger the new well-capitalized and well-managed requirements for holding companies. Service corporations have even broader powers than financial holding companies, but it is likely that the investments in these corporations would have to be deducted from core capital.

B. Source of strength

All thrift holding companies will become subject to the source-of-strength doctrine. Effectively codifying a Federal Reserve regulation, section 616(d) of the Act states that the Federal Reserve shall require each savings and loan holding company (and bank holding company) to serve as a source of strength for its subsidiary depository institution. That is, a holding company must have “the ability . . . to provide financial assistance to [a subsidiary] insured depository institution in the event of financial distress of the insured depository institution.” Final rules implementing the doctrine should be issued by July 21, 2012, but the Federal Reserve could invoke its existing supervisory authority to enforce the doctrine on July 21 of this year. The forthcoming rules may require periodic reports from bank and thrift holding companies that will

⁵ Savings associations are required to deduct investments in “non-includable” subsidiaries from core capital, but this rule appears to be somewhat less stringent than the bank holding company rule.

enable the regulators to assess the ability of the holding companies to provide assistance and to enforce compliance with the requirement.

OTS historically has rejected the source-of-strength doctrine, although the substance may have been implicit in the supervision of specific savings and loan holding companies. The current thrift holding company examination manual takes care not to mention the source-of-strength doctrine, but the manual's discussion of capital adequacy on a consolidated basis and of the ability to raise funds in the future encompasses support of a subsidiary thrift. To some extent, a thrift holding company guarantee of an undercapitalized subsidiary depository institution's compliance with a capital restoration plan, required by the prompt corrective action regime, has served as a substitute for an enforceable source-of-strength doctrine.

From a planning perspective, thrift holding companies should bear in mind that the requirement is to maintain the "ability" to provide assistance. This ability will be the subject of every holding company examination. Accordingly, every thrift holding company will need to think through its capacity to provide financial support, regardless of the condition of the subsidiary savings association.

The ability to act as a source of strength could entail different approaches to capital policy at a holding company. One obvious way to demonstrate ability would be to hold liquid assets at the holding company in a sufficient amount to contribute the necessary funds to a distressed subsidiary. Alternatively, a holding company should be able to demonstrate its ability to access the capital markets for additional funds. Either course has little meaning for the large number of savings and loan holding companies that are shell entities. There is no point in holding liquid assets in reserve at the holding company; these funds could always be put to better use at the operating subsidiary thrift. Access to the capital markets by a shell company will be solely a function of the condition of the thrift subsidiary; accordingly, a holding company brings no greater ability to raise funds than does the subsidiary.

What of a duty on the part of a thrift holding company to make a capital contribution when its subsidiary savings association becomes distressed? Dodd-Frank is on its face ambiguous: a holding company is required to "serve" as a source of strength, but source of strength is defined simply as the "ability" to provide support. The Federal Reserve has been clear, however, and has taken the position that the doctrine is not limited to the demonstration of "ability," and that it requires the contribution of capital when needed. The agency has enforced the duty in several written agreements and consent orders in recent years with the boilerplate that a holding company use its resources "to serve as a source of strength to the [subsidiary bank], including, but not limited to, taking steps to ensure that the [subsidiary bank] complies with" an order or agreement that the bank has entered into with its regulator. The underlying bank-level enforcement document typically sets new capital requirements for the bank, requires the submission of a recapitalization plan, and specifies acceptable ways of raising new capital—always including (but not limited to) contributions from the holding company.

Yet section 616(d) and the existing consent orders do not necessarily suggest that a federal bank regulator will respond differently than it does now when the only source of new bank capital is the holding company and the company declines to provide it. This scenario has arisen repeatedly since 2008. Typically (if not always), a holding company refuses to make additional capital contributions on the view that doing so disadvantages its shareholders and creditors. We are not aware that the Federal Reserve has sought to litigate the matter.⁶ It could be argued that the codification of the doctrine in Dodd-Frank removes the impediment to enforcement that courts have found in litigated cases—the MCorp decision and a handful of other precedents—but whether the Federal Reserve or the FDIC will take on this issue remains to be seen.

⁶ The FDIC has asserted the doctrine unsuccessfully in claims in bankruptcy against the estates of insolvent holding companies, but no broadly applicable guidance has emerged.

In any event, and notwithstanding the uncertainties surrounding implementation of the doctrine, savings and loan holding companies should devote time and energy to analyzing the possible sources of distress at a subsidiary thrift and to determining how the company may be in a position to provide further assistance.

C. Federal Preemption and State Enforcement

Dodd-Frank addresses at some length federal preemption and the regulatory and enforcement roles of the state. While much of current federal preemption law remains intact, the changes effected by Dodd-Frank are complex, and beyond the scope of this memorandum,⁷ From a concrete business perspective, however, five elements of the preemption provisions warrant attention: (i) the impact on operating subsidiaries and agents, (ii) the implicit repeal of two OTS regulations, (iii) the heightened role of state attorneys general (the "State AGs"), (iv) the continuing vitality of particular preemption provisions in current federal consumer protection statutes, and (v) the survival (or not) of past preemption determinations by the OCC and OTS..

Operating subsidiaries and agents. Over the past 15 years, OTS has expanded federal preemption to cover operating subsidiaries and, subject to certain conditions, agents. (The OCC has done so as well, but to a lesser extent, particularly with respect to agents, than has OTS.) Operating subsidiaries often have been used to house various residential mortgage loan operations. Recently, federal thrifts have sought to use agents to expand their mortgage origination business.

Section 1046 of Dodd-Frank explicitly strips these arrangements of the benefit of federal preemption, beginning on July 21, 2011. This change is not limited to state consumer financial laws. Importantly, the manner in which section 1045 becomes effective should require the immediate attention of any thrift that relies on operating subsidiaries or agents. Existing structures and arrangements are not broadly grandfathered. Rather, the contracts that these entities entered into before July 21, 2011, remain unaffected by the preemption change. Any contracts entered into thereafter by any operating subsidiary or agent must comply fully with state law.

Accordingly, a federal thrift should review all activities of its operating subsidiaries or agents with two considerations in mind. One, operating subsidiaries and agents will become subject to applicable state licensing laws. Two, any forms of contracts used by these entities and that also rely on preemption should be reviewed to ensure that any contracts entered into on or after July 21 comply with state law requirements.

Occupation of the field. The Act states that HOLA "does not occupy the field in any area of State law." This rather theoretical statement may have important practical results for some activities by federal thrifts. By way of background, federal thrifts may avoid state law under one or more of three theories: the applicable federal statute or regulation explicitly preempts state law; state law conflicts with the operation of the relevant federal law; or the pertinent federal law covers an area of law so broadly that no state law may apply to this area. In a number of instances, courts and OTS have interpreted HOLA as a statute that fits the latter theory; HOLA "occupies the field" of the regulation of federally chartered savings associations.⁸

At least two consequences flow from the elimination of this theory in the construction of HOLA. First, OTS has in place two preemption regulations, 12 C.F.R. §§ 545.2 and 560.2, both of which are based solely on "occupation of the field." These regulations no longer will be available to demonstrate the preemption of a state law. Second, OTS has invoked "occupation of the field" as the sole basis for the preemption of a number of state laws, including certain laws addressing mortgage lending and restrictions on gift cards. These interpretations will cease to be available as legal support for federal preemption. Of course, HOLA

⁷ We have discussed in detail federal preemption after Dodd-Frank in our Federal Preemption User Guide (July 2010), available at <http://www.mofo.com/files/Uploads/Images/100723UserGuide.pdf>. Among other things, this memorandum does not address "conflict" preemption or the standards and process by which state laws are deemed preempted.

⁸ Of course, explicit statements of preemption in federal statutes that were not expressly amended or repealed by Dodd-Frank continue to remain in effect.

still will have preemptive effect to the extent that a state law conflicts with the purpose or operation of the statute.

These changes take effect on July 21 and do not require rulemaking in order to become effective. As with the activities of operating subsidiaries and agents, a federal savings association should assess the extent to which it relies on federal preemption to avoid state licensing or other restrictions and whether this preemption is based on an “occupation of the field” interpretation by OTS. Where there may be an issue, it also would be worthwhile reviewing contract forms.

State enforcement. Federal thrifts are likely to see new enforcement and regulatory initiatives on the part of the states, as a result of Dodd-Frank. State AGs are permitted to bring civil actions to enforce any regulations issued by the CFPB, although they do not have authority to enforce Dodd-Frank statutory provisions on a stand-alone basis. The Act also confirms that State AGs may go to court to enforce non-preempted state law against all thrifts (and banks). Before bringing an action, the State AGs must consult with the CFPB. State financial regulatory agencies do not have comparable authority.⁹

It is not possible to predict what issues may attract the attention of State AGs. While they will not have any federal law to enforce until the CFPB begins to issue regulations, it would be prudent for all thrift institutions to refocus on consumer compliance matters. There is some lead time here until the CFPB begins to issue final rules. Once rules are issued, the State AGs could wield considerable power. In light of the cooperation between the State AGs and the nascent CFPB in developing a proposal on home foreclosures and related issues, there is some potential for the State AGs to act as a kind of enforcement arm of the CFPB. Indeed, the State AGs can bring civil actions against thrifts with less than \$10 billion in assets to enforce CFPB rules, even though the CFPB itself lacks direct enforcement authority over these institutions.

Other statutory preemption provisions. While Dodd-Frank works some potentially important practical changes to federal preemption, federal thrifts should also bear in mind the limits of the Dodd-Frank modifications. Among other things, all of the federal consumer protection statutes for which rulemaking authority is granted to the CFPB contain their own preemption provisions. These statutes include the most significant federal financial consumer protection laws: the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Fair Credit Reporting Act, and the privacy provisions of the Gramm-Leach-Bliley Act. These provisions are *not* uniform and in some cases involve a complicated analysis of the roles of federal and state agencies. None of these provisions are modified by Dodd-Frank.

Existing preemption regulations and other interpretations. The extent to which existing preemption regulations, orders, guidance, and interpretations by the OCC and OTS survive Dodd-Frank is complex and will require additional analysis. The rules for the transition of OTS functions to the Federal Reserve, the FDIC, and the OCC provide that all essentially all determinations, interpretations, and other actions of OTS remain in effect according to their terms. The Act is not explicit, however, in reconciling this provision with the other preemption-specific provisions. Looking just to the preemption provisions in the Act, three variables could affect whether OTS preemption determinations survive.

- Is a contract involved? The Act is explicit that regulations and other agency actions addressing the applicability of state law to any contract entered into on or before July 21, 2010, remain in effect. The Act does not rule out preemption in respect of contracts entered into after July 21, but federal thrifts should be careful in evaluating whether to assert preemption claims as to these contracts.
- Is the state law at issue a “state consumer financial law”? Such a law is one that (a) does not discriminate against national banks and (b) “specifically regulates the manner, content, or terms and conditions of any financial transaction . . . or any account related thereto, with respect to a consumer. For these laws, federal preemption is available only if the law would have a

⁹ Both State AGs and state regulators have broad enforcement authority with respect to state-chartered thrifts.

discriminatory effect on a national bank, prevents or significantly interferes with the exercise of national bank powers, or is preempted by a federal law other than title LXII of the Revised Statutes of the United States.¹⁰ This provision largely confirms existing law, and the new aspects relate to the process for making preemption determinations in the future. Under this provision, most if not all existing federal preemption determinations involving state consumer financial laws should survive.

- Is the theory of preemption solely “occupation of the field”? As discussed above, this theory no longer is available to support federal preemption. Whether this repeal reaches back is unclear. Conceivably a court could rely on this provision to overrule a pre-Dodd-Frank determination.

If the preemption issue does not involve a contract, does not relate to a state consumer financial law, and does not rest exclusively on “occupation of the field,” then it seems clear that existing preemption determinations of the OCC and OTS should remain operative.

D. Examination and supervision

On July 21, all thrift institutions will be examined by (for them) new federal banking agencies—the Federal Reserve for thrift holding companies and either the OCC or the FDIC for savings associations. While safety and soundness continues to be the touchstone of examinations, each agency has its own approach. The impact on thrift institutions is almost impossible to predict, but a few observations are in order. All regulators use a preexamination request for information and certain documents. These are not uniform across the agencies, and thrift institutions will need to be prepared to respond to different kinds of requests.

At the holding company level, the Federal Reserve is likely to undertake “more intensive” supervision, according to its recent notice regarding the application of the bank holding company regulatory framework to savings and loan holding companies. Capital adequacy is likely to be a particular focus, and the ratios the Federal Reserve applies to assess leverage differ from those traditionally used by OTS. Two other important changes will occur. First, thrift holding companies will see an entirely new set of examiners. The Act guarantees OTS staff positions and salary preservation at the OCC or the FDIC. Because there is no similar guarantee at the Federal Reserve, few if any OTS examiners are likely to join the Federal Reserve.

Second, a new and extensive series of reports is in the offing. Until Dodd-Frank, savings and loan holding companies reported their financials and limited other information to OTS on a quarterly basis. On Feb. 8, 2011, the Federal Reserve published a proposal under which thrift holding companies would be required to submit the same reports as bank holding companies. The new reports would include, at a minimum, the FR Y-9C (call report-type data at the holding company on a consolidated basis), the FR Y-9LP (parent company-only financials), and the FR Y-8 (affiliate transactions). Additional reports would be necessary for structural changes, the financial condition of non-functionally regulated nonbank subsidiaries, equity investments in nonbank financial companies, and affiliate transactions.

Changes in examinations by the OCC and the FDIC are more qualitative; anecdotally, both agencies tend to focus on management procedures—including documentation of decisions, risk management, and corporate governance—in ways that OTS has not.

E. Qualified thrift lender test

Savings and loan holding company status and the avoidance of bank holding company status have depended for decades on compliance by each thrift subsidiary with the QTL Test. As all thrift holding companies know, the test basically requires that 65% of a savings association’s assets be invested in assets relating to residential mortgage loans. (Certain other assets are includable as well.) After failing a test, a

¹⁰ This last provision is potentially complicated because Title LXII includes most but not necessarily all provisions of the National Bank Act as it has been amended.

thrift has had one year in which to rehabilitate itself and avoid sanctions. If the thrift is unable to do so, then three restrictions take effect: (i) any new activities by a subsidiary thrift are limited to those available to national banks; (ii) interstate branching is limited to that permissible for national banks; and (iii) the thrift is subject to the same limits on dividend payments by a national bank. Additionally, within one year, the holding company must register as a bank holding company and become subject to the various restrictions on bank holding company activities.

Dodd-Frank introduces three new restrictions in the event of QTL non-compliance—all of which appear to have taken effect already, on July 22, 2010. First, the one-year grace period no longer protects the thrift from limits on new activities and dividend payments. Second, dividend payments become permissible only if specifically approved by both the Federal Reserve and the OCC and only if necessary to meet holding company obligations. Third, the OCC has explicit authority to bring a formal enforcement action to compel compliance with the test.

F. Intermediate holding companies

The grandfathering of unitary thrift holding companies in existence on May 4, 1999, is largely unaffected by Dodd-Frank. In addition to the new requirements for savings and loan holding companies across the board, however, one potential requirement for the grandfathered companies has been added. The Federal Reserve may (and in some situations must) require that a grandfathered unitary establish an intermediate holding company between it and the thrift and other subsidiaries engaged in financial activities.¹¹ The purpose of the intermediate holding company is to enable the Federal Reserve to focus on the financial activities within the overall organization and, by implication, to avoid regulation of nonfinancial activities.

The evident purpose of the new requirement is to streamline supervision. The Federal Reserve still may undertake limited examinations of and require reports from grandfathered holding companies and may in some cases undertake enforcement actions. Additionally, creation of an intermediate holding company does not relieve the grandfathered company from the source-of-strength doctrine or from holding company capital requirements.¹²

G. Insider transactions

Currently, under section 22(d) of the Federal Reserve Act, a bank may purchase from or sell to a director an asset only if either the transaction is on market terms or it has been authorized by a majority of disinterested directors. Dodd-Frank replaces this requirement with a more stringent provision that applies to both thrifts and banks. The requirements for insider transactions now apply to transactions with executive officers and principal shareholders as well as with directors. The transaction must be on market terms, regardless of any board action. If the transaction exceeds 10% of the capital and surplus of the bank or thrift, then advance approval from a majority of disinterested directors is necessary. This amendment takes effect on July 21.

Loans and other extensions of credit to insiders are subject to long-standing rules on amounts and on the procedures by which such transactions must be approved. Dodd-Frank expands the types of extensions of credit subject to these limits to include derivative transactions, repos and reverse repos, and securities lending and borrowing transactions.

II. Changes to the Capital Rules

Over the next several years, new capital requirements will roll out for all insured depository institutions and their holding companies. Dodd-Frank anticipates broad reforms to the current bank regulatory capital requirements but

¹¹ Certain internal financial activities may continue to be held outside the intermediate holding company structure.

¹² As noted above, a grandfathered unitary thrift holding company is exempt from the well-capitalized and well-managed requirements for holding companies engaged in financial, nonbank activities. This exemption also should apply to intermediate holding companies.

offers few specifics. Most if not all of new capital requirements will be informed by the new sets of international capital standards popularly referred to as Basel II and Basel III.

Before turning to some of the important details, the threshold question is what new requirements will reach the vast majority of thrift and bank holding companies, i.e., those with fewer than \$50 billion in consolidated assets. There is no clear answer, but certain changes seem predictable. To begin with, Dodd-Frank requires that all thrift holding companies become subject (at some point) to the rules now prevailing at the depository institution level. Dodd-Frank also requires that a countercyclical element be added to the capital rules. Further, the new well-capitalized requirement for savings and loan holding companies engaged in financial activities imports current bank holding company capital requirements for all such thrift holding companies. Otherwise, capital provisions in the Act cover only the largest banks.

The federal bank regulators have the authority to and are at least informally obligated to make other substantial changes. They have in general terms agreed to both Basel II and Basel III. When the financial crisis began in 2007 and picked up steam in 2008, the U.S. regulators had finalized (but not fully implemented) sophisticated Basel II rules for the largest banks and had proposed a less complex set of rules for other bank and thrift institutions. There is every reason to think that the regulators will implement fully the large bank Basel II rules and will bring some form of the proposed rules for other banks and thrifts to completion.

The implementation of Basel III for all but the largest banks is more difficult to predict. Again, the U.S. has agreed to Basel III, but Basel III by its terms is limited to the largest international banks. Unlike Basel II, there is no “short form” version for other banks. Nevertheless, Dodd-Frank contemplates higher capital requirements across the banking industry. The provisions of Basel III that would achieve this result do not require a high level of sophisticated financial analysis that only the largest banks can afford and therefore could be applied to virtually all banks. Accordingly, we address below a number of Basel III changes that are likely to affect the capital structure of any thrift organization. We do not address Basel II in detail because a proposal has been in circulation since 2008 and because Basel II changes are unlikely to have nearly as significant an effect on capital structure as will Basel III.

- **Composition of capital—Dodd-Frank.** Section 171 of Dodd-Frank, also known as the Collins Amendment, directs the federal banking agencies to set new minimum risk-based and leverage requirements for all thrift and bank holding companies. These requirements must be at least as stringent as those that now apply to banks and savings associations.¹³
- **Composition of capital—Basel III.** The required composition of Tier 1 capital will change. Tier 1 capital is expected to consist “predominantly” of common equity and retained earnings. Historically, the Federal Reserve has required that common stock constitute at least 50% of Tier 1 capital. A new requirement has not been specified, but we may expect that it will materially exceed 50%. Based on regulatory actions during the financial crisis to shore up bank capital and on certain enforcement actions, we anticipate that the federal bank regulatory agencies will require something greater than 51%.

Components of Tier 1 that are not common equity will be required to be subordinated to all creditors, must include a provision enabling the issuer to defer dividend or coupon payments, and must have no incentives to redeem the instruments in times of stress.

- **Trust preferreds and other hybrid instruments.** Crucially, the requirement in the Collins Amendment that holding companies become subject to the same capital rules now applicable to their subsidiary insured depository institutions means that trust-preferred securities and other hybrid instruments will be excluded from Tier 1 capital on a going-forward basis. Holding companies with consolidated assets of less than \$15 billion—a universe that includes the vast majority of thrift holding companies—may continue to include in

¹³ Small bank holding companies—those with less than \$500 million in consolidated assets—are fully exempt from this requirement. Similarly sized savings and loan holding companies may have, like all other thrift holding companies, a five-year exemption (see below), but they do not have the same permanent exception.

Tier 1 any trust preferreds issued before May 19, 2010.¹⁴ (The \$15 billion-plus institutions may phase out their pre-May 19, 2010, trust preferreds from Tier 1 over the period between January 2013 and January 2016.)

- **Five-year grace period for thrift holding companies.** The new minimum requirements under section 171 will not apply to savings and loan holding companies until July 21, 2015. The practical effect of this provision is not entirely clear. The grace period does not apply to the Federal Reserve's separate authority to set capital requirements for holding companies, and that authority could be the avenue for new capital requirements for thrift holding companies. At the same time, it is clear that the grace period does not cover the elimination of trust-preferred securities from Tier 1, nor does it apply to new countercyclical capital measures that are required in section 616 of the Act.
- **Minority interests in consolidated subsidiaries.** Currently, minority interests in the form of common stock or noncumulative perpetual preferred in depository institution subsidiaries are fully includable in Tier 1 capital. Minority interests in the same subsidiaries that are in the form of cumulative preferred and minority interests in the form of common stock or noncumulative perpetual preferred in non-depository subsidiaries may in the aggregate (and including certain other equity instruments) comprise up to 25% of a bank holding company's Tier 1 capital. Basel III will reduce the includable amounts of these interests, using a complicated series of calculations in which "surplus" capital is subtracted from the interests in ways that reflect the nature of the equity instruments.
- **New deductions from capital.** Basel III enumerates several types of assets that must be deducted from Tier 1 capital, either for the first time or in greater amounts than before. Asset classes affected include investments in other financial institutions, mortgage servicing rights, cash flow hedge reserves, gains on sale in securitization transactions, defined benefit pension fund assets and liabilities, and treasury stock.
- **New capital ratios.** Basel III introduces a more complex set of capital ratios, for which the Federal Reserve and the other federal banking agencies already have statutory authority to implement. The new measurements will phase in over several years. Within the next two years, the following standards will come into effect:
 - **Tangible common equity ratio.** This new ratio—which is not risk-based—begins at 3.5% on January 1, 2013, and grows to 4.5% by January 1, 2015.
 - **Tier 1 risk-based capital.** The new minimum of 4.5% (up from the current 4% for U.S. entities) takes effect in 2013. In 2015, it will be 6%.
 - **Total risk-based capital.** The new international standard will be 8% in 2013, up from 6%. Please note that the standard rule for U.S. banking institutions already is 8% and has been at this level for some time .

Other Basel III capital changes will phase in over a longer period but are worth keeping in mind:

- **Capital conservation buffer.** This buffer requires additional common equity Tier 1 capital simply on the theory that banking institutions should hold capital above the regulatory minimums. Under Basel III, this buffer does not come into play until 2016. At that point, a banking institution will be required to hold an additional 0.625% in Tier 1 common equity capital, measured against risk-based assets. This amount increases incrementally over the following three years so that by January 1, 2019, the buffer will be 2.5%.

¹⁴ Note that the Dodd-Frank treatment of these securities is slightly different from Basel III, but Dodd-Frank of course governs.

Over the last three years, of course, the federal banking agencies effectively have created conservation buffers in specific situations. For example, for a well-capitalized institution, a Capital Purchase investment by the Treasury Department was a form of a conservation buffer and could vary between 1 and 3%.

- *Countercyclical buffer.* Section 616(a) of Dodd-Frank requires the federal banking agencies to promulgate capital rules with a countercyclical component, that is, an element forcing banking institutions to raise capital in prosperous times so that it can be drawn down in times of financial stress. Under Basel III, this buffer essentially is an extension of the conservation buffer. The countercyclical buffer is to be phased in along the same time frame as the conservation buffer. Basel III caps the countercyclical buffer at 2.5% (once fully in place), but the ceiling is solely for international reciprocity purposes, and regulators may impose higher requirements on domestic institutions. Specific buffer requirements will be set on a national basis (with up to 12 months' advance notice) and will be based on a complicated calculation involving the relationship between the ratio of private sector debt to gross domestic product and the trend of that ratio.
- *Contingent capital.* Dodd-Frank contemplates a contingent capital requirement—i.e., an instrument that converts to equity in times of financial stress—at least for the largest U.S. banks (and other systemically significant financial institutions). The Act requires only a study of contingent capital by the Financial Stability Oversight Council to be completed within two year and authorizes—but does not require—the Federal Reserve to issue a rule after the report has been completed. Dodd-Frank does not otherwise identify the types of instruments that might be subject to a conversion requirement, nor does it set forth a trigger other than “financial stress.” The current Basel III position is more specific: all noncommon Tier 1 and Tier 2 capital instruments must contain a clause that allows them to be written off or requires that they be converted to common equity upon the occurrence of a trigger event. The trigger event is the earlier of a determination that without the write-off or conversion the institution will fail, or the injection of public sector capital to avert failure. The contingent capital requirement is still under discussion, however, and a few national regulators have generated other proposals.
- *Leverage ratio.* For completeness purposes, we note that Basel III includes an explicit leverage ratio for the first time. Thrift organizations in the U.S. already are accustomed to leverage requirements, and there are specified minimums for savings associations. A leverage requirement will be new at the savings and loan holding company level (although not new for bank holding companies). The Basel III proposal is 3%, which would phase in slowly over several years. Savings associations currently must maintain a leverage ratio of 4% in order to be adequately capitalized. The impact of even a 3% requirement on a thrift holding company, particularly one with significant nonbank operations, could be significant, however.
- **Liquidity.** The federal banking regulators traditionally have measured holding company liquidity in a qualitative manner, without specific, industry-wide benchmarks. Basel III introduces two new liquidity measures:
 - *Liquidity coverage ratio.* This calculation (the “LCR”) is designed to measure the ability of a banking organization to meet liquidity needs over the next 30 calendar days. Regulators will effectively set the denominator by specifying a “significantly severe liquidity stress scenario” that will determine liquidity needs. Several factors will inform the regulators' decisions, and liquidity needs may be driven by several different sources, not simply depositors. The desired outcome is that the ratio of an institution's high-quality, unencumbered liquid assets to total net cash outflows over the next 30 days exceeds 100%. The LCR will be subject to a three-year observation period beginning Jan. 12, 2012; it then is expected to be applied formally on Jan. 1, 2015.

- *Net stable funding ratio.* This ratio (the “NSFR”) is intended to provide a liquidity assessment over a one-year period. The ratio itself is nominally straightforward: available amounts of stable funding must exceed the required amount of stable funding. “Available stable funding” includes all Tier 1 and Tier 2 capital, any other preferred stock not includable in Tier 2, and borrowings and liabilities with effective remaining maturities of more than one year. Deposits and unsecured wholesale funding are also includable, subject to various haircuts. With respect to required stable funding, Basel III identifies the amounts of funding necessary to support different types of assets and applies an adjustment factor (much like risk weights used in Basel II). An observation period for the NSFR begins on Jan. 1, 2013, with full implementation scheduled for Jan. 1, 2018.

III. Important Thrift-Level Authorities and Limits

Several differences between federal thrifts and national banks either disappear under or take on potentially more significance in Dodd-Frank. In particular, a savings association’s authority to engage in the widest possible range of activities through a service corporation and its relatively broader commercial lending powers continue to represent the advantages of the thrift charter. By contrast, however, the authority to branch freely on an interstate basis is no longer unique to the thrift charter. As discussed above, the penalty for failure to meet the qualified thrift lender test also increases.

Additionally, some changes in Dodd-Frank apply nearly equally to banks and thrifts, but should be considered in reviewing existing or prospective operations.

A. Service corporations

Under HOLA, a federal savings association may create a service corporation subsidiary subject only to the condition that the thrift’s aggregate investments in all service corporation subsidiaries may not exceed 3% of the thrift’s assets. The statute does not impose any restriction on the activities of a service corporation. However, by regulation, OTS limits activities to those “reasonably related to the activities of financial institutions.” OTS has specified a large number of preapproved activities, and other activities may be permitted upon application.

The range of possible service corporation activities appears to be wider than the set of financial activities available under the basic measure of financial activities, section 4(k) of the Bank Holding Company Act. Specifically, a service corporation may undertake real estate development (and not merely through debt-previously-contracted authority) and may act as a real estate broker for third parties, a power that the Federal Reserve has not authorized under section 4(k).¹⁵

B. Commercial real estate lending

A thrift engaged in a substantial amount of commercial real estate or other commercial lending may be subject to more intense scrutiny by the OCC or the FDIC—both of which have greater experience than OTS in examining these assets. Dodd-Frank does not change the commercial lending authority of a federal thrift. HOLA creates two asset buckets that are available for this kind of lending. A federal thrift may make loans secured by commercial real estate in an amount up to 400% of total capital and, separately, any commercial loans (including secured loans) in an amount up to 20% of total assets.¹⁶ The first bucket alone exceeds the current guideline for banks of 300% of capital.

¹⁵ A bank holding company may make small, passive investments in companies engaged in nonfinancial activities through its authority under section 4(c)(6) of the BHCA and through its merchant banking authority, but the restrictions on investment amounts or on the ability to manage or operate the investment appear to make these authorities more limited than those available to federal thrifts under the service corporation authority.

¹⁶ Technically, the restriction on branching also takes effect, but note that commercial loans in excess of 10% of total assets must consist solely of small business loans.

The practical effect of this legal difference is a little difficult to determine. OTS has criticized several thrifts for excessive commercial real estate lending even where the amount of lending is well within the statutory limits. The OCC is unlikely to show great leniency to the federal thrifts that come under its jurisdiction on July 21, and the statutory buckets in HOLA do not prevent the OCC from imposing more stringent safety-and-soundness limits. Indeed, the immediate lesson for a federal thrift may be to measure its portfolio of commercial real estate loans against the 300%-of-capital ceiling and, if the portfolio exceeds the ceiling, to consider how the portfolio might be reduced.

C. Affiliate transactions

Dodd-Frank expands the scope of the current section 23A and 23B affiliate transaction restrictions in a number of ways. The amendments are scheduled to take effect on July 21, 2012. The Act expands the definition of affiliate to include any investment fund for which a bank or thrift—or any of their affiliates serves as an investment adviser.

Other changes to section 23A are designed to capture the credit risk generated by sophisticated affiliate transactions. Repurchase agreements now will be treated as extensions of credit (and therefore subject to the particular limits on affiliate loans). Covered transactions, which are subject to quantitative and qualitative limits, now include the borrowing and lending of securities and derivative transactions with affiliates, if these transactions create credit exposure for the depository institution involved. Finally, any investment fund for which a bank or thrift—or any affiliate—serves as an investment adviser is itself an affiliate of the bank or thrift.

The Act also codifies current practice with respect to exemptions. The Federal Reserve does not have sole authority to grant exemptions from either section 23A or 23B. Exemptions require the approval of the federal regulator of the depository institution involved and the non-objection of the FDIC.

D. Lending limits

Dodd-Frank amends two lending limit provisions in a comparable fashion, and these changes will take effect on July 21, 2012.

For loans to third parties, national banks now are subject to two ceilings on loans and other extensions of credit to a single borrower. The Act broadens this provision to include derivative transactions, repos and reverse repos, and securities lending and borrowing transactions. Federal thrifts have a more complicated loan-to-one-borrower provision, and, accordingly, the Act simply confirms that the OCC may impose more stringent limits on federal thrifts, presumably along the lines of the new limits for national banks.

Conclusion

The changes to the thrift industry that are coming as the result of Dodd-Frank will be dramatic for nearly every thrift institution. These changes will affect key internal operations, as well as various retail products, and will require continuous monitoring for an extended period to ensure that business goals remain achievable under the new regulatory regime.

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