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Savings and Loan Holding Companies: Supervision by the Federal Reserve Board

Savings and loan holding companies ("SLHCs") will face important changes when the Federal Reserve Board ("FRB") takes over the supervisory responsibilities of the Office of Thrift Supervision ("OTS") on July 21, 2011. The first formal step in this transition occurred on April 15, when the FRB published a notice seeking comment on the application to thrift holding companies of its examination and supervision framework for bank holding companies (the "Notice").[1] The Notice states that the FRB's supervision regime would not require "any specific action" by SLHCs before the transfer date. The potential impact of some of the changes, however, warrants serious attention now by most SLHCs.

Critically, the Notice appears to be the only written guidance from the FRB before the transfer date. The Notice states that guidance and proposed rules will be issued after July 21, taking into account comments on the Notice. Comments are due by May 23.

The Notice explicitly describes a supervisory regime that is "more intensive" than that to which SLHCs are accustomed. For that reason alone, every SLHC should pay careful attention to the Notice. Additionally, the Notice outlines changes across two dimensions—the nature of an examination based almost solely on the size of the SLHC and changes that are industry-wide or that, at least, could affect a large segment of the thrift industry, regardless of size.[2]

Certain SLHCs may have greater exposure under the FRB supervisory regime—among them small SLHCs, grandfathered unitary SLHCs, and SLHCs with a considerable portion of their capital in hybrid instruments[3]—and should give meaningful consideration to the possibility of submitting a comment. In any event, all SLHCs should review the Notice, since it is the only guidance that will be forthcoming before the FRB takes over from OTS.

We address below first the implications of the Notice for differently sized SLHCs and then turn to industry-wide concerns embedded in the Notice. This advisory should be read in conjunction with our user guide from March, Future for Thrift Institutions.[4]

INSTITUTION-SPECIFIC CONCERNS

The FRB's framework would have different effects on different SLHCs. The FRB divides BHCs into six "supervisory portfolios,"[5] a different method than OTS's current use of three categories, one of which is limited to a handful of

1 76 Fed. Reg. 22662 (Apr. 22, 2011).

2 Additionally, an important change will be examination teams that likely are wholly new; very few if any OTS examiners are expected to transfer to the FRB.

3 These instruments include trust-preferred securities, mandatory convertible preferred stock and other instruments that are restricted core capital elements under the capital rules for bank holding companies ("BHCs") and instruments that Basel III will phase out of Tier 1 capital between 2013 and 2022.

4 The guide is available at http://www.mofo.com/files/Uploads/Images/110331-User-Guide-Thrift-Institutions.pdf.

5 The definitions of these categories and the basic nature of supervision are set forth in two FRB Supervision and Regulation Letters, SR 02-1 (Jan. 9, 2002) (BHCs of $5 billion or less) and SR 08-9 (Oct. 16, 2008) (BHCs of $10 billion or more). By way of a refresher, OTS assigns an SLHC to one of

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institutions. Both the FRB and OTS regimes distinguish between complex and non-complex institutions. The relevant factors are much the same, but non-complex SLHCs under the OTS process effectively would be treated as complex by the FRB if they have either (i) assets in excess of $1 billion, (ii) a material amount of debt outstanding, or (iii) risk management consolidated at the holding company level.

Briefly, SLHCs could expect the following, and may wish to comment, depending primarily on their asset size. Smaller SLHCs and grandfathered unitary thrift holding companies could be particularly affected.

- ***Less than $500 million in assets.*** These SLHCs presumably would qualify for the FRB's policy statements on small BHCs.[6] These statements exempt small BHCs from the industry-wide capital requirements. The reporting requirements for small BHCs also are lighter than for other BHCs; a small BHC need only file semi-annually (rather than quarterly), and the required contents are more limited.

  There is one regulatory capital wrinkle for these SLHCs that the FRB has the capacity to iron out, and it should be encouraged to do so. Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires that the current bank-level capital requirements be applied at the holding company level. Among other results, this directive would exclude trust-preferred securities from Tier 1 capital. Small BHCs are permanently exempt from this requirement. Identically-sized SLHCs do not, however, enjoy the same exemption, although there is a five-year grace period for all SLHCs. The implications of this change warrant specific attention by each small SLHC[7], but some inevitably would be affected adversely. We believe, however, that the FRB has intrinsic authority under its general regulatory authority to level the playing field.

  Comments would be appropriate (a) to confirm the application of the small bank policy statements to similarly sized SLHCs and (b) to give these SLHCs comparable treatment under section 171.

- ***Less than $1 billion in assets***. This category would include smaller SLHCs that may be able to take advantage of the less onerous capital and reporting requirements for small BHCs. This category also includes, of course, SLHCs with assets between $500 million and $1 billion, to which the full-blown capital and reporting requirements would apply. In other respects, however, the FRB does not distinguish between the two for supervisory purposes.

three categories, and for the vast majority of SLHCs only two categories are relevant. Category I includes noncomplex and low-risk institutions; Category II encompasses complex or higher risk companies; and Category III SLHCs that are conglomerates. Whether an institution is a Category I or a Category II institution depends primarily on four threshold questions: (i) whether the holding company has significant activities other than operating a thrift, (ii) whether the holding company is engaged in activities other than investing cash from dividends or proceeds from stock sales; (iii) whether the holding company has minimal debt that it can service with its own resources; and (iv) whether, in its cash management operations, the company invests solely in highly liquid securities or in high risk, highly-leveraged instruments. Any SLHC with a composite CORE rating of 3, 4, or 5 must be deemed Category II. Category III institutions have multiple entities engaged in different businesses; they are identified on a case-by-case basis by the regional office and headquarters staff in Washington, D.C.

6 SLHCs of this size should note that the FRB imposes three additional conditions before a BHC is eligible for the small bank policies: the BHC may not (i) be engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) conduct significant off-balance sheet activities (including securitizations and asset management or administration) either directly or through a nonbank subsidiary; or (iii) have a material amount of debt or equity securities outstanding (other than trust-preferred securities) that are registered with the Securities and Exchange Commission.

7 In at least some cases, the five-year period may be sufficient time for outstanding trust-preferred securities to run off or be redeemed. However, small BHCs may continue to issue trust-preferreds and include them in capital, an option not available to small SLHCs.

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Many of the SLHCs in this group could be affected by the transfer of OTS authority to the FRB. Under the current OTS regime, SLHCs with assets of less than $1 billion generally are treated as Category I institutions. Under the FRB's approach, these SLHCs would fall into one of three different sub-categories. The consequences would be as follows:

- First, for noncomplex SLHCs that control thrifts with satisfactory composite and management ratings, the FRB would assign the same ratings to the holding company, and the actual examination will consist of a review of recent examination reports and related correspondence.
- Second, for similar SLHCs but with a subsidiary thrift in less than satisfactory condition, with less than a satisfactory management rating, or with a material supervisory issue, the FRB would conduct an off-site examination to determine management and composite ratings. (Note that this examination may be lighter than those for larger holding companies; the FRB assigns only management and composite ratings, not the full range of ratings.) On-site examinations may be necessary.
- Third, for SLHCs with less than $1 billion in assets but that nevertheless are complex, the FRB should follow largely the same approach as for Category II SLHCs. Additionally, though, this examination would be "full scope." That is, the FRB would assign the full set of holding company ratings to these SLHCs—thus increasing the probability of an on-site examination.

These probable changes give rise to the possibility that SLHCs currently in Category I could become subject to an examination that otherwise would be appropriate for Category II institutions. Accordingly, comments urging the FRB to follow, at least presumptively, the substance of the OTS process for categorizing these smaller SLHCs for examination purposes may be warranted.

- ***Between $1 billion and $5 billion in assets.*** For these institutions, the FRB does not draw any formal distinction between complex and non-complex. Examinations of these SLHCs would be full-scope, often with a full or partial on-site exam. Of course, in practice supervision would vary depending on each SLHC's particular operations.

  The significance of this category is that SLHCs of this size that are treated as Category I under the OTS system now would be supervised essentially as Category II institutions. As with SLHCs with assets of less than $1 billion, it may be appropriate to ask the FRB to confirm that it will observe the same risk-based approach to SLHCs of this size that OTS has used and will not materially change the nature of the examination of these institutions solely because of their size.

- ***Between $5 and $10 billion in assets***. There is something of a lacuna for these institutions in the FRB's recent written guidance on examinations. Earlier guidance, however, encompasses these holding companies.[8] The guidance implies that all BHCs of this size are complex and makes clear that (as with other BHCs), an examination focuses on the particular risks of each institution. Regular onsite examinations are the norm.

  SLHCs of this size may be the least affected by the changes. These institutions almost certainly are Category II in OTS parlance, and the FRB's risk-focused examinations are likely to parallel the OTS approach. It may be worthwhile seeking confirmation of this result, however. Some of the industry-wide concerns discussed below, particularly consolidated regulatory capital requirements may be of particular relevance to SLHCs in this category.

8 *See* SR Letter No. 99-15 (SUP) (June 23, 1999); SR Letter No. 97-24 (SUP) (Oct. 27, 1997).

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- ***More than $10 billion in assets.*** The FRB sometimes refers to these institutions as regional BHCs that are not large and complex banking organizations ("LCBOs"). These BHCs are monitored on a continuous basis, but typically the FRB does not maintain a day-to-day onsite presence.

  In addition to generally heightened supervision, each SLHC of this size should be prepared to conduct stress tests. Supervision of nonthrift subsidiaries of SLHCs of this size is likely to be markedly more intense. The FRB examines the financial condition of comparable bank subsidiaries in some detail, and, as a result of Dodd-Frank, is no longer required to defer to the primary functional regulator of these subsidiaries.

- **Large and complex banking organizations.** The definition of these institutions ("LCBOs") has varied over the years but now may have been settled—for BHCs—by Dodd-Frank.[9] The provisions of Dodd-Frank addressing systemic risk suggest that any BHC with more than $50 billion in assets is systemically important and, by inference, large and complex. At a minimum, the FRB must create heightened prudential standards for these institutions. How similarly sized SLHCs will be handled is unclear. The automatic treatment of the $50 billion-plus institutions clearly applies only to BHCs. While there are a few SLHCs that would exceed the $50 billion threshold, the Financial Stability Oversight Council ("FSOC") will have to make a decision on a case-by-case basis as to whether any one SLHC (or any other nonbanking financial company) is systemically important. Even without such a determination, though, the FRB could subject these largest SLHCs to more rigorous standards.

  Without trying to tease out the differences between the OTS and FRB approaches to institutions of this size and, given the small number of affected SLHCs, suffice it to say that the SLHCs of this size have been deemed Category III in the OTS regime and should be accustomed to continuous supervision, although probably of a somewhat less intense variety than the FRB will undertake. Although it is not certain, the SLHCs of this size should prepare for a continuous on-site presence by the FRB. As for whether these SLHCs should be subject to heightened prudential standards, these institutions may want to suggest that the FRB wait and see how the FSOC treats them before making its own decision.

- ***Grandfathered unitary SLHCs***. There is no correlative in the FRB's supervisory framework for these institutions. The impact of supervision by the FRB has the potential to be severe. The FRB traditionally has examined a BHC and its nonbanking subsidiaries in order to assess the BHC's overall condition and not strictly its relationship with bank subsidiary—a far broader approach than OTS has taken with diversified SLHCs. The FRB has, however, limited experience with non-financial activities. One particularly important element of FRB supervision will be the imposition of new capital requirements at the holding company level. While the Notice recognizes that adjustments to the capital rules will be necessary for these institutions, there is no telling what those adjustments might be.

  Dodd-Frank creates an intermediate holding company that serves as a shield for the non-financial activities of a grandfathered unitary SLHCs, but it is available only at the FRB's direction and not at the SLHC's election. Now would be the time for a grandfathered unitary to seek comfort from the FRB that it will enable the establishment of intermediate holding companies.

INDUSTRY-WIDE CONCERNS

The Notice identifies three broad categories of changes to the current supervisory framework for all SLHCs: consolidated supervision, the holding company rating system and regulatory capital. Each set of changes may warrant comment,

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9 The FRB first separately identified LCBOs for supervisory purposes in 1997, SR Letter No. 97-24 (SUP). Additional supervisory provisions were added in SR Letter No. 99-15 (SUP) (these are same letters that cover institutions between $5 and $10 billion). A subset of large and complex BHCs are those subject to the advanced approach in Basel II—institutions with more than either $250 billion in consolidated assets or $10 billion in foreign exposures, *see* 72 Fed. Reg. 69396 (Dec. 7, 2007), codified in 12 C.F.R. part 225, App. G.

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depending on the particular circumstances of an SLHC.

Consolidated supervision

Not surprisingly, the greatest differences between the supervision philosophies of OTS and the FRB will be felt by complex SLHCs engaged in nonbanking activities. For many of the smaller SLHCs, the examination process will rely substantially if not entirely on the condition of the subsidiary thrift.

OTS describes its supervisory regime as one that "evaluates activities or operations with a high risk profile, including risks that have a direct impact on the thrift relationship or indirectly pose higher than normal risk to any material subsidiary, including the thrift." In the Notice, the FRB explains that

> the Board's consolidated supervision of SLHCs 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 may entail greater continuous supervisory monitoring of larger SLHCs.

Breaking this statement down, there are two lessons for all SLHCs and two additional take-aways for larger SLHCs engaged in nonbanking activities.

As to all SLHCs, the FRB tends to concentrate more on internal structure and procedures than OTS has done. In particular, the ways in which risk is managed are scrutinized with care. In practice, this will mean that an SLHC must be prepared to identify the persons responsible for identifying and assessing risks, to describe its procedures for controlling risk, and to explain the role of senior management and the board in reviewing risk management. Among other things, the boards of SLHCs may find that the FRB expects them to participate more extensively in risk management than the OTS has required. Further, an SLHC will need to document with care its risk management process.

The second lesson for all SLHCs relates to consolidated liquidity. The starting point for liquidity analysis is the Interagency Policy Statement on Funding and Liquidity Risk Management,[10] so in this respect, supervision should be relatively uniform. However, the OTS handbook for SLHCs identifies three liquidity issues in broad terms—ability to meet short-term obligations, debts owed to the SLHC by any subsidiary, and duration matching (or lack thereof) between assets and liabilities.[11] The comparable discussion in the bank holding company is far more granular[12] and will, at a minimum, require greater preparation for an examination.[13]

For SLHCs engaged in nonbanking activities, OTS historically has not attempted supervision of any of these activities in and of themselves but has examined these SLHCs in order simply to assess their relationships with their subsidiary savings associations. By contrast, since BHCs first gained the ability in 1999 to engage in relatively unrestricted nonbanking financial activities, the FRB has taken an active interest in the safety and soundness of those businesses,

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10 *See* 75 Fed. Reg. 13656 (Mar. 22, 2010).

11 *See* OTS Holding Companies Handbook § 600, at 600.9.

12 *See* FRB, Bank Holding Company Supervision Manual § 4010.2.

13 Basel III introduces another approach to liquidity (a "liquidity coverage ratio" and a "net stable funding ratio"). These ratios will be new for BHCs as well as SLHCs. At least the larger SLHCs should begin to consider these new ratios, since the FRB could undertake an "observation period" of them at any time, although they would not take effect formally until 2015 and 2019.

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nearly (but not quite) on an independent basis. Originally, the FRB was required to defer to the functional regulator of nonbank subsidiaries (e.g., the SEC in the case of a broker-dealer). Dodd-Frank has lifted that deference requirement. SLHCs, as well as BHCs, can expect greater attention to their nonbanking operations.

Finally, with respect to continuous supervisory monitoring, we discussed this issue briefly above. For any SLHCs with greater than $10 billion in assets, continuous monitoring is a virtual certainty, particularly in the first few years of FRB supervision. Even SLHCs with less than $10 billion in assets may be subject to this requirement. Continuous supervision for these SLHCs that are not deemed large and complex is conducted almost entirely off-site, but that is in part because the FRB has in place a much more detailed reporting system than the OTS has established. SLHCs currently must provide a quarterly report that incorporates the quarterly financial statements provided in periodic SEC filings or that are prepared internally for management purposes. By contrast, the FRB has a series of what are known as FY Y-9 reports that require specific and detailed information that might not otherwise have been prepared.[14]

Rating system

OTS and the FRB use nominally different criteria in examining holding companies, which result in some changes for SLHCs. The OTS framework uses a “CORE” analysis: capital adequacy, organizational structure, risk management and earnings. The FRB employs a RIF/C(D) system in which risk management (R), impact (I), and financial condition (F) result in a composite score, the “C.” “D” incorporates the composite CAMELS rating of each bank subsidiary.

Without taking apart each regime in detail, two differences are apparent. First, the OTS framework does not identify asset quality as a specific element of the examination, but the FRB will review this aspect of a holding company’s operations. Second, the “impact” element of the FRB framework addresses the result on a bank subsidiary of safety and soundness issues at other, nondepository subsidiaries. This element has no real counterpart in the OTS regime—and reflects the greater attention the FRB pays to the holding company structure as a whole, rather than simply the relationship with a depository institution subsidiary.

Capital adequacy

The application of the industry-wide BHC capital requirements to SLHCs is a complex matter, and we discussed them at some length in our March user guide. Requirements for both BHCs and SLHCs will evolve over the next decade as a result both of Dodd-Frank and the international Basel II and III standards. These issues go far beyond the relatively brief discussion in the Notice. The Notice seeks comment on two specific and somewhat overlapping issues: (i) the exclusion of debt and equity instruments of SLHCs from regulatory capital and (ii) the appropriateness of the Basel III transition periods for SLHCs.[15] We will limit our discussion here to these two issues and not venture further.[16]

With respect to changes in the capital treatment of certain instruments issued by SLHCs, the affected debt and equity instruments would be the subordinated debt underlying trust-preferred (and enhanced trust-preferred) securities, mandatory convertible preferred stock, and, at the thrift level, REIT preferred stock or other minority interests in

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14 The FRB and the other federal banking agencies have issued a separate notice that outlines a proposal that, among other things, would subject SLHCs to the same reporting requirements as BHCs. *See* 76 Fed. Reg. 7082 (Feb. 8, 2011).

15 Grandfathered unitary SLHCs have their own separate capital issues, which we have discussed above.

16 OTS issued advice about capital planning in March, urging thrift institutions to set internal capital standards and to conduct appropriate stress tests or “what-if” scenarios. *See* CEO Letter No. 380 (Mar. 15, 2011).

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consolidated subsidiaries. OTS currently treats these instruments as Tier 1 capital in its review of capital adequacy and does not impose a hard ceiling on inclusion. Like the FRB, OTS effectively requires that voting common stock be the predominant form of Tier 1 capital.

These instruments will be treated less favorably after the transfer of supervisory authority to the FRB. However, three different outcomes are possible, as follows:

- First, the FRB could, in the exercise of its general supervisory powers, which include explicit authority to set capital requirements for SLHCs, impose the same hard ceiling that applies to BHCs. These instruments are restricted core capital elements and may not exceed 25% of Tier 1 capital. There are no statutory restrictions on the FRB's ability to make this decision, and it could, therefore, happen shortly.
- Second, section 171 of Dodd-Frank applies all of the current bank- and thrift-level regulatory capital requirements to holding companies—which also would introduce the 25% cap on these instruments. This change does not become effective, though, until July 15, 2015.[17] The cap does not apply to such instruments issued before May 19, 2010, by SLHCs with less than $15 billion in consolidated assets.
- Third—and here we consider the FRB's second issue—Basel III will exclude some of these instruments from Tier 1 entirely. Specifically, Tier 1-eligible interests must be perpetual and may not have a maturity date; all of these instruments have maturity dates. (Other Basel III criteria also may exclude these instruments.) These exclusions will phase in between 2013 and 2022, reducing the includable amount by 10% each year until it reaches zero in 2022. Of course, Basel III is not yet law in the U.S., and it is not a foregone conclusion that Basel III will apply to all BHCs and SLHCs (even after taking account of the FRB's policy statements for small institutions). For planning purposes, however, an SLHC should assume that the FRB (and other federal banking agencies) will adopt Basel III along the suggested timeline, which would mean a rule taking effect in 2013.[18]

A few observations are in order. Every SLHC should, as a first step, calculate the percentage of these restricted core capital elements in their own Tier 1 capital and the time frame over which the instruments will run off.

- SLHCs with amounts of these securities that exceed the 25% limit now may run a risk of non-compliance were the FRB to apply the current BHC rules. These SLHCs therefore may wish to consider urging the FRB to implement any capital changes consistently with the requirements in section 171, thus avoiding a restriction before 2015.
- SLHCs with any of these instruments that would still be outstanding after January 1, 2013, when Basel III would begin to exclude 10% of the value of these instruments from Tier 1 capital, may wish to consider asking the FRB for a longer phase-in period, or at least the possibility of an extended period on a case-by-case basis.
- The timing analysis is important because section 171 and Basel III have different implementation dates, with section 171 taking effect in 2015 and Basel III phasing in between 2013 and 2022. The grandfathering of such instruments issued before May 19, 2010, by SLHCs with less than $15 billion in consolidated assets also will come into play. This variation could have different effects on different SLHCs.

CONCLUSION

The transfer of the supervision function to the FRB on the transfer date will, over time, require several adjustments by an SLHC in dealing with examinations. These adjustments could in some instances affect the operations of the company.

17 As we discussed above, there is an open issue as to whether SLHCs with assets of less than $500 million should be fully exempt from this requirement.

18 The Notice indicates that the FRB will do so.

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Since the Notice will be the only opportunity before the transfer date for an SLHC to comment on the FRB's plan to apply the BHC examination framework to SLHCs, nearly every SLHC, with the possible exception of shell holding companies controlling only a thrift and with consolidated assets of less than $1 billion, should review carefully the impact of the FRB's supervisory framework and consider a comment on the Notice.

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