

Federal Reserve Bank of Atlanta

Benefiting from the Flexibility of a Bank Holding Company Structure

A bank holding company (BHC) or savings and loan holding company (SLHC) is one that controls one or more banks/thrifts but does not necessarily engage in banking itself. The purpose of a BHC is to serve as a source of strength and capital for a subsidiary bank, diversify activities, and provide liquidity and a market for BHC common stock.

All BHCs are required to register with Federal Reserve System's Board of Governors. No fees are involved with filing applications with the Federal Reserve for BHC formation. In some situations, an institution that meets certain criteria (such as regulatory ratings or capital levels) qualifies for expedited processing.

The Federal Reserve takes a tailored, risk-focused view on BHC inspections. The reporting requirements and supervisory approach are based on the BHC's size, complexity, and risk profile.

Federal Reserve Supervision: Efficient and Reduced Burden

- The Federal Reserve coordinates extensively with the primary regulator for a BHC's subsidiary depository institution to reduce burdens and duplicative efforts (SR Letter 16-4). If the subsidiary is a state member bank, the Federal Reserve conducts consolidated supervision reviews of the BHC and SMB.
- The Federal Reserve reduces regulatory burden in line with the efforts of the Federal Financial Institutions Examination Council, such as raising reporting thresholds for the FRY9C; eliminating or combining certain line items and schedules in the FRY9C, SP, and LP; reducing certain reporting requirements to only semiannual; or eliminating certain reports such as the FR Y 2052(b).
- For small, noncomplex BHCs with less than \$3 billion in assets, the Federal Reserve's supervision is offsite and requires minimal supervisory contact with BHCs.
- Although BHCs require a board of directors, BHCs and their subsidiary depository institution may be made up of the same people, hold joint meetings, and have joint committees.

Federal Reserve Supervision: Timely Communications and Local Relationships

- The Federal Reserve ensures timely effective communication of supervisory findings and maintains open communication with institution management to minimize disruption to an organization's operations (SR Letter 19-5).
- The 12 Reserve Banks (with numerous branches around the country) provide BHCs direct local access for supervisory decisions and responsiveness to questions or issues.

Small Holding Company Advantage

Regulation Y, Appendix C to Part 225 – Small BHC/SLHC Policy Statements

- BHCs under \$3 billion in consolidated assets that meet certain qualitative factors are exempted from consolidated capital requirements by the Federal Reserve's Small BHC/SLHC Policy Statement, which permits capital adequacy to be evaluated at the depository institution level, without considering a BHC's consolidated capital.

- The Policy Statement also allows small BHCs to incur various kinds of debt, including senior debt and secured debt, in greater amounts than banks or BHCs in general.
- The Policy Statement permits small BHCs to incur a debt-to-equity ratio up to 300 percent, subject to certain conditions. Generally, BHC debt-to-equity ratios above 30 percent are discouraged for large BHCs.
- The Policy Statement permits the use of various types of merger and acquisition debt in the transfer of ownership of small banks, the formation and expansion of small holding companies, or stock repurchases.
- BHCs may use debt to finance up to 75 percent of the purchase price of the bank(s) or company to be acquired.

Structural Flexibility: Mergers and Acquisitions

- BHCs provide flexibility in structuring strategic transactions, such as acquiring several banks and operating them as separate subsidiaries, thereby maintaining an acquired institution's legal and corporate identity, board, and management structure.
- BHCs also provide organizational flexibility when merging an acquired bank with an existing subsidiary bank.
 - The BHC can merge the subsidiary bank at any time after the acquisition, reducing the chances of timing problems with IT core processor conversions, or other types of integration risk or costs, thereby providing a transition period to acclimate a target's customers and communities to the acquisition.
 - Without a BHC involved in a bank-to-bank merger, the banks must be fully integrated on day one of the acquisition.
- To ensure compliance with state laws, the BHC structure may permit the transfer of acquired assets or acquired activities that are impermissible for the depository institution under state law.

Financial Flexibility

- BHCs can purchase problem assets, such as loans, securities, or other real estate, from their subsidiary depository institutions, thereby reducing the level of classified assets at the bank and serving as a source of financial strength to the bank.
- BHCs may use debt to raise common equity Tier 1 capital for their subsidiary banks, avoiding extra costs and dilution of issuing common stock. The interest payments on such debt can be a deductible expense on the BHC's consolidated income tax returns. This transaction can also increase the organization's return on equity.
- Regulation W does not apply to a BHC's transactions with nonbank affiliates.
- BHCs may issue employee equity awards, including restricted stock awards, without any impact on the capital of a subsidiary bank.
- BHCs are not subject to loan and derivative limitations with respect to each borrower/counterparty. BHCs may lend money and/or purchase loans, and there are no loan-to-one borrower rules.
- Grandfathered Unitary SLHCs have no restrictions on permitted activities, providing a greater diversification of income and risk. However, they must meet the same safety and soundness expectations as other BHCs.

Permissible Activities

- BHCs are extremely useful for organizations engaged in nonbanking activities.
- Regulation Y allows BHCs to enter into a number of approved nonbanking activities closely related to banking (BHC Act Section 4(c)(8) and Regulation Y 225.21 and 225.28).
- An eligible BHC may elect to become a financial holding company.
 - A financial holding company may engage in an even broader range of nonbanking activities that are incidental to banking or financial in nature, thereby engaging in an even wider range of income-producing activities than banks (BHC Act Section 4(k) and Regulation Y 225.86).
 - Activities include insurance underwriting, securities underwriting, broker-dealer operations, and merchant banking. They also include the formation of a captive insurance company—a new trend among activities—facilitating risk management and a broader range of underwriting of certain uninsured business risks.
- BHCs may purchase up to 5 percent of any class of voting securities of any entity without prior regulatory approval, allowing diversification of income and risk, (BHC Act, Section 4(c)(6)).

Capital Flexibility

- BHCs are able to repurchase stock without regulatory approval, within certain limits.
 - Regulation Y 225.4(b) permits stock redemptions of up to 10 percent of BHC consolidated net worth in the preceding 12 months without prior approval, assuming the BHC and subsidiary bank will be well managed, well capitalized, and without other significant supervisory issues.
 - This increases share liquidity, increases shareholder return by the purchase of undervalued stock, and is a tax efficient means of generating returns to shareholders.
 - Banks are limited in their ability to make a market in their stock. State and national bank statutes that require prior approval of any reductions in capital constrain banks' stock repurchases.
- BHCs can still issue trust-preferred securities and hold grandfathered trust-preferred securities, even if assumed in an acquisition. Trust-preferred securities are still treated like debt for tax purposes.
- BHCs with assets less than \$15 billion but greater than \$500 million are permitted to include trust preferred securities (TRUPS) issued before May 19, 2010, as Tier 1 capital. TRUPS issued after May 19, 2010, are no longer counted as Tier 1 capital for BHCs greater than \$500 million.
- BHCs with assets less than \$500 million can continue to issue TRUPS as Tier 1 capital.
- Many BHCs are replacing TRUPS with subordinated debt, which can be counted as Tier 2 capital in most instances.
- Although Basel III capital rules have made capital instruments substantially uniform between BHCs and banks, many BHCs have been a source of financial strength for their subsidiary bank by using unsecured debt (such as lines of credit or subordinated debt) to fund expansion and growth or cash flow.
- Prompt corrective action capital rules only apply at the bank level.

Better Investor Relations

- Bank dividends are limited by statute, which varies among the various types of bank charters. BHCs are subject to SR Letter 09-4, which generally provides more flexibility on the payment of dividends.
- Publicly traded BHCs with securities registered under federal securities laws file SEC reports providing financial and corporate information, creating greater transparency to investors.
- Publicly traded depository institutions without a BHC that hold securities registered under the federal securities laws file with their primary federal regulators, which is not as transparent to the public.
- Although banks are exempt from SEC registration and reporting requirements, many of these same reporting requirements shift to the bank's primary regulator if the BHC structure is not in use.
- A BHC can provide shareholder liquidity for both large, publicly traded BHCs and smaller BHCs. BHC shareholders receive liquidity through loans collateralized by BHC stock at the subsidiary bank since the BHC stock is eligible as collateral, subject to limits of Sections 23A and B (as long as the subsidiary bank loans are not used for the purchase the BHC stock, or the loan proceeds are not used for the benefit of, or transferred to, an affiliate). Bank shareholders cannot borrow from the bank and then use the bank stock as collateral.

If you are interested in forming a Bank Holding Company or have questions on the benefits or application process, please reach out to:

Steve Wise, Vice President, *Community and Regional Banking* (404-498-7351)

Suzanna Costello, Vice President, *Applications* (404-498-7159).

You can find and complete the application here: <https://bit.ly/30a9uPx>