

Dodd-Frank Act Mandates Stricter Capital Requirements for Financial Institutions

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) imposes a number of more stringent capital requirements on financial companies, as well as other companies—including swap dealers and nonbank financial companies that are determined to be of systemic risk. The so-called “Collins Amendment” has introduced the most publicized of these requirements and is likely to have the most immediate impact. However, there are a number of other provisions in the Act that likely will result in financial companies needing to raise additional capital. Furthermore, at the same time financial companies will be working to comply with the capital requirements established under the Act, they may find their efforts complicated by revisions to existing international capital standards currently being considered by the Basel Committee on Banking Supervision that would also require increased capital.

The Collins Amendment

The Collins Amendment, incorporated into the Act as part of Section 171, is designed to ensure that “financial institutions hold sufficient capital to absorb losses during future periods of financial distress,” a goal that the amendment’s proponents have deemed especially important in light of the Act’s prohibition of taxpayer bailouts of financial companies.¹ The amendment is also intended to protect against regulatory arbitrage (“shopping” among regulators for more favorable treatment) and prevent the excessive leverage accumulated by large nonbank financial institutions during the financial crisis.²

Section 171 directs federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, their holding companies (including US intermediate holding companies owned by foreign organizations), and nonbank financial companies that have been determined to be systemically significant by the Financial Stability Oversight Council (FSOC). The section creates two floors for leverage and risk-based capital requirements:

¹ Letter by Shelia Bair to Sen. Collins, Cong. Rec. S.3460 (May 10, 2010).

² *Id.*

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Financial Regulatory Chart

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- (1) They may not be less than the leverage and risk-based capital requirements, respectively, established for insured depository institutions; and
- (2) They may not be quantitatively lower than the leverage and risk-based capital requirements, respectively, in effect for insured depository institutions as of the date of the Act's enactment.

Essentially, the Act requires regulators, at a minimum, to apply to bank holding companies and other systemically significant nonbank financial companies the same capital and risk standards that they apply to banks insured by the Federal Deposit Insurance Corporation. One important implication of this requirement is that hybrid capital instruments, such as trust preferred securities, will no longer be included in the definition of tier 1 capital. Under existing regulations for bank holding companies, tier 1 capital, which drives the numerator in the leverage and risk-based capital ratios, includes common stock, retained earnings, certain types of preferred stock, and trust preferred securities. Since trust preferred securities currently are not counted as tier 1 capital for insured banks, the effect of Section 171 is that they will no longer be included as tier 1 capital for bank holding companies.

The exclusion of trust preferred securities from tier 1 capital could significantly erode the regulatory capital cushions of bank holding companies that have traditionally relied on trust preferreds. In order to meet capital requirements under forthcoming regulations, bank holding companies may be forced to raise other forms of tier 1 capital, for example by issuing perpetual non-cumulative preferred stock. Since common stock must typically constitute at least 50 percent of tier 1 capital, many bank holding companies and systemically significant nonbank companies may also be forced to consider dilutive secondary offerings of common stock.

In order to ease this compliance burden, Section 171 contemplates a number of exemptions and phase-in periods. For example, the following companies are completely exempt from the requirements of Section 171:

- Certain small bank holding companies;³ and

- All federal home loan banks.

In addition, all Troubled Asset Relief Program (TARP) securities (regardless of the size of the institution) are exempted from the requirements of Section 171.

Furthermore, depository institution holding companies with assets less than \$15 billion (as of December 31, 2009), as well as organizations that were mutual holding companies on May 19, 2010, are completely exempted from the required "regulatory capital deductions" with respect to securities issued before a cutoff date of May 19, 2010. While the term "regulatory capital deduction" is not defined in the Act, it appears to refer to the capital deductions arising from the exclusion of trust preferreds and other hybrid securities from tier 1 capital.

The section does apply retroactively to all debt or equity issued after the cutoff date by holding companies with consolidated assets of over \$15 billion as of December 31, 2009 and by large nonbank financial companies determined to be of systemic risk. However, the section provides for a three-year phase-in period beginning in 2013 for regulatory capital deductions required for debt or equity issued by these institutions before the cutoff date. Furthermore, subject to the exceptions noted above, thrift holding companies and other depository institution holding companies not supervised by the Board of Governors of the Federal Reserve System (the Federal Reserve) as of the cutoff date would not be subject to the general leverage and risk-based capital requirements until five years after enactment, but would be subject to the three year phase-in period for regulatory capital deductions beginning in 2013. Finally, US intermediate holding companies of foreign banks that have relied on Federal Reserve Supervision and Regulation Letter SR-01-1, which exempts such intermediate holding companies from the Federal Reserve's capital adequacy guidelines, would not be subject to the requirements of Section 171 until five years after enactment (except for capital requirements affecting securities issued after the cutoff date, which would be immediately applicable).

³ This exemption applies to small bank holding companies subject to the Small Bank Holding Company Policy Statement of the Board of Governors of the Federal Reserve System. This includes bank holding companies with pro forma consolidated assets of less than \$500 million that (i) are not engaged in significant nonbanking

activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet activities; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission.

In addition to the Collins Amendment requirements, Section 171 requires the federal banking agencies to develop capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies determined to be of systemic risk that address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but also to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity. These rules would address the risks arising from:

- Significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repurchase and reverse repurchase agreements;
- Concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid two-way markets; and
- Concentrations in market share for any activity that would substantially disrupt financial markets if the institution is unexpectedly forced to cease the activity.

Other Provisions on Capital Requirements

The Act also contains a number of other provisions that address capital requirements.

For example, the Federal Reserve is directed to impose more stringent risk-based capital requirements and leverage limits on those systemically significant nonbank financial companies it supervises and on other bank holding companies with total consolidated assets of at least \$50 billion (unless it determines that doing so is not appropriate in light of the company's activities). It is also permitted to require a minimum amount of contingent capital (a type of debt security that is designed to convert into equity when a particular trigger is met) that is convertible to equity in times of financial stress. The Federal Reserve may impose these heightened prudential standards either on its own initiative or pursuant to recommendations by the FSOC. For purposes of determining whether these capital requirements are met, the Act requires that the computation take into account a company's off-balance sheet activities (unless the Federal Reserve grants an exemption).

Title VI of the Act, which reforms the regulation of insured depository institutions and their holding companies, also permits the Federal Reserve and the Office of Thrift Supervision, respectively, to issue regulations relating to the capital requirements of bank holding companies and thrift holding companies. As noted in the Arnold & Porter Advisory on the regulation of thrift holding companies under the Act, the Act will for the first time subject all thrift holding companies to consolidated capital requirements, as established pursuant to the Collins Amendment.⁴ Title VI directs the federal banking agencies to seek to make such holding company capital requirements (as well as the capital requirements for insured depository institutions) countercyclical so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction. Finally, Title VI requires a thrift holding company—as well as a bank holding company—to serve as a source of financial strength for its depository institution subsidiary. Any company that directly or indirectly controls an insured depository institution that is not a subsidiary of a bank or thrift holding company must also serve as a source of financial strength for the depository institution.

Furthermore, the Act requires regulators to issue capital requirements for registered swap dealers and major swap participants in connection with their derivatives activities. In setting these capital requirements, regulators must take into account the risks associated with the other types of activities engaged by the swap dealer or major swap participant that are not otherwise subject to regulation, and must ensure that the requirements are appropriate for the risks associated with non-cleared swaps held by the swap dealer or major swap participant.

Required Studies on Capital Requirements

The Act also requires regulators to conduct various studies relating to capital requirements. For example, one provision requires the US Comptroller General to review the capital requirements applicable to US intermediate holding companies of foreign depository institution holding companies. The FSOC is also required to conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank financial companies

⁴ Available at: http://www.arnoldporter.com/public_document.cfm?id=16144&key=4E0.

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supervised by the Federal Reserve and large bank holding companies subject to heightened prudential standards.

The Comptroller General is also directed to conduct a study on the inclusion of hybrid capital instruments, such as trust preferred securities, in tier 1 capital. The study is specifically required to consider the consequences of disqualifying trust preferred securities from tier 1 capital and whether such disqualification could lead to the failure or undercapitalization of banking organizations. The study would be due to Congress within 18 months of the Act's enactment and must contain recommendations as to legislative or regulatory action with respect to the treatment of hybrid capital instruments. However, it is unknown whether the outcome of the study would result in any changes to the Collins Amendment's requirements or the other capital requirements imposed by the Act.

While financial institution capital has always been a key regulatory concern, the recent economic crisis has focused even more attention on its critical role. The capital provisions of the Act promise changes in determining the appropriate quantity and quality of regulatory capital, both in the short and long term, and likely will result in many companies needing to issue additional capital to remain in compliance. This need may well be magnified if the capital rules currently being considered by the Basel Committee are adopted.

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