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SAVINGS AND LOAN HOLDING COMPANIES AND THEIR SUBSIDIARIES TO BE SUBJECT TO NEW REGULATORY REGIMES

A. PATRICK DOYLE, BETH S. DESIMONE, AND KATHLEEN A. SCOTT

The authors explain that savings and loan holding companies and their savings institution subsidiaries now are subject to new regulatory regimes as a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Savings and loan holding companies (“SLHCs”) and their savings institution subsidiaries will be subject to new regulatory regimes under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”). This change is chiefly due to the fact that the Act abolishes the Office of Thrift Supervision (“OTS”) and moves examination, supervision, and regulation responsibilities to the Board of Governors of the Federal Reserve System (“Federal Reserve”) for SLHCs, and to either the Office of the Comptroller of the Currency (“OCC”) for federal savings institutions or the Federal Deposit Insurance Corporation (“FDIC”) for state savings institutions. However, because of the unique nature of SLHCs, particularly those that are grandfathered from the activities restrictions of the Home Owners’ Loan Act (“HOLA”), there are some other significant provisions in the Act that may impact SLHCs and their subsidiaries more disproportionately than other types of holding companies.

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HISTORICAL ROLE OF SLHCs

SLHCs and their subsidiaries have always occupied a unique niche in the financial system. Savings institutions have historically focused on providing mortgage loans and housing-related products and services. While these powers have been broadened in recent years to include a wide variety of consumer lending and some commercial lending powers, the Qualified Thrift Lender Test, which requires savings institutions to retain at least 65 percent of its qualified assets in mortgage and consumer related assets, has kept these institutions mostly focused in the housing finance area.

Furthermore, until 1999, when the Gramm-Leach-Bliley Act was enacted, savings institutions could be owned by any type of company, and those companies were not subject to restrictions on their activities as had been the case with bank holding companies. With the enactment of the Gramm-Leach-Bliley Act, companies acquiring savings institutions were required to limit their activities to those permitted to financial holding companies under the Bank Holding Company Act. However, those companies which owned a savings institution as of May 4, 1999, were “grandfathered” and not subject to those activity restrictions unless certain requirements were not met.

Because the OTS had experience supervising holding companies that engaged in a variety of activities, insurance and securities companies in particular favored owning savings institutions over commercial banks. Thus, many “grandfathered” SLHCs are insurance companies or securities companies. In addition, there are other “grandfathered” savings and loan holding companies which are engaged in activities such as manufacturing and energy generation — activities clearly beyond those permitted to financial companies. Unfortunately, because the financial crisis in part was caused by a collapse of the housing market, savings institutions were hit hard in the past two years. Several of the largest and most visible financial collapses in 2008 and 2009 involved savings institutions and SLHCs — Washington Mutual, Lehman Brothers Holdings, Inc., and American International Group, Inc. Thus, it was generally assumed that as part of financial reform, the OTS was to be abolished, and increased (and arguably different) regulation had to be imposed on the thrift industry.

IMPACT OF THE ACT ON SLHCs AND THEIR SUBSIDIARIES — CHANGE IN REGULATORY REGIMES

Accordingly, under the Act, one year after enactment, the responsibilities of the OTS, which oversees SLHCs, charters federal savings institutions and examines and regulates federally- and state-chartered savings institutions, are transferred to other agencies and the OTS is abolished 90 days after the date of the transfer.

The examination and supervision of SLHCs will move to the Federal Reserve. However, SLHCs would continue to operate under the provisions of the HOLA. Those SLHCs that are “grandfathered” for purposes of the HOLA’s activity restrictions would remain so grandfathered and thus could continue to engage in any activity. Nevertheless, as the regulator of SLHCs, the Federal Reserve will examine and supervise SLHCs, and it should be expected that the Federal Reserve will be a much more rigorous regulator than the OTS. The Federal Reserve will have authority to assess SLHCs with total consolidated assets of \$50 billion or more to recoup the total expenses that the Federal Reserve estimates are necessary or appropriate to carry out its supervisory and regulatory responsibilities with respect to SLHCs.

Examination and supervision of federal savings institutions will move to the OCC, and fall under the responsibility of a new Deputy Comptroller for the Supervision and Examination of Federal Savings Associations. Federal savings institutions would continue to operate under the provisions of the HOLA, as interpreted by the OCC. Any new regulations applying to savings institutions pursuant to the HOLA would be issued by the OCC. Federal supervision and examination of state-chartered savings institutions will be transferred to the FDIC. The states would continue to have authority — including examination authority — over the institutions they charter. With the abolishment of the OTS, the OTS seat on the FDIC board will go to the director of the new Bureau of Consumer Financial Protection.

There are some additional restrictions placed on SLHCs. For example:

- All SLHCs will for the first time be subject to consolidated capital requirements, which presumably will be modeled after those applicable to bank holding companies. “Grandfathered” savings and loan holding

companies that engage in nonfinancial activities would be required to establish an intermediate holding company, if the Federal Reserve determines that the establishment of such a company is necessary for the agency to appropriately supervise activities that are determined to be financial, or to ensure that the Federal Reserve's supervision does not extend to the nonfinancial activities of such company.

- The internal financial activities of a grandfathered savings and loan holding company and its affiliates, such as internal treasury, investment, and employee benefits functions, are not required to be transferred into this intermediate holding company.
- Underwriting or selling insurance is considered a financial activity as defined in Section 4(k) of the Bank Holding Company Act so it would appear that there would be no need for an intermediate holding company with respect to an SLHC owned by an insurance company unless that SLHC engaged in a large number of nonfinancial activities, thus making it appropriate to require a walling off of the company's financial activities.
- The so-called "source of strength" doctrine is made statutory and applied for the first time to SLHCs, which means that SLHCs will now have to serve as a source of strength to their savings institutions subsidiaries. In addition, the doctrine is expanded to include a requirement that a grandfathered savings and loan holding company also must serve as a source of strength to any intermediate holding company that it directly or indirectly controls.
- All financial companies, including SLHCs, are prohibited from merging or consolidating with, acquiring all or substantially all of the assets of, or otherwise acquiring control of, another company, if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction. In this connection, with respect to insurance companies, the term "liabilities" is to be defined by the Federal Reserve by regulation "in order to provide for consistent and equitable treatment of such companies."

There also are additional operational restrictions placed on savings institutions:

- The ability of federal savings institutions to branch interstate, subject to the provisions of Section 5(r) of the HOLA, is preserved. However, so are the multistate multiple savings and loan holding company restrictions in the HOLA — which impose activity restrictions similar to those of a bank holding company on any SLHC if it were to acquire and maintain two savings institution subsidiaries.
- Conversions of charters are prohibited without approval of the regulators if the institution is subject to an enforcement action.
- In interstate transactions, the depository institutions involved must be “well capitalized” and “well managed,” a stronger standard than currently in place.
- Federal savings institutions would be subject to national bank lending limits, which are revised (as are Regulation O provisions) to include derivative, repurchase, reverse repurchase, securities lending, and securities borrowing transactions.
- The number of “covered transactions” subject to the restrictions of Section 23A of the Federal Reserve Act would be increased to include:
 - An affiliate’s use of debt obligations as collateral;
 - Transactions between a member bank and an affiliate (or a subsidiary) involving the borrowing or lending of securities resulting in credit exposure by the member bank or any subsidiary; and
 - Derivative transactions between a member bank (or its subsidiary) and an affiliate resulting in credit exposure to the member bank or subsidiary.
- Loans issued by member banks on behalf of affiliates, credit exposures resulting from securities lending or borrower transactions and derivative transactions would be required to be secured at all times. The scope of Section 23A also is extended to include investment funds where a member bank or affiliate serves as an adviser.

While there is no requirement that SLHCs convert to bank holding companies or that savings institutions convert to commercial banks, the U.S. General Accountability Office (“GAO”) is required to undertake a study to determine if savings institutions still should enjoy their status as “nonbanks” for purposes of the Bank Holding Company Act. The GAO is to determine the adequacy of federal bank regulation of federal savings institutions and other insured savings institutions and the potential consequences of subjecting those institutions (actually, the owners of those institutions) to the requirements and restrictions of the Bank Holding Company Act.

OTHER POSSIBLE IMPACTS ON SLHCs: COULD THEY BE OF SYSTEMIC RISK?

In addition to the changes in regulatory regimes and operational standards, SLHCs could be impacted by the systemic risk and resolution authority provisions of the Act. Under the systemic risk provisions of the Act, the Federal Reserve is given the authority to impose additional supervision over large interconnected bank holding companies, as well as over nonbank financial companies that are determined by the new Financial Stability Oversight Council (“FSOC”) to pose a threat to the financial stability of the United States. These enhanced requirements include increased capital requirements, leverage and concentration limits, liquidity requirements, submission of a resolution plan, credit exposure report requirements, enhanced public disclosures, short-term debt limits, and overall risk management requirements.

- SLHCs are considered “nonbank financial companies” under these provisions. However, a vote of two-thirds of the FSOC, including the chair (the Secretary of the Treasury) would be needed for any particular nonbank financial company to be determined to be of systemic risk to the U.S. economy. This determination can be appealed.
- In making this determination, the FSOC must consider the following:
 - The degree of leverage at the company;
 - The amount and nature of the company’s financial assets;

- The amount and types of the company's liabilities, including the degree of reliance on short-term funding;
- The extent and type of the company's off-balance sheet exposures;
- The extent and type of the transactions and relationship of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system;
- The importance of the company as a source of credit for low income, minority, or underserved communities, and the impact that the failure of the company would have on the availability of credit in such communities;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- The degree to which the company is already regulated by one or more primary federal regulatory agencies;
- The operation of or ownership interest in any clearing, settlement or payment business;
- The extent to which (i) assets are managed rather than owned by the company; and (ii) ownership of assets under management is diffuse; and
- Any other risk-related factors that the FSOC deems appropriate.

It is expected that regulations will be issued which will illuminate how these factors will be applied and weighed by the FSOC. However, it is expected that only the very largest SLHCs would be evaluated by the FSOC to determine whether they present systemic risk.

Nevertheless, the Act also gives the FSOC the ability to recommend to the primary financial regulatory agencies (defined as the federal banking, securities, commodities and housing regulators, and state insurance commissioners) that they impose new or heightened standards and safeguards for a financial activity

or practice conducted by financial companies under their respective jurisdictions. Thus, even if a particular SLHC is not targeted for heightened supervision by the Federal Reserve as a systemic risk, there still could be additional regulation imposed on a particular financial activity in which an SLHC might directly or indirectly engage.

In the event one or more of such companies are determined to present a systemic risk, and the FSOC determines that a condition, practice or activity of that particular nonbank financial company does not comply with Title I or rules or orders prescribed thereunder, or otherwise “poses a grave threat to the financial stability of the United States,” it may, after notice and opportunity for comment, order the nonbank financial company to sell off certain assets or sell or terminate certain operations (presumably even if that nonbank financial company is an SLHC and the operation in question is permissible for that SLHC). An order may be issued without the opportunity for a hearing if expeditious action is needed to protect the public interest.

In addition, the FDIC is given the authority to liquidate SLHCs where a systemic risk determination has been made if the Secretary of the Treasury, upon the recommendation of the FDIC and the Federal Reserve and in consultation with the President, finds that the company is in default or in danger of default, the failure of the company and its resolution under applicable federal or state law would have serious adverse effects on U.S. financial stability and the appointment of the FDIC would avoid or mitigate such adverse effects.

For SLHCs that are insurance companies, however, the FDIC would not be appointed the receiver upon such a determination by the Secretary of the Treasury. Furthermore, the determination that the company be placed into a receivership cannot be made without the approval of the director of the new Federal Insurance Office. If this hurdle is met, the insurance company then would be liquidated under applicable state insurance law, unless the appropriate state insurance regulator does not take steps to place the insurance company into liquidation proceedings by 60 days after the date that the Secretary of the Treasury has made the receivership determination. In that event, the FDIC would have the authority to stand in the place of the state insurance regulator and file the appropriate judicial action in the appropriate state court to place such company into liquidation under the applicable state insurance law.

The FDIC is authorized to assess financial companies, including SLHCs, to

recoup funds expended on the resolution of financial companies. While assessments first are to be made against large bank holding companies and nonbank financial companies that have been determined to present systemic risk, if there is a deficiency, then the FDIC could assess other nonbank financial companies. Thus, an SLHC could be subject to this special assessment whether or not it has been determined to present a systemic risk. However, the FDIC is required to undertake a risk-based assessment and one of the factors to be taken into account by the FDIC in deciding whether to assess an insurance company is the extent to which the insurance company was “assessed pursuant to applicable state law to cover (or reimburse payments made to cover) the costs of the rehabilitation, liquidation, or other state insolvency proceeding with respect to one or more insurance companies.”

IMPACT OF THE VOLCKER RULE ON SLHCs AND THEIR SUBSIDIARIES

SLHCs also will be subject to the Volcker Rule, which prohibits “banking entities” from engaging in proprietary trading or acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or a private equity fund. For an SLHC that is, or is owned by, an insurance company, however, the Volcker Rule may have little practical effect due to certain exceptions contained therein.