Changing Landscape: Thrift Holding Companies and Their New Regulator

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The Dodd-Frank Act, effective July 21, 2011, eliminated the Office of Thrift Supervision ("OTS") and transferred its regulatory authority to the Office of the Comptroller of the Currency, the Federal Reserve Board ("FRB"), and the Federal Deposit Insurance Corporation. Regulatory authority over 430 thrift holding companies ("Thrift HCs") shifted from the OTS to the FRB. All OTS regulations, guidelines, and other advisories dealing with Thrift HCs remain in effect; those regulations are re-codified in new Federal Reserve Regulation LL and MM.

Last April, the FRB expressed its intention to assess the condition, performance, and activities of Thrift HCs on a consolidated risk-based basis in a manner consistent with its established approach regarding bank holding company supervision. In particular, the FRB intends to gain information, insight, and experience with its new crop of regulated institutions through a series of "Discovery Reviews." These reviews will form the basis of the approach the FRB will use to establish ratings for the new institutions under its jurisdiction.

Bank Holding Company Supervision and Regulation

The Board has supervised and regulated bank holding companies for sixty-five years and, over that time, has developed some strong regulatory policies.

These strong policies include applying bank capital requirements to bank holding companies,[1] an approach that other countries do not take under the Basel capital regimen and an approach that the OTS never took.

The Board also has long required that a bank holding company be a source of financial and managerial strength to its subsidiary banks, which means that, if a subsidiary bank needs capital, it is a legal duty of the parent holding company to raise and infuse that capital even if that is at the expense of the bank holding company's other creditors or investors. This is a policy that has never been applied to Thrift HCs.

All of these regulatory changes occur at a time of increasing regulatory scrutiny over the effect incentive compensation has on risk-taking.

Differences Between Bank Holding Company Regulation and Thrift HC Regulation

While it might appear that regulation of bank holding companies and Thrift HCs raise similar issues, there are significant differences between the two.

By way of illustration, grandfathered unitary holding companies historically were permitted to engage in a variety of diverse, non-depository businesses. These non-depository businesses, viewed from the prism of the FRB, might appear to be activities akin to fitting the proverbial elephant through the eye of the needle. For example, one activity, insurance, has a totally different accounting standard. GAAP accounting is not the norm, and capital levels are set by state insurance regulators. Applying standard GAAP-based bank capital requirements to such holding companies is not as easy a fit and raises more questions than it answers.

Also, many Thrift HCs are in mutual form; being a source of strength to a subsidiary depository institution by raising equity capital is not as simple a proposition for a mutual as it is for a stock bank holding company.

Further, in the case of a thrift holding company that is an insurance company, applying the "source of strength" requirement to a thrift holding company might even create tension both between regulators and between the regulators and the company, with its obligations to its policy-holders.

Finally, the concentration in real estate-related assets that is the essence of the mission of a thrift is highly unusual for the FRB to reconcile in the context of consolidated bank holding company supervision.

There also are a myriad of other bank holding company regulatory requirements that the FRB will eventually need to decide whether to apply to Thrift HCs. Examples of differing requirements for holding companies include the duty of bank holding companies, under Federal Reserve Regulation Y, to file suspicious activity reports. Bank holding companies with more than $10 billion in assets also are subject to Federal Reserve stress testing requirements, independent of those to be imposed under the Dodd-Frank Act on all financial companies of that size. Another difference is the limits on bank holding companies of repurchases of their own shares,[2] and large bank holding companies will soon be subject to a rigorous annual capital planning process. Bank holding companies are also subject to a policy limiting the payment of dividends to current earnings.[3] Each of these requirements will need to be reviewed by the FRB and a determination made as to how it will be applied to Thrift HCs.

Bank Holding Company Regulation Already Determined to Be Applicable to Thrift HCs

For the time being, however, the FRB has identified three elements of its bank holding company supervision program that it will apply to Thrift HCs: (1) its consolidated supervision program for large and regional holding companies, (2) its supervisory program for small, noncomplex holding companies, and (3) its holding company rating system.

The Board has also explained how it expects to approach the regulation of Thrift HCs, and some clients have already experienced Federal Reserve examinations that may offer some lessons here. It appears that the Federal Reserve recognizes the unusual issues that Thrift HCs raise and respects those issues. For example, in establishing bank holding company-like reporting obligations on Thrift HCs, the FRB has temporarily exempted Thrift HCs that are insurance companies. The FRB has indicated that it may place Thrift HCs with significant insurance activities in a separate supervisory portfolio.[4]

In order to learn more about the wide diversity of firms that are Thrift HCs, the FRB will communicate with the

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subsidiary thrift's regulators and state insurance commissioners in the case of Thrift HCs that are insurance companies.

The Board also is initially conducting "discovery reviews"[5] to enable it to learn about these non-bank firms and develop plans to supervise them and also to enable such firms to discern the FRB's expectations. The first cycle of these reviews is expected to be completed by July 2012. The reviews focus on structure, intercompany financial transactions, overall financial condition, corporate governance, risk management, and internal audit.

In the case of Thrift HCs focused on insurance and broker-dealer lines of business, examiners will review key financial activities and associated risk management.

The Board's supervisory staff will communicate with a Thrift HC's and its subsidiaries' other regulators, develop an initial supervisory profile (including potential consumer compliance risks outside of the thrift subsidiary), and also develop an initial financial assessment of the Thrift HC. That information will be used to develop supervisory plans, conduct targeted discovery reviews, and compile financial data to support horizontal and peer reviews.

And, of course, these initial assessments will also cast the initial regulatory assessment of the institutions within a formal ratings system—which itself has long-term implications for each institution.

The purpose essentially is to determine whether the thrift holding company conducts operations in a safe and sound manner.

Consolidated Enterprise-wide Supervision

The basis of consolidated enterprise-wide supervision is that large holding companies tend to manage risks on a consolidated basis, and risks across legal entities. Thus, risk cannot be monitored properly through supervision directed at a single legal entity in the organization.

The Board's consolidated supervision program has some similarities to the supervisory program formerly employed by the OTS. However, the FRB has suggested that its consolidated supervision program may entail more intensive supervisory activities than under the OTS practice. For example, the FRB's supervision of Thrift HCs may entail more rigorous review of internal control functions and consolidated liquidity, as well as discovery reviews of specific activities. In addition, the FRB's program may entail heightened review of all nonbank activities (that are greater than those that BHCs can engage in) and greater continuous monitoring of larger Thrift HCs.

Small, Non-complex Holding Companies Supervision

The Board, like the OTS, employs a special program for small non-complex[6] holding companies; in those cases, the FRB assigns a rating based on the rating of the lead depository institution and, typically, no on-site work is undertaken.

Larger ($1 billion to $10 billion in total assets) non-complex holding companies rated satisfactory are inspected on-site every two years. Complex holding companies are inspected annually.

Holding Company Ratings

The FRB will rely on reports filed with and issued by other regulators, publicly-available information, and externally-audited financial statements. It currently rates bank holding companies and will likely eventually rate Thrift HCs based on their risk management (R), financial condition (F), and the "impact" of nonbank entities on subsidiary depository institutions (I), using continuous monitoring,[7] discovery reviews, and testing. For nontraditional bank holding companies, i.e. those in which the significant non-depository affiliates are regulated by a functional regulator and the subsidiary depository institutions are small in relation to the nondepository entities, the FRB will look to the functional regulator for assessment of risk management and financial condition, reserving to itself assessment of the impact of the nonbank activities on the depository institution. The "R," "F," and "I" components together make up a bank holding company's RFI rating.

In order to inform the Thrift HCs how well they conform to the FRB's supervisory expectations, the FRB will issue each thrift holding company an "indicative rating," rather than a final RFI rating. The "indicative rating" will indicate to the Thrift HC how the Thrift HC would have been rated if the RFI rating system was formally applied.

In communicating inspection findings, Federal Reserve examiners will use traditional bank examination terminology, differentiating criticisms among those matters requiring immediate attention ("MRIAs"), matters requiring attention ("MRAs"), and observations.

The Board is aware that Thrift HCs traditionally have been given confidential so-called "CORE"[8] ratings by the OTS, but the FRB is considering transitioning Thrift HCs to the confidential RFI rating system that the FRB uses for bank holding companies after initial reviews of Thrift HCs are conducted. A primary difference between the OTS's CORE rating system and the FRB's RFI rating system is that the latter explicitly takes into account asset quality; however, this may not affect many Thrift HCs to the extent that asset quality might have been subsumed in the capital and earnings components of CORE. Similarly, while the FRB imposes bank-like capital requirements on bank holding companies and bases its RFI rating on compliance with those requirements, it recognizes that Thrift HCs are not subject to such capital standards. Until it imposes such standards on Thrift HCs, the FRB will, like the OTS, assess capital based on qualitative judgment, like that employed by the OTS. The FRB has also suggested that, when it eventually proposes regulations to implement the Basel Committee on Banking Supervision's Basel III framework, these regulations may apply to Thrift HCs.

Attorney-Client Privilege

At one time, there was considerable concern whether providing bank regulators access to material that was subject to the attorney-client privilege might somehow constitute a waiver of this privilege. Normally, the privilege is not waived when a holder of the material discloses it under compulsion of law, and many believed that complying with requests of bank examiners is, in effect, done ultimately under compulsion of law.

However, all ambiguity on this subject was eliminated in 2006 when Congress amended the Federal Deposit Insurance Act to provide that the submission by any person of any information to a federal banking agency for any purpose in the course of any supervisory or regulatory process of such agency shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under federal or state law as to any person other than such agency.

This statutory language is broad enough to protect against waiver any attorney-client privileged information provided by a Thrift HC to the FRB in any inspection or discovery review conducted by the FRB.

Conclusion

The change in responsibility for Thrift HC supervision and regulation from the OTS to the FRB likely will have substantive consequences for all Thrift HCs. It is therefore important for Thrift Holding Companies to pay particular attention to the potential for new interpretations of regulations that pertain and to retain experienced counsel for guidance in compliance activities.

Endnotes

1 SR 11-11 directs the FRB's supervisory personnel to apply in their initial inspection of Thrift HCs principles set forth in SR 99-18 on assessing capital adequacy in relation to risk at large bank holding companies. However, that is to support an evaluation of the Thrift HC's capital planning process and a qualitative assessment of the sufficiency of the Thrift HC's capital.

2 The FRB has, in SR 11-11, directed its supervisory personnel in their first cycle of supervising Thrift HCs to apply principles set forth in SR 09-4, which sets forth supervisory guidance on stock redemptions and repurchases by bank holding companies.

3 SR 09-4, which the FRB has directed its supervisory personnel to apply in their first cycle of examinations of Thrift HCs, covers payments of dividends by bank holding companies.

4 The FRB is also contemplating including Thrift HCs with significant commercial activities in a separate supervisory portfolio, and Thrift HCs with significant broker-dealer activities in yet another separate supervisory portfolio. Currently, large complex bank holding companies and regional bank holding companies, as well as bank holding companies with total consolidated assets of $5 billion or less are each in separate supervisory portfolios.

5 A "discovery review" is an inspection activity designed to improve the understanding of a particular business activity or control process to address a knowledge gap previously identified.

6 Complexity is reviewed annually and is based on size, structure, intercompany transactions, nature and scale of nonbank activities, whether such activities are reviewed by another regulator, whether they are traditional closely related to banking activities or those permitted under the Gramm-Leach-Bliley Act (e.g. insurance, securities, merchant banking), whether risk management is consolidated, and whether the holding company has material debt outstanding to the public.

7 "Continuous monitoring" includes meetings with management, analysis of MIS, review of audit findings, and coordinating with functional regulators.

8 The "CORE" rating system had individual component ratings for capital, organizational structure, risk management, and earnings, but includes a composite rating of consolidated risk management and consolidated strength.