GETTING THE DEAL THROUGH

Banking Regulation

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Regulatory framework

1 What are the principal governmental and regulatory policies that govern the banking sector?

Because the deposits held by US banks are insured by the federal government, many governmental and regulatory policies are aimed at protecting these deposits by requiring safe and sound banking practices. This is accomplished through regulatory capital adequacy requirements and regulations relating to appropriate lending, investment and other business practices, and so on.

2 Please summarise the primary statutes and regulations that govern the banking industry.

The principal statutes governing the US banking industry are:

- the Federal Deposit Insurance Act (the FDIA), which provides for federal deposit insurance and vests the Federal Deposit Insurance Corporation (the FDIC) with regulatory authority over FDIC-insured banks;
- the Bank Holding Company Act of 1956, as amended (the BHC Act), which subjects companies that control banks – called 'bank holding companies' – to supervision and regulation by the board of governors of the Federal Reserve System (the Federal Reserve);
- the National Bank Act, which provided for the establishment of national banks (ie, banks with charters issued by the federal government) and vested the Office of the Comptroller of the Currency (the OCC) with regulatory authority over them;
- the Federal Reserve Act, which established the Federal Reserve System and contains restrictions applicable to banks, such as section 23A of the Federal Reserve Act, which limits transactions between a bank and its affiliates; and
- the Home Owners' Loan Act (HOLA), which provided for the establishment of federal savings banks.

3 Which regulatory authorities are primarily responsible for overseeing banks?

There are three federal bank regulators as well as a multitude of state banking authorities. The three federal bank regulators are:

- the Federal Reserve System, which has primary supervisory authority over bank holding companies, savings and loan holding companies and state-chartered banks that have elected to become members of the Federal Reserve System;
- the Federal Deposit Insurance Corporation (FDIC), which, in addition to administering the Deposit Insurance Fund, also has primary supervisory authority over state-chartered banks that have opted not to become members of the Federal Reserve System. The FDIC also has oversight authority at a secondary level over all other types of FDIC-insured banks; and
- the Office of the Comptroller of the Currency, which has primary supervisory authority over national banks and federal savings banks.

In addition, the National Credit Union Administration has oversight over federal credit unions and insures deposits held by both federal and state chartered credit unions through the National Credit Union Share Insurance Fund, a federal fund backed by the full faith and credit of the US government.

4 Describe the extent to which deposits are insured by the government. Describe the extent to which the government has taken an ownership interest in the banking sector and intends to maintain, increase or decrease that interest.

The FDIC protects depositors against the loss of their insured deposits if an FDIC-insured institution fails. FDIC insurance is backed by the full faith and credit of the US government. The basic limit on federal deposit insurance coverage is US$250,000 per depositor. On 9 November 2010, the FDIC issued a Final Rule implementing section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that provides for unlimited insurance coverage of non-interest-bearing transaction accounts. From 31 December 2010 to 31 December 2012 all non-interest-bearing transaction accounts are fully insured, regardless of the balance of the account, at all FDIC-insured institutions. The unlimited insurance coverage is available to all depositors, including consumers, businesses and government entities. This unlimited insurance coverage is separate from, and in addition to, the insurance coverage provided to a depositor's other deposit accounts held at an FDIC-insured institution.

A non-interest-bearing transaction account is a deposit account where interest is neither accrued nor paid; depositors are permitted to make an unlimited number of transfers and withdrawals; and the bank does not reserve the right to require advance notice of an intended withdrawal.

Beginning during the financial crisis in 2008 and continuing through 2009, financial institutions of all sizes sought to increase their capital levels for a variety of reasons, including to help absorb current and future losses, to ensure that capital ratios stayed above regulatory minimums and also to convey a sense of financial strength and confidence to investors, customers, counterparties and competitors. Capital-raising in 2008 was significantly aided by the implementation of the Capital Purchase Program (CPP) under the Troubled Asset Relief Program (TARP) in which financial institutions sold senior preferred shares and warrants exercisable for common stock to the Treasury. By 31 December 2008 the Treasury had invested approximately US$178 billion in 214 financial institutions through the CPP, and by 31 March 2009 this amount had grown to nearly US$199 billion in 532 financial institutions. By year end 2009, the Treasury had invested in nearly 700 banks with over US$200 billion in TARP funds. Since that time, as the US banking industry has returned to health, a substantial number of banks have repaid their TARP funds.

5 Which legal and regulatory limitations apply to transactions between a bank and its affiliates? What constitutes an 'affiliate' for this purpose? Briefly describe the range of permissible and prohibited activities for financial institutions and whether there have been any changes to how those activities are classified.

Transactions between an FDIC-insured bank or thrift are subject to sections 23A and 23B of the Federal Reserve Act. These restrictions effectively make it impracticable for the FDIC-insured institution to lend to its affiliates or purchase assets from them. In addition, all other transactions between the FDIC-insured institution and its affiliates must be at fair market value. For this purpose, an 'affiliate' is:

- any company that controls the bank or thrift;
- any company that is under common control with the bank or thrift;
- any company with a majority of interlocking directors with a bank or thrift; or
- any company that is sponsored or advised by a bank or thrift.

'Control' for this purpose is ownership of 25 per cent or more of any class of voting securities, but also includes control in any other manner. Note that a controlling relationship can exist for the purposes of section 23A even at an ownership level of less than 25 per cent of voting securities.

Companies that control a US bank or thrift are generally limited in the types of activities in which they can engage to financial services activities including securities underwriting, insurance (both agency and underwriting) and merchant banking. While there are certain exceptions to this rule, over the past several years US regulators and Congress have gradually eliminated or scaled back these exceptions.

6 What are the principal regulatory challenges facing the banking industry?

Much of the focus of the US banking industry has been to adjust to heightened supervision by the bank regulators in the aftermath of the recent financial crisis. In addition, a broad spectrum of legislators have attributed part of the blame for the financial crisis to a lack of comprehensive and rigorous regulatory supervision and a breakdown in risk management on the part of the affected financial institutions. As discussed in the following question, addressing these issues will be among the leading regulatory challenges facing the banking industry in the coming years.

7 How has regulation changed in response to the recent crisis in the banking industry?

The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on 21 July 2010, constitutes the most sweeping financial reform legislation since the Great Depression. Dodd-Frank vests federal bank regulators with an additional level of control over the shape and strategic direction of the US financial services industry, but with some notable exceptions (such as the enhanced supervision of large non-bank financial institutions) many of the results it achieves could probably have been achieved by regulators under pre-existing law, given their broad supervisory powers to assure safety and soundness. Its real impact may instead lie in the legislative direction that the law gives to regulators and institutions. The law's precise final effect remains substantially in flux due to its general pattern of mandating that regulators adopt regulations to implement its broad contours, still very much a work-in-progress. The following is a synopsis of some of the major provisions of Dodd-Frank.

The Financial Stability Oversight Council

Dodd-Frank adds several new regulatory bodies to a financial regulatory system already often characterised as balkanised. (It eliminates only one, the Office of Thrift Supervision. The OTS was abolished on 21 July 2011. The thrift charter was retained but oversight of savings and loans and their holding companies was transferred to other federal bank regulators.) A notable new addition is the Financial Stability Oversight Council (FSOC). The FSOC is intended to identify and respond to emerging risks throughout the financial system and to promote market discipline. The FSOC is chaired by the secretary of the Treasury and its membership includes the Federal Reserve, the Securities and Exchange Commission, Commodity Futures Trading Commission, OCC, FDIC, Federal Housing Finance Agency, National Credit Union Administration, the new Bureau of Consumer Financial Protection and an independent member with insurance expertise appointed by the president.

The FSOC can require that a non-bank financial company be regulated by the Federal Reserve and subjected to certain prudential standards if material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness or mix of activities of the company, could pose a threat to the financial stability of the United States. This represents a significant expansion of Federal Reserve authority. As a result, large non-bank financial companies – such as insurance companies, investment firms, finance companies and even industrial companies with significant financial operations – will for the first time potentially fall within the regulatory purview of the Federal Reserve.

Federal Reserve regulation, as exemplified by its supervision of bank holding companies, is qualitatively different from other types of financial regulation. It is organisation-wide and encompasses all legal entities in the holding company structure, even those located offshore. In contrast, the regulation of insurance companies, broker-dealers, mutual fund companies and finance companies currently focuses on specific licensed subsidiaries and provides for nominal, if any, regulation of the parent company and affiliates. In addition, Federal Reserve regulation is relatively less specifically prescriptive and formulaic and more principles-based, flexible and discretionary. The 'goal posts' in Federal Reserve supervision are not always clearly spelled out in written regulations, but also incorporate horizontal reviews of peer institutions (ie, an evolving best practices review) and judgements as to what constitutes safe and sound practices. To address concerns about the potential breadth of supervision, Dodd-Frank permits (and enables the Federal Reserve to require) a non-bank financial company that becomes subject to Federal Reserve supervision to concentrate its financial activities under an intermediate holding company, generally freeing the entities outside of that intermediate holding company from Federal Reserve supervision.

In a further significant expansion of its authority, if the Federal Reserve determines that a bank holding company with assets of US$50 billion or more, or a systemically important non-bank financial company, poses a 'grave threat' to the financial stability of the United States, the Federal Reserve can, subject to approval by the FSOC, limit the company's ability to engage in M&A activity or require the company to limit or terminate a particular business activity. The Federal Reserve could also direct the company to sell assets, including those held off-balance sheet.

Bureau of Consumer Financial Protection

One of Dodd-Frank's potentially most far-reaching provisions is the creation of the new Bureau of Consumer Financial Protection (the Bureau). The Bureau is likely to become a powerful and highly influential new regulator. For the first time, there will be a single federal regulator focused solely on consumer financial protection.

Although 'housed' within the Federal Reserve, the Bureau is likely to be virtually independent in practice because its director is a presidential appointee (subject to Senate confirmation) and because of a congressional mandate to the Federal Reserve providing for the Bureau's budget. It is authorised to develop consumer protection rules for both bank and non-bank companies that offer consumer

financial products and services. Virtually all of the consumer protection functions of the Federal Reserve, OCC, OTS, FDIC, Federal Trade Commission, National Credit Union Administration and the Department of Housing and Urban Development will move to the Bureau. Consistent with Dodd-Frank's overall theme of focusing on larger banks, the Bureau will also have the authority to examine, and enforce consumer regulatory compliance at, banks and credit unions with assets over US$10 billion and their affiliates. It will also have this authority at all mortgage-related businesses (lenders, servicers and mortgage brokers), larger participants in the market for consumer financial products or services (to be specified by Bureau rule), businesses that the Bureau has reasonable cause to determine are posing risk to consumers in offering consumer financial products or services, private educational lenders and payday lenders. Banks with assets of US$10 billion or less will not be subject to Bureau examination but, like others, will need to comply with its rules.

Under Dodd-Frank's regulatory scheme, the extensive federal regulations that currently govern consumer finance will remain in place. The Bureau will have the ability to craft new regulations to amend and supplement the current regulatory framework. But the Bureau is not intended to pre-empt all state consumer finance regulation. Dodd-Frank encourages states to set their own standards by making it clear that the regulations issued by the Bureau are intended to serve only as a 'floor'.

Dodd-Frank provides for other reforms affecting consumer finance. In mortgage lending, it requires expanded disclosures and enhanced consumer protection. As to debit cards, it requires the Federal Reserve to issue rules limiting interchange fees so that they are 'reasonable and proportional' to the cost incurred by the issuer with respect to the applicable transaction, which will undoubtedly affect the terms and usage of debit cards. These reforms can be viewed as part of a continuum with other recent initiatives limiting banks' ability to generate revenue from cardholders, including the Credit CARD Act of 2009 and recent Federal Reserve rules restricting banks from charging overdraft fees without express cardholder permission.

Enhanced supervision and prudential standards; the Collins amendment

Dodd-Frank enshrines a principle of tighter regulation for banks that are larger and, it is supposed, a greater risk to systemic stability. For bank holding companies with US$50 billion or more in assets, Dodd-Frank directs the Federal Reserve to establish prudential standards for capital, leverage, liquidity, risk management and other requirements that become stricter as companies grow in size and complexity. The FSOC is to make recommendations concerning these enhanced prudential standards. This may reinforce and expand existing practical differences in regulation between larger money-centre banks, on the one hand, and community banks on the other. Dodd-Frank similarly empowers the Federal Reserve to establish more stringent prudential standards for supervised non-bank financial companies.

In keeping with the Basel III framework, Dodd-Frank contemplates that the Federal Reserve will seek to make capital requirements counter-cyclical, such that the amount of capital financial institutions are required to maintain increases in times of economic expansion and decreases in times of economic contraction. As the economy evolves, it will be interesting to see how this increasingly prescriptive approach to capital and liquidity interacts with the pressures of international competition in the global financial system.

To help assess the adequacy of these prudential standards on an ongoing basis, Dodd-Frank requires the Federal Reserve to conduct an annual 'stress test' for each bank holding company with US$50 billion or more in assets and each non-bank financial company under its supervision. These entities are required to conduct semi-annual stress tests of their own and to report the results to regulators. Federally regulated financial companies with over US$10 billion in assets are required to conduct annual stress tests and report the results.

The so-called Collins amendment requires federal regulators to impose new minimum leverage ratio and risk-based capital requirements for companies supervised by the Federal Reserve. Generally applicable leverage ratio and risk-based capital requirements, and those in effect for banks at the time of Dodd-Frank's enactment, will serve as a floor for these new standards. It also eliminates trust preferred securities and other hybrid securities as a component of Tier I capital for bank and thrift holding companies. The restriction is subject to a three-year phase-in period (five years for thrift holding companies), to begin on 1 January 2013 with respect to securities issued before 19 May 2010. The Collins amendment grandfathers trust preferred securities issued before 19 May 2010 by bank holding companies with less than US$15 billion of assets as of 31 December 2009 and by entities that were mutual holding companies on 19 May 2010, exempts bank holding companies with assets of less than US$500 million, and exempts TARP preferred stock. These changes, part of a larger trend to enhance the focus on common equity as regulatory capital, will require larger bank holding companies to raise tens of billions of dollars of replacement capital and will have a long-term impact on the business models of bank holding companies as they seek to compensate for the effect on equity returns.

Concentration limits

Efforts to revive the Glass-Steagall act's separation of investment banking from commercial banking and to break up the largest financial institutions have, so far, proved unsuccessful. However, Dodd-Frank, through a combination of outright prohibitions and economic disincentives, potentially makes it more difficult for the largest institutions to expand.

Dodd-Frank requires that bank holding companies with assets of US$50 billion or more (as well as systemically important non-bank financial companies) obtain Federal Reserve approval prior to acquiring more than 5 per cent of the voting shares of a wide range of financial companies with consolidated assets of US$10 billion or more. This will now require bank holding companies to seek advance approval for acquisitions that, under prior law, would have required only notice to the Federal Reserve. These companies are also subject to a new, explicit concentration limit: they may not acquire any other company if the total consolidated liabilities of the acquirer would exceed 10 per cent of the aggregate consolidated liabilities of all US financial companies. The denominator is calculated as of a year-end date, to be determined, as specified by the Federal Reserve. FSOC has recommended that, to reduce volatility in the calculation, the Federal Reserve base its determination of the denominator on a rolling two-year aggregate average of included financial liabilities. It has also acknowledged other challenges in calculating the denominator. As the FSOC has noted, the liability cap embodies asymmetries that will place US financial firms at a competitive disadvantage to foreign-based competitors. Because of the way the cap is structured, a large US firm close to the limit may not be able to acquire a foreign firm with even a small presence in the United States, while the same foreign firm would not be prohibited from acquiring that US firm. This, according to the FSOC, 'could increase the degree to which the largest firms operating in the US financial sector are foreign-based'.

The Volcker rule

A centrepiece of the statute is the so-called Volcker rule, intended to prohibit banks from engaging in the business of trading securities or other financial instruments as principals. The compromise version of the Volcker rule adopted in Dodd-Frank requires the regulators to implement regulations to prohibit proprietary trading and investments in, and sponsorship of, hedge funds and private equity funds, by banks and their affiliates and holding companies. The rule also empowers the federal regulators to subject supervised non-bank financial companies conducting these activities to additional capital requirements and quantitative limits on the activities.

The statute relies on broad definitions and defers many hard questions to the federal bank regulators. The definition of 'proprietary trading' is imprecise. The Volcker rule also includes a potentially broad-sweeping provision empowering federal regulators to require a banking entity to terminate an activity or dispose of an investment if there is 'reasonable cause' that the investment or activity 'functions as an evasion' of the rule. As one would expect, and as the FSOC has acknowledged, it is very difficult to distinguish between prohibited 'proprietary trading', on the one hand, and client-driven activities that continue to be permitted, including transactions in which an institution acts as principal such as hedging and market-making. The rule also permits de minimis investments by bank holding companies in hedge funds and private equity funds that they organise and offer, defined as investments that do not exceed 3 per cent of the total ownership interests of any particular fund and that do not, in the aggregate, exceed 3 per cent of the banking entity's Tier I capital.

Depending on the nature of the activity or investment in question, financial institutions may have up to 10 years to conform to the rule's requirements. The rule will become effective on the earlier of 12 months after federal regulators adopt final rules under it and 21 July 2012, and banking entities will have a two-year transition period following effectiveness to conform their activities and investments to the rule's requirements (subject to up to three one-year extensions). Further, upon application by a banking entity, the Federal Reserve may extend the transition period for up to a maximum of five years with respect to an equity or ownership interest in an 'illiquid fund', defined as a fund that as of 1 May 2010 was invested and contractually committed to invest principally in illiquid assets (such as private equity portfolio companies) and that makes all investments pursuant to an investment strategy to invest principally in illiquid assets.

Enhanced resolution authority

In an effort to avert taxpayer-funded bail-outs, Dodd-Frank empowers the Federal Reserve and the FDIC to recommend that, based on an assessment of systemic risk, the secretary of the Treasury appoint the FDIC as receiver for a 'financial company.' The covered companies include domestic bank holding companies, non-bank financial companies supervised by the Federal Reserve, companies predominantly engaged in activities that the Federal Reserve determines are financial in nature or incidental thereto, and any subsidiary of the foregoing. The secretary can appoint the FDIC as receiver if the secretary determines that the financial company is in default or in danger of default, the company's failure and resolution through other means would have a serious adverse effect on the financial stability of the United States, no viable private sector alternative is available, any effect on the claims or interests of creditors, counterparties, shareholders and other market participants is appropriate given the impact of a receivership on the financial stability of the United States, any liquidation would avoid or mitigate such effects, and a federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order. The secretary's determination will be subject to only deferential review by the courts, to be overturned only if it is 'arbitrary and capricious'.

The new role created by Dodd-Frank is a substantial expansion of the FDIC's mandate. In the past, the FDIC has acted as receiver for insured depository institutions closed by their principal regulators. Under Dodd-Frank, a substantially broader scope of institutions can now be put into FDIC receivership. Any financial company put into receivership must be liquidated. No taxpayer funds may be used to prevent liquidation, which will limit the alternatives to FDIC receivership and may make it more challenging for a company to arrange private investment once it is within the 'zone of danger'.

To facilitate the orderly unwinding of a large failing financial institution, Dodd-Frank requires all bank holding companies with US$50 billion or more in assets and non-bank financial companies supervised by the Federal Reserve to submit periodically to regulators a 'living will' for the company's rapid and orderly resolution in the event of material financial distress or failure. Enhanced reporting is required as well, including periodic reports about credit exposure to other significant financial institutions. If the Federal Reserve and the FDIC determine that a living will is not credible or would not facilitate an orderly resolution of the company, they are empowered to jointly impose enhanced prudential standards or require divestitures.

Derivatives

Dodd-Frank creates a new regulatory regime that grants the SEC and the Commodity Futures Trading Commission (CFTC) authority to regulate over-the-counter derivatives, including foreign exchange swaps. Dodd-Frank mandates central clearing and exchange trading for derivatives that can be cleared. Capital requirements are to be imposed on swap dealers and major swap participants. While evidently focused on decreasing the credit risk associated with derivatives, Dodd-Frank at the same time requires banking organisations to move certain derivatives activities, such as commodity-based swaps, from their subsidiary banks – their most creditworthy and regulated entities – to less-regulated non-bank affiliates. Banking organisations will be permitted to retain swap activities for purposes of hedging and similar risk-mitigating activities directly related to the bank's activities, activities involving rates or reference assets permitted as national bank investments (eg, interest rate swaps and currency swaps) and activities involving credit default swaps cleared through a clearing-house.

Limitation on OCC pre-emption of state law

Dodd-Frank significantly weakens the OCC's pre-emption power, which will render national banks newly susceptible to an array of state laws.

The OCC has traditionally taken a broad view of the pre-emptive effect of federal bank regulation over state law, a position that has been valued by holders of national banking charters as protecting them against the application of diverse and divergent state laws. With effect from the transfer of certain powers to the Bureau of Consumer Financial Protection, the OCC will be able to pre-empt state consumer financial laws only if application of the state law would have a discriminatory effect on national banks relative to a state-chartered bank, the state law prevents or significantly interferes with the exercise by the national bank of its powers (employing a legal standard that requires the OCC to marshal substantial evidence supporting pre-emption) or the state law is pre-empted by another federal law. Procedurally, Dodd-Frank requires the OCC to make pre-emption determinations on a case-by-case basis (ie, the determination must be limited to the impact of a particular state law on any national bank that is subject to that law, or the law of any other state with 'substantively equivalent' terms) and to first consult the Bureau in determining whether a state law has substantively equivalent terms to another law that the OCC is pre-empting. A court reviewing an OCC pre-emption determination will be required to inquire into the validity of the OCC's reasoning (in contrast to the deferential standard of review generally applied to federal administrative decisions). Dodd-Frank also expressly applies state consumer financial laws to any subsidiary or affiliate of a national bank (other than one itself chartered as a national bank), which may encourage national banks to consolidate subsidiaries within the bank to benefit from what pre-emption remains. Dodd-Frank also significantly limits the pre-emption of state law in respect of federal savings associations.

Corporate governance; executive compensation

Dodd-Frank expressly authorises the SEC to adopt rules under which shareholders would be able to nominate directors using the company's proxy materials, but prescribes no ownership thresholds for proxy access, reserving rulemaking discretion to the SEC. Dodd-Frank further requires that a company disclose whether it has

separated its chairman and CEO and why, and requires the stock exchanges to prohibit broker discretionary voting in the election of directors, executive compensation or any other significant matter, as determined by the SEC. Dodd-Frank also requires each publicly traded bank holding company and non-bank financial holding company supervised by the Federal Reserve to establish a board-level 'risk committee' with responsibility for enterprise-wide risk oversight. The statute prescribes the composition of the risk committee, which must include a minimum proportion of independent members to be prescribed by the Federal Reserve and at least one 'risk management expert' having experience in identifying, assessing and managing risk exposures of large, complex firms.

Executive compensation provisions of Dodd-Frank include (among others) a requirement for a non-binding shareholder vote on executive compensation at least once every three years ('say-on-pay'), new disclosure and shareholder approval requirements relating to 'golden parachute' arrangements, a requirement that compensation committee members satisfy enhanced independence standards, enhanced annual proxy disclosure and adoption of clawback policies applicable in the event of an accounting restatement due to material non-compliance with financial reporting requirements. In addition, for 'covered financial institutions' with US$1 billion or more in assets, section 956 of Dodd-Frank requires regulators to issue guidance regarding the disclosure of all company incentive compensation structures and the prohibition of incentive compensation arrangements that provide 'excessive compensation' or encourage inappropriate risks, and in March 2011 the federal banking and other regulatory agencies jointly issued the proposed rule implementing section 956 of Dodd-Frank.

Private fund managers

Subject to limited exemptions, Dodd-Frank requires SEC registration for any investment adviser to a private investment fund with at least US$150 million of assets under management. Registration would bring significantly increased reporting and disclosure obligations for each advised fund. Dodd-Frank requires the SEC to enact changes to regulation D to deny the exemption to any person subject to specified federal or state disciplinary orders based on securities or related violations, and authorises the SEC to compel disclosure of confidential client information 'for purposes of assessment of potential systemic risk'.

Short-sale reforms

Dodd-Frank endeavours to curb abusive short selling by requiring the SEC to adopt rules providing for public disclosure by institutions filing reports under section 13(f) of the Securities Exchange Act of 1934, as amended, regarding short sales, and prohibits any 'manipulative' short sale of any security (and empowers the SEC to adopt appropriate rules).

Other notable provisions

Other noteworthy provisions of Dodd-Frank include, among others:

- making permanent the increase in the FDIC deposit insurance limit to US$250,000 per account;
- significantly increased regulation of credit rating agencies, including via the creation of an Office of Credit Ratings within the SEC to improve internal controls, enhance transparency and mitigate conflicts of interest;
- establishment of a 'Federal Insurance Office' as part of the Department of the Treasury to monitor industry developments and make recommendations to the FSOC with respect to specific entities that should be subject to enhanced prudential standards;
- a requirement that securitisers and issuers of asset-backed securities together generally retain 'not less than 5 per cent of the credit risk for any asset' other than 'qualified mortgages';
- a limitation on the Federal Reserve's ability to make emergency loans under section 13(3) of the Federal Reserve Act (assistance is restricted to participants in a programme or facility with 'broad-based eligibility', prohibiting assistance to a single company); and
- enhanced SEC enforcement authority and an expanded whistleblower bounty programme.

8 In what ways do you anticipate the legal and regulatory policy changing over the next few years?

In addition to the reform mandated by Dodd-Frank, the difficulties experienced by the US financial services industry have resulted in more rigorous regulation that has cut across the financial services industry. As capital levels across the industry have increased, policymakers have increasingly turned their focus to encouraging banks to increase lending activity. A key challenge for banks going forward will be reconciling these two, at times competing, policy objectives of stronger capital and increased lending. As capital expectations continue to evolve, policymakers will need to strike a balance such that capital requirements are not so stringent that they limit credit availability and economic growth or encourage an expansion of the more loosely regulated non-bank financial sector. The increased capital requirements have been accompanied by a greater emphasis on higher quality forms of capital, with a widely reported focus on common equity and the ubiquitous 'Tier I common equity ratio'. It is the federal banking regulators' position that common equity should constitute a large majority of a banking firm's Tier I capital because it is permanent, deeply subordinated and does not oblige the issuer to make any payments to investors. Capital must absorb losses and permit the issuer to continue operating as a going concern, as opposed to just serving as a buffer against losses in the event of a liquidation. While the standard regulatory capital benchmarks of 'well capitalised', 'adequately capitalised' and the like under the current law have remained unchanged through the crisis, many institutions have already been required to have higher capital standards under individualised memoranda of understanding or other informal regulatory actions. In the near future, financial institutions should expect that the baseline minimum capital requirements for financial institutions will likely be similarly increased and should be prepared to raise capital in the future with a heightened focus on the composition of capital, particularly the amount of common equity.

Supervision

9 How are banks supervised by their regulatory authorities? How often do these examinations occur and how extensive are they?

Banks are subject to extensive statutes and regulations. In addition, the applicable banking authorities conduct periodic on-site examinations. Based on these examinations, the authorities issue detailed written reports articulating these concerns.

10 How do the regulatory authorities enforce banking laws and regulations?

Federal bank regulators have a formidable array of enforcement mechanisms. Set forth below is a brief overview of the types of enforcement actions generally used by the federal bank regulators in order of increasing severity, including whether the actions are made public by the regulators. In general, enforcement actions can be divided into two categories: informal and formal. Usually less severe in scope, informal actions are generally not made public by the regulators and often remain undisclosed by the target, while formal actions are in all but a few rare instances made public.

Informal actions

Informal supervisory directives

All banks maintain a close supervisory relationship with their primary regulators. When that relationship is functioning at its best,

all material transactions and plans are shared and discussed with the bank's regulators, and a good deal of informal supervisory direction is provided by the regulators to the bank. All banks receive informal advice and direction from their regulators and often make significant adjustments to their operations and capital, liquidity and controls as a result of that informal input.

Supervisory criticisms within examination reports
Bank regulators deliver formal examination reports to their regulated institutions on a regular periodic basis. These examination reports often contain express criticisms or concerns regarding a bank's operations or controls and directives from the regulators concerning the steps that need to be taken to correct such deficiencies or address such concerns. Examination materials are expressly confidential and may not be publicly disclosed by the institution.

Supervisory letter
A supervisory letter is an informal communication from a regulator to a bank either requesting information with respect to a targeted area or specific transaction or requesting that the bank take, or refrain from taking, certain actions. Supervisory letters are generally not publicly disclosed by the regulators and are used to call attention to specific areas of concern.

Commitment letter
A commitment letter is an informal written agreement between a bank and its regulator in which the bank commits to take certain corrective actions. Commitment letters often are entered into in connection with an approval request for a specific transaction or an expansion of powers. Commitment letters are generally not publicly disclosed by the regulators. The regulators also sometimes seek board level commitments through the adoption by the board of formal resolutions on a given matter.

Memorandum of understanding
A memorandum of understanding is also considered an informal enforcement action, and is typically executed by the full board of a banking organisation and the regulator. Memoranda of understanding are generally not publicly disclosed by the regulators.

Formal actions
Formal written agreement
A formal written agreement is an agreement typically signed by the board of directors of a bank and the regulator. Formal written agreements are generally publicly disclosed by the regulators in the absence of a compelling reason to maintain confidentiality.

Cease-and-desist order
A cease-and-desist order is imposed after the issuance of a notice of charges, a hearing before an administrative law judge and a final decision by the regulator. More often, banks consent to a cease-and-desist order in order to expedite resolution by dispensing with the need for the notice and administrative hearing – these are often referred to as 'consent orders'. Temporary cease-and-desist orders can be issued on an interim basis pending completion of the steps necessary to issue a final cease-and-desist order. The regulators are required by law to publicly disclose cease-and-desist orders.

Troubled condition
The federal bank regulators also have the ability to declare a bank or bank holding company to be in 'troubled condition', which then subjects the bank or bank holding company to heightened scrutiny, including a requirement that any addition or change of directors or senior executive officers be subject to prior regulatory approval. A troubled bank or bank holding company also becomes subject to the FDIC's 'golden parachute' regulations, which require prior regulatory approval in order to make a broad range of payments to any officers, directors, employees or controlling shareholders that are contingent on the termination of that person's employment.

In addition, federal bank regulators may impose civil money penalties in a number of circumstances, including: violations of law, formal written agreements, final orders or conditions imposed in writing; unsafe or unsound banking practices; or breaches of fiduciary duty.

11 What are the most common enforcement issues and how have they been addressed by the regulators and the banks?

Following the terrorist attacks on 11 September 2001, enforcement actions requiring that banks strengthen their BSA/AML compliance programmes became particularly widespread. Then, during the financial crisis, BSA/AML concerns took a back seat to more fundamental concerns by the US bank regulators centering on capital adequacy, asset quality, managerial competence and risk management. Post-crisis, regulatory enforcement actions have focused again on BSA/AML, capital adequacy and, more recently, mortgage servicing practices.

12 How has bank supervision changed in response to the recent crisis?

The US bank regulators have assumed a much more assertive stance in the financial services industry. This dynamic has placed an even greater premium on the importance of bank's maintaining good regulatory relations.

Capital requirements

13 Describe the legal and regulatory capital adequacy requirements for banks. Must banks make contingent capital arrangements?

The federal bank regulators have issued risk-based capital guidelines, which require bank holding companies to maintain certain ratios of 'qualifying capital' to risk-weighted assets. 'Qualifying capital' is classified as either 'core capital', referred to as 'Tier I capital', or 'supplementary capital', referred to as 'Tier II capital'. Tier I capital consists of common equity; minority interests in the equity accounts of consolidated subsidiaries and a limited amount of qualifying perpetual preferred equity, reduced by goodwill; investments in unconsolidated banking and finance subsidiaries; and reciprocal holdings of capital instruments in banking organisations. Tier II capital consists of perpetual preferred equity not qualifying for Tier I (subject to certain conditions), perpetual debt, mandatory convertible debt, certain hybrid financial instruments, a limited amount of the allowance for loan and lease losses and a limited amount of term subordinated debt and intermediate-term preferred stock. In calculating 'risk-weighted assets', certain risk percentages are applied to particular categories of both on- and off-balance sheet assets. These are also 'leverage ratio' guidelines, requiring institutions to maintain specified ratios of Tier I capital to average total assets (net of allowance for loan losses and goodwill).

The guidelines require that banking organisations maintain a minimum ratio of Tier I capital to risk-weighted assets of 4 per cent and a minimum ratio of total capital to risk-weighted assets of 8 per cent. The minimum leverage ratio is 3 per cent for 'strong bank holding companies' and for bank holding companies that have implemented the Federal Reserve's risk-based capital measure for market risk. For all other bank holding companies, the minimum leverage ratio is 4 per cent.

The Federal Reserve's risk-based capital guidelines establish only the minimum levels of capital that bank holding companies are expected to maintain, and bank holding companies generally maintain capital well in excess of these minimums. Moreover, a bank holding company that is contemplating or experiencing significant growth, whether internally or by acquisition, is expected to maintain strong capital levels substantially above the minimum ratios, and

its capital ratios should not decline significantly below these strong levels as a result of the acquisition or other expansion.

New capital guidelines, commonly referred to as Basel III, are now in the process of being implemented. When fully phased in on 1 January 2019 they will require financial institutions subject to the regulations to maintain a Tier I common equity ratio of at least 4.5 per cent plus and additional 2.5 per cent 'capital conservation buffer' which is designed to absorb losses during periods of economic stress. Also under Basel III there is expected to be a narrow definition of Tier I common as well as stricter asset risk weightings, particularly on trading, derivatives and securitisation activities. Contingent capital arrangements are not required at this time.

14 How are the capital adequacy guidelines enforced?

The FDIA provides that each federal agency must take 'prompt corrective action to resolve the problems of insured depository institutions' and sets forth strict guidelines governing what constitutes prompt corrective action.

Capitalisation categories

The FDIA establishes a comprehensive regulatory scheme based upon capital adequacy, with better capitalised institutions being subject to lower deposit insurance premiums and greater operating flexibility. The FDIA and the regulations promulgated thereunder establish five categories based on a depository institution's capital position:

- 'well capitalised' institutions have a total risk-based capital ratio above 10 per cent, a Tier I risk-based capital ratio above 6 per cent, a leverage ratio above 5 per cent, and may not be subject to an order, written agreement or directive relating to capital;
- 'adequately capitalised' institutions have a total risk-based capital ratio above 8 per cent, a Tier I risk-based capital ratio above 4 per cent and a leverage ratio above 4 per cent (or a leverage ratio above 3 per cent if the institution has a supervisory rating of 1);
- 'undercapitalised' institutions are those that fail to meet the requirements of an adequately capitalised institution;
- 'significantly undercapitalised' institutions are those with a total risk-based capital ratio above 6 per cent, a Tier I risk-based capital ratio above 3 per cent or a leverage ratio above 3 per cent; and
- 'critically undercapitalised' institutions are those with less than 2 per cent tangible equity to total asset ratio.

If an agency determines an institution is in an unsafe or unsound condition or engaging in an unsafe or unsound activity, it may impose more stringent treatment than would otherwise apply, based upon the category of capitalisation into which the institution falls. An institution may be deemed to be engaging in an unsafe or unsound practice if it has received a less than satisfactory rating for asset quality, management, earnings or liquidity in its most recent report on examination.

Federal bank regulators also have the authority to issue capital directives that are used to enforce specific capital levels at a bank. Such directives can be issued pursuant to the Prompt Corrective Action regulations promulgated under FDICIA or otherwise, and are often accompanied by a formal enforcement action. Capital directives often require that a bank submit a capital plan within a specified number of days that indicates in detail how the bank proposes to increase its capital levels. Capital plans are typically accompanied by a capital maintenance and liquidity maintenance agreement executed between the parent holding company and the bank pursuant to which the parent holding company agrees to make available to the bank adequate capital to assist the bank in successfully implementing its capital plan.

15 What happens in the event that a bank becomes undercapitalised?

Once an institution becomes undercapitalised (whether by failure to meet capital ratios or by regulatory determination), a host of significant restrictions and regulations come into play. The federal agencies are required to closely monitor all undercapitalised institutions and their compliance with FDICIA capital restoration plans.

All undercapitalised institutions are required to submit an acceptable capital restoration plan to the appropriate federal agencies pursuant to a deadline to be established by the agencies. The capital restoration plan must specify:

- the steps that the institution will take to become adequately capitalised;
- the levels of capital to be obtained during each year that the plan is in effect;
- how the institution will comply with the restrictions applicable to the institution; and
- the types and levels of activities in which the institution will engage.

In addition, before a plan can be accepted, each company having control of the institution must guarantee that the institution will comply with the plan until said institution has been adequately capitalised on average during four consecutive quarters and provide appropriate assurances of performance. 'Control' for this purpose is defined as it is under the BHC Act.

The aggregate liability of controlling companies under such guarantees is limited to the lesser of 5 per cent of the depository institution's total assets at the time it becomes undercapitalised and the amount necessary to bring the institution into compliance with all applicable capital standards as of the time that the institution fails to comply with the plan. The provision requiring a holding company to guarantee the performance of its subsidiary depository institutions can raise significant creditors rights issues that should be carefully examined before any such guarantee is granted.

In addition, the asset growth of undercapitalised institutions is restricted. An undercapitalised institution may not increase its quarterly average total assets unless:

- its capital restoration plan has been accepted by the appropriate agency;
- any increase is consistent with the plan; and
- the institution's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the institution to become adequately capitalised within a reasonable period.

Likewise, an undercapitalised institution may not acquire any interest in any company, establish any additional branch office or engage in any new line of business unless its capital restoration plan has been accepted and the board of the FDIC determines that the proposed action will further the purposes of FDIA. These requirements make significant expansion by undercapitalised institutions generally unfeasible.

Significantly undercapitalised institutions

Once an institution becomes significantly undercapitalised (or if it fails to take steps to become adequately capitalised) it becomes potentially subject to a series of draconian measures, within the discretion of the regulatory agencies. In addition, as described below, companies controlling such institutions also become potentially subject to several significant restrictions.

The following may be imposed by statute or by appropriate agency action:

- requiring the institution to recapitalise by selling enough shares (including voting stock) or obligations to adequately capitalise the institution and, if grounds for the appointment of a receiver or conservator exist, requiring the institution to be sold or merged;

- requiring any company having control of the institution to divest the institution if the appropriate agency determines that divestiture would improve the institution's financial condition and future prospects;
- requiring the institution to comply with section 23A of the Federal Reserve Act if the provision exempting transactions with certain affiliated institutions did not apply, or otherwise restricting transactions with affiliates;
- restricting interest rates paid on new deposits, including renewals and rollovers, substantially to the prevailing rates of interest on deposits of comparable amounts and maturities in the region where the institution is located;
- restricting asset growth even more stringently than for undercapitalised institutions, or requiring asset shrinkage;
- requiring the institution to alter, reduce or terminate any activity the agency determines poses excessive risk;
- ordering a new election of the board; dismissing any director or senior executive officer who held office for more than 180 days immediately before the institution became undercapitalised; or requiring the institution to employ qualified senior executive officers who, if the agency so specifies, shall be subject to agency approval. While directors and senior executive officers that have been dismissed have the right to petition the agency for reinstatement, they bear the burden of proving that their continued employment would materially strengthen the institution;
- prohibiting the acceptance of deposits, including renewals and rollovers, from deposit brokers;
- prohibiting any bank holding company having control of the institution from making any capital distribution without prior approval of the Federal Reserve;
- requiring the institution to divest or liquidate any subsidiary the agency determines to be in danger of becoming insolvent and a significant risk to the institution or likely to cause a significant dissipation of the institution's assets or earnings;
- requiring any company having control of the institution to divest or liquidate any affiliate other than an insured depository institution the appropriate agency for such company determines to be in danger of becoming insolvent and a significant risk to the institution or likely to cause a significant dissipation of the institution's assets or earnings; or
- requiring the institution to take any other action the agency determines to be more appropriate.

The FDIA sets forth a presumption that the following actions will be taken unless the agency determines such actions would not be appropriate:
- requiring the sale of shares or obligations or requiring the institution to be sold or merged;
- restrictions on affiliate transactions; and
- restrictions on interest rates.

All significantly undercapitalised institutions and all undercapitalised institutions that fail to submit an acceptable capital restoration plan in a timely manner or that fail in any material respect to implement a plan accepted by the agency are required to obtain prior agency approval before paying any bonus to any senior executive officer or providing compensation to any senior executive officer at a rate that exceeds the officer's rate of compensation (excluding bonuses, stock options and profit-sharing) during the 12 months prior to the month in which the institution became undercapitalised. Agency approval may not be granted if the institution has failed to submit an acceptable capital restoration plan.

Critically undercapitalised institutions

The FDIC is required to act by regulation or order to restrict the activities of critically undercapitalised institutions. At a minimum, the FDIC is required to prohibit critically undercapitalised institutions from doing any of the following without the FDIC's prior written approval:
- entering into any material transaction other than in the ordinary course of business;
- extending credit for any highly leveraged transaction;
- amending the institution's charter or by-laws;
- making any material change in accounting methods;
- engaging in certain types of affiliate transactions;
- paying excessive compensation or bonuses; and
- paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a rate significantly exceeding the prevailing market rate on insured deposits.

The FDIA calls for the appropriate federal agency within 90 days after an institution becomes critically undercapitalised to either:
- appoint a receiver, or with the concurrence of the FDIC, a conservator, for the institution; or
- take such other action as the agency determines with the concurrence of the FDIC would be more appropriate (after documenting why such action would be better).

16 What are the legal and regulatory processes in the event that a bank becomes insolvent?

When confronted with an insured depository institution on the brink of failure, the FDIC is required by law to guarantee insured deposits and dispose of the failed institution's assets in the 'least costly' manner to the FDIC's bank insurance fund (with surplus funds after repaying the FDIC, if any, flowing to uninsured depositors, creditors and then shareholders of the failed institution). This disposition process is referred to as a 'resolution'. The FDIA expressly requires the affirmative, documented determination by the FDIC that its exercise of authority with respect to a resolution of a troubled institution is necessary to meet the FDIC's insurance obligations on insured deposits and provides for a resolution that when measured in terms of the total amount of expenditures (immediate or long-term, direct or contingent) is the 'least costly to the [FDIC] of all possible methods'. The statute clarifies that the cost of any efforts at a resolution must be less than the value of insured deposits minus the present value of reasonably expected recoveries in a liquidation of the troubled bank. This exacting 'least cost' standard may only be waived if, upon the written recommendation of and approval by two-thirds of the members of the board of directors of the FDIC and two-thirds of the board of governors of the Federal Reserve System, the secretary of the Treasury (in consultation with the president) determines that:
- the least cost approach would pose systemic risks (ie, have serious adverse effects on economic conditions or financial stability); and
- the proposed resolution would mitigate these adverse effects.

FDIC-orchestrated dispositions of failed or failing federally insured depository institutions are most commonly structured as a purchase and assumption (a P&A) transaction whereby the FDIC oversees the assumption of all insured deposits of the failed bank by one or more acquiring banks and the transfer of some or all assets of, and the assumption of some or all other liabilities of, the failing bank by the acquiring banks. A number of variations of P&A transactions exist and features of different variations may be combined in a particular case. The two most prevalent variants are bridge bank arrangements and loss-sharing agreements. Each of these two variants has proven particularly useful in large, complex resolutions. A P&A transaction affords the opportunity for the acquiring bank to pay a premium for the going-concern value of the failed bank, thereby reducing the FDIC's total cost of resolution and increasing the probability that the FDIC may avoid a loss in guaranteeing insured deposits. A P&A transaction may also provide for assistance to the acquiring bank in

capitalising or supporting the credit risk of the acquired assets and liabilities. The terms of the transaction may be highly customised based on the intentions of the ultimate acquirer and may exclude certain assets or categories of assets that are carved out by the FDIC into a segregated fund to be professionally managed and liquidated over time (whether by the acquirer or by some other third party).

Two less common structures are an open bank assistance transaction and a deposit payoff. In an open bank assistance transaction, the FDIC provides ongoing support to the troubled institution to facilitate a turnaround plan as it works through its capital issues. In order to provide open bank assistance, the board of directors of the FDIC, the Federal Reserve and the secretary of the Treasury must all determine that not to do so would cause systemic risks. In a deposit payoff, the FDIC assumes and honours insured deposits (and possibly uninsured deposits) and liquidates the troubled institutions assets through receivership.

17 Have capital adequacy guidelines changed, or are they expected to change in the near future?

In response to the current crisis in the banking industry, the Treasury has called for more stringent capital regulations with minimum capital requirements in excess of current requirements. While it is all but certain that new higher capital requirements will be imposed on the US banking industry, the regulatory agencies have not proposed any final guidelines. In addition, Dodd Frank requires the Federal Reserve to increase capital requirements, the larger and more complex a banking organisation becomes.

Ownership restrictions and implications

18 Describe the legal and regulatory limitations regarding the types of entities and individuals that may own a controlling interest in a bank. What constitutes 'control' for this purpose?

Both individuals and companies, regardless of whether they are foreign or domestic, may acquire controlling interests in US banks, provided they meet the applicable statutory and regulatory requirements discussed in question 23 and obtain prior approval from the appropriate regulators. As discussed in question 23, the need for prior approval can be triggered by an acquisition of as little as 10 per cent of the voting stock of a bank or a company that controls a bank or even by the acquisition of non-voting equity securities.

19 Are there any restrictions on foreign ownership of banks?

Foreign acquirers of US banks are generally subject to the same limitations and processes as US acquirers. The principal difference is that the US regulators will first ensure that the foreign acquirer is subject to comprehensive consolidated supervision in its home country. This is discussed in more detail in question 24. Foreign acquirers should also be aware of filing requirements with the Committee on Foreign Investment in the US (CFIUS).

20 What are the legal and regulatory implications for entities that control banks?

With certain exceptions, companies (but not individuals) that acquire control of a US bank will be limited to engaging in financial services activities. For example, an automobile manufacturer is generally precluded from acquiring a US bank. However, non-financial companies are not precluded by law from acquiring or establishing an FDIC-insured 'industrial bank', a special type of bank – although the ownership by non-financial companies of industrial banks has generated significant controversy in recent years and there is currently a moratorium in place on such transactions.

21 What are the legal and regulatory duties and responsibilities of an entity or individual that controls a bank?

An investment that constitutes 'control' under the BHC Act by a company in a bank has several implications. From a bank regulatory perspective, the company would be deemed to be the parent bank holding company of the bank. Consequently, the company would be subject to the Federal Reserve's 'source of strength' doctrine, which provides that a bank holding company must serve as a source of financial and managerial strength to its subsidiary banks. Under this doctrine, the Federal Reserve may require the company to provide additional capital to the bank in the event that the bank were under financial stress. Note that there is no cap on the amount of capital that the Federal Reserve can require that the company provide to the bank. By its terms, the source of strength doctrine only applies to companies and not to individuals that control banks because, under the BHC Act, individuals cannot be deemed to be bank holding companies.

In addition, a finding of control under the BHC Act would mean that the company would control the bank for purposes of the prompt corrective action regulations issued by the federal bank regulators, which are discussed in greater detail in question 15. Under these regulations, an FDIC insured bank is required to file a capital restoration plan with its primary federal bank regulator within 45 days of becoming 'undercapitalised', 'significantly undercapitalised' or 'critically undercapitalised'. The regulations further require that the capital plan include a performance guarantee by each company that 'controls' the bank – control for this purpose is identical to control under the BHC Act. The prompt corrective action regulations limit the aggregate liability under performance guarantees, which are joint and several obligations, for all companies that control a bank to the lesser of:

- an amount equal to 5 per cent of the bank's total assets at the time that the bank was notified that it was undercapitalised; or
- the amount necessary to restore the bank to adequately capitalised status (ie, a total risk based capital ratio of 8 per cent or greater, a Tier I capital ratio of 4 per cent or greater and a leverage ratio of 4 per cent or greater).

A finding of control would have other regulatory implications as well. Sections 23A and 23B of the Federal Reserve Act would place restrictions on transactions between the company (including its affiliates) and the bank. Hence, any loan, asset transfer or other transactions between the company and the bank would be subject to a number of stringent limitations and an overall requirement that they be at arm's length. Moreover, if the Federal Reserve were to commence an enforcement action against the bank, its controlling shareholders may become parties to the proceeding, depending on the particular facts and circumstances.

22 What are the implications for a controlling entity or individual in the event that a bank becomes insolvent?

In the event that a bank is declared insolvent, the US bank regulators may assume control of the bank and ultimately offer it for sale to third parties. If the regulators determine that the bank failed due to mismanagement by the parent company or controlling individual, they may pursue enforcement actions.

Changes in control

23 Describe the regulatory approvals needed to acquire control of a bank. How is 'control' defined for this purpose?

The statutory authority for federal regulation of acquisitions of banks, other insured depository institutions, bank holding companies and other insured depository institution holding companies, and their respective subsidiaries, emanates primarily from:

- the Bank Holding Company (BHC) Act, which regulates acquisitions of control of a bank or bank holding company by a 'company', as well as the acquisition of foreign subsidiaries and the commencement or acquisition of companies engaged in non-bank activities by a holding company or non-bank subsidiary;
- the Bank Merger Act, which regulates mergers between insured depository institutions and acquisitions of assets and assumptions of liabilities of one insured depository institution by another;
- The Home Owners' Loan Act (HOLA), which regulates acquisitions of control of thrifts and thrift holding companies; and
- the Change in Bank Control Act of 1978 (the Control Act), which governs all acquisitions of control of a bank, thrift or holding company by a 'company' other than those covered by the BHC Act, HOLA and the Bank Merger Act as well as by individuals. The Control Act provides that if a proposed acquisition is subject to the provisions of the BHC Act, HOLA or the Bank Merger Act, then the acquiring person need not comply with the Control Act.

Frequently, a particular bank acquisition involves the acquisition by one bank holding company of shares of another bank holding company followed by a merger between the two subsidiary banks. Such transactions are subject to prior regulatory approval under the BHC Act, on the one hand, and the Bank Merger Act, on the other.

BHC Act

Under the BHC Act, prior approval by the Federal Reserve is required for the acquisition by a 'company' of 'control' of a bank or of substantially all of the assets of a bank. Prior Federal Reserve approval also is required under the BHC Act for an existing bank holding company to acquire direct or indirect ownership or control of voting shares of a bank or bank holding company if it will own or control more than 5 per cent of the voting shares after such acquisition and merge with another bank holding company. Such approval is not required for the acquisition of additional shares in a bank or bank holding company by a company that already owns or controls a majority of the voting shares prior to such acquisition.

A company is deemed to 'control' a bank or bank holding company under the BHC Act if:

- it has the power to vote 25 per cent or more of any class of 'voting securities' of the bank or holding company;
- it has the power to control 'in any manner' the election of a majority of the board of the bank or holding company; or
- the Federal Reserve determines after notice and an opportunity for hearing that the company has the power to directly or indirectly exercise a controlling influence over the management or policies of the bank or holding company.

The BHC Act contains a statutory presumption that a company that owns, controls or has the power to vote less than 5 per cent of the voting securities of a bank or bank holding company does not have 'control' for purposes of the BHC Act.

The Federal Reserve's regulations provide that the term 'voting securities' includes any securities giving the holder power to vote for directors or to direct the conduct of operations or other significant policies of the issuer. Preferred stock is deemed not to be a class of voting securities if it does not carry the right to vote for directors, its voting rights are limited solely to the type customarily provided by statute with regard to matters that significantly and adversely affect the rights or preferences of the preferred stock and it represents an essentially passive investment or financing device.

In addition to acquisitions of voting securities, Federal Reserve regulations identify a number of situations in which there is a rebuttable presumption that a company controls a bank or bank holding company for purposes of the BHC Act. This presumption will apply if:

- a company enters into a contract with a bank or bank holding company pursuant to which the first company directs or exercises significant influence over the management of the bank;
- a company and its management and principal shareholders own, control or hold with the power to vote, 25 per cent or more of any class of voting securities of a bank or bank holding company and the first company itself owns, controls or holds, with the power to vote, more than 5 per cent of any class of voting securities of the bank or bank holding company; or
- the two companies have one or more management officials in common, the first company owns, controls or holds, with the power to vote, more than 5 per cent of any class of voting securities of the other company and no other person controls as much as 5 per cent of any class of voting securities of the other company.

The Federal Reserve has also identified a number of circumstances that may indicate the existence of a control relationship under the BHC Act. Such indicia of control include:

- agreements that substantially limit the discretion of a bank holding company's management over major policies of the company, including restrictions on entering into new banking activities without approval of another company or requirements for extensive consultation with the other company regarding financial matters;
- agreements that restrict a bank holding company from selling a majority of the voting shares of its subsidiary banks;
- agreements that give another company the ability to control the ultimate disposition of voting securities to a person of the other company's choice and to secure the economic benefits therefrom;
- an investment of substantial size, even if in non-voting securities;
- agreements that require that one holder's voting securities be redeemed at a premium upon transfer of shares held by another holder; and
- agreements giving a company the ability to direct a bank holding company's use of the proceeds of the first company's investment.

The Federal Reserve has stated that provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control of the acquiree by the acquiring company. Such mitigating provisions may include:

- covenants that leave management free to conduct banking and permissible non-banking activities;
- a 'call' right that permits the acquiree to repurchase the acquiring company's equity investment;
- a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of these rights if the right of first refusal is not exercised;
- agreements involving rights with respect to less than 25 per cent of the acquiree's voting shares; and
- holding down the size of any non-voting equity investment in the acquiree below the 25 per cent level.

With respect to the last point, the Federal Reserve has consistently taken the view (except in rare circumstances) that non-voting equity investments by bank holding companies may not be equal to 25 per cent or more of a target's total equity. In addition, the Federal Reserve has viewed subordinated debt as equity for purposes of this limitation.

Change in Bank Control Act

The Control Act provides that a 'person' seeking to effect an acquisition of 'control' of a bank holding company or a federally insured depository institution must give prior written notice to the 'appropriate federal banking agency'. The agency then has a specified period to disapprove the acquisition. If not disapproved within that

period, the acquisition may be consummated. An acquisition may be made prior to expiry of the period if the agency issues written notice of its intent not to disapprove the acquisition.

The concept of control used in the Control Act differs somewhat from that used in the BHC Act. The Control Act defines 'control' as the power, directly or indirectly, to direct the management or policies, or to vote 25 per cent or more of any class of voting securities, of an insured bank. In addition, Federal Reserve regulations provide that a person is rebuttably presumed to 'control' a bank under the Control Act if the person:

- 'owns, controls, or holds with the power to vote 25 per cent or more of any class of voting securities of the institution'; or
- 'owns, controls or holds with power to vote 10 per cent or more [...] of any class of voting securities of the institution'; and if
- the institution's shares are registered pursuant to section 12 of the Exchange Act; or
- no other person would own a greater percentage of the institution's outstanding shares.

Bank Merger Act

The Bank Merger Act provides that no insured bank or other insured depository institution may merge with, or acquire the assets or assume the liabilities of, another insured depository institution without the prior written approval of the 'responsible agency' and prescribes certain procedures (including procedures for obtaining shareholder approval and for appraisal of shares held by dissenting holders) for such mergers.

Where the acquiring or resulting bank is to be a national bank or a bank chartered in the District of Columbia, the OCC is the responsible agency. Where the acquiring or resulting bank is to be a state-chartered bank that is a member of the Federal Reserve System, the Federal Reserve is the responsible agency. Where the acquiring or resulting bank will be a state-chartered bank (other than a savings bank) that is not a member of the Federal Reserve System, the FDIC is the responsible agency.

Where the acquiring or resulting institution is to be a thrift, the OTS is the responsible agency. In addition, a 'deposit transfer' application to the OTS may be required where the transferring or disappearing institution is a thrift.

HOLA

HOLA governs acquisitions of control of insured federal or state thrifts (including savings associations, savings and loan associations, building and loan associations and federal savings banks) and holding companies of such thrifts.

Thrift regulations provide that a company generally cannot acquire control of a thrift, directly or indirectly, unless it first receives written approval from the Federal Reserve. The regulations create two thresholds for determining 'control': conclusive control and control subject to rebuttal. The regulations also establish presumptions of concerted action for purposes of determining the circumstances under which it might be appropriate to aggregate the holdings of different investors.

A company will be deemed to conclusively control a thrift if an acquirer directly or indirectly, or acting in concert with one or more persons or companies:

- acquires more than 25 per cent of any class of voting stock;
- acquires irrevocable proxies representing more than 25 per cent of any class of voting stock;
- acquires any combination of voting stock and irrevocable proxies representing more than 25 per cent of any class of voting stock;
- controls in any manner the election of a majority of the directors of the thrift; or
- can exercise a controlling influence over the management or policies of the thrift.

Subject to rebuttal, an acquirer will be deemed to control a thrift if the acquirer directly or indirectly, or acting in concert with one or more persons or companies:

- acquires more than 10 per cent of any class of voting stock and one or more additional 'control factors' are present, including:
  - being one of the two largest holders of any class of voting stock;
  - holding more than 25 per cent of total equity;
  - holding more than 35 per cent of combined debt securities and equity; or
  - being party to agreements that give an investor a material economic stake in a thrift or thrift holding company or that give an investor the power to influence a material aspect of management or policy;
- acquires more than 25 per cent of any class of stock and one or more of the above control factors are present; or
- holds any combination of voting stock and proxies, representing more than 25 per cent of any class of voting stock, that enables an acquirer to:
  - elect one-third of the board of directors;
  - cause the shareholders of the thrift to approve its acquisition or reorganisation; or
  - exert a controlling influence on a material aspect of its business operations.

To satisfy the thrift regulations, an investor should, prior to an acquisition of equity securities, debt securities, or both, of a thrift or thrift holding company that could subject the investor to a finding of control subject to rebuttal, submit to and have approved by the Federal Reserve a rebuttal of control agreement. Rebuttals of control contain a series of passivity commitments.

24 Are the regulatory authorities receptive to foreign acquirers? How is the regulatory process different for a foreign acquirer?

The receptivity of the US regulatory authorities to foreign acquirers of US banks depends in large part on whether the acquirer is subject to comprehensive consolidated supervision by its home country supervisor as discussed below. The filings are essentially the same for a foreign acquirer of a US bank. However, a foreign acquirer raises some different considerations. Also, as noted in question 19, foreign acquirers need to be mindful of CFIUS filing requirements.

Capital

In considering applications by foreign banks to acquire US banks, the Federal Reserve has looked to whether the capital levels of a foreign bank exceed the minimum levels that would be required under the Basel Capital Accord both before and after the merger. The Federal Reserve also looks to whether a foreign bank's capital levels are considered to be equivalent to the capital levels that would be required of a US banking organisation. In doing so, the Federal Reserve will typically consult a foreign bank's home country supervisor. Another important factor is that the US-insured depository institutions controlled by the foreign bank both before and after the merger meet the requirements to be deemed well capitalised.

Requirement of comprehensive supervision

Under the BHC Act, the Federal Reserve is precluded from approving an application by a foreign bank to acquire a US bank unless the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. In essence, the Federal Reserve must determine that the bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the bank, including its relationships to any affiliate, to assess the bank's overall financial condition and its compliance with laws and regulations.

If the Federal Reserve has previously determined that a particular home country supervisor practices comprehensive consolidated supervision, the finding is relatively easy for the Federal Reserve to make in the context of subsequent acquisitions by other banks from the same home country. Conversely, if the Federal Reserve has not previously made such a determination with respect to particular home country supervisor, the determination process can take months and even years.

Similarly, the Federal Reserve must also determine that a foreign bank that is applying to acquire a US bank provide adequate assurances that it will make available such information on its operations and activities and those of its affiliates as the Federal Reserve deems appropriate to determine and enforce compliance with the BHC Act. To make this determination, the Federal Reserve reviews the restrictions on disclosures in jurisdictions where the foreign bank has material operations and consults with the relevant non-US governmental authorities concerning access to information. The Federal Reserve also expects that the foreign bank commits to making available such information on its operations and those of its affiliates that the Federal Reserve deems necessary.

25 What factors are considered by the relevant regulatory authorities in considering an acquisition of control of bank?

Section 3(c) of the BHC Act sets out the criteria that the Federal Reserve must apply in acting upon BHC Act applications. The criteria are:

- antitrust;
- financial condition and future prospects;
- management resources;
- convenience and needs of the community; and
- impact on systemic risk.

In every case, the Federal Reserve must also take into consideration the effectiveness of the company or companies in combating money-laundering activities, including in overseas branches.

Antitrust

The BHC Act provides that the Federal Reserve may not approve an acquisition that would result in a monopoly in or furtherance of a combination or conspiracy to monopolise or to attempt to monopolise the business of banking in any part of the US or might have the effect in any section of the country of substantially lessening competition, unless the board finds that the anti-competitive effects of the transaction are clearly outweighed by the convenience and needs of the communities to be served.

During the Federal Reserve's review of an acquisition under the BHC Act, the Antitrust Division of the Department of Justice (the Justice Department) also has an opportunity to evaluate the competitive issues raised by the proposed transaction and may submit its comments to the Federal Reserve. If the Federal Reserve approves the acquisition, the BHC Act provides that the transaction may not be consummated for 30 days (or 15 days if the Justice Department has not submitted adverse comments with respect to competitive factors), during which time the Justice Department may challenge the transaction in a federal district court.

Evaluating the antitrust implications raised by in-market bank acquisitions can be a complex task owing to the fact that the Federal Reserve and the Justice Department apply different methodologies and focus on different competitive concerns. Most notable among those differences is the relevant product market defined by the two agencies. The Federal Reserve continues to invoke the 'cluster' of banking services market definition adopted by the US Supreme Court more than 40 years ago. The Federal Reserve's primary tool for evaluating the antitrust implications raised by a bank merger is to measure the effect of the proposed merger on the concentration levels within locally limited geographic markets. In contrast, the Justice Department evaluates disaggregated product markets, including, among others, small-business lending and middle-market lending, in addition to retail banking services. At times, these differences can lead to conflicting outcomes at the two agencies with respect to whether a particular transaction raises antitrust concerns, and, if so, the level of divestiture required to resolve those concerns.

Financial condition and future prospects

The BHC Act provides that, in considering proposed acquisitions of bank shares or assets, '[i]n every case, the Federal Reserve Board shall take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned'. The Federal Reserve's consideration of this factor generally centres around the adequacy of the resulting company's capital. This analysis turns on the following three measures of capital adequacy:

- whether the resulting company will satisfy the Federal Reserve's published risk-based capital adequacy guidelines, which establish minimum levels of capital that bank holding companies are expected to meet;
- how the resulting company's capitalisation compares to the capitalisation of the two combining companies; and
- how the resulting company's capitalisation compares to the capitalisation of its peers.

Management resources

The BHC Act requires the Federal Reserve to take 'managerial resources' into account in considering applications for acquisitions. Applications that have been denied on the grounds of inadequate managerial resources have generally involved attempted acquisitions of relatively small banks by persons with little or no experience in managing a banking business.

Such managerial concerns are not limited to these circumstances, however. As part of the application process, the Federal Reserve staff frequently seeks and obtains detailed information to document an acquirer's managerial resources. Such information often takes the form of strategic business plans for the combined company, integration plans and staffing and cost savings projections. In addition, the federal regulators also scrutinise the larger bank holding companies' management, staffing, planning and implementation of acquisitions as part of the examination process. Any adverse examination reports in this area can be expected to impact an applicant during the application process.

Convenience and needs of the community

The Federal Reserve is required to take into consideration the 'convenience and needs of the community to be served' in approving or rejecting an application under section 3 of the BHC Act. This consideration generally relates to the nature, quality and availability of the applicant's actual or planned products and services, including, for example, the hours and locations of operation, interest rates on deposits and size of available loans.

As a practical matter, the Federal Reserve has almost always determined that the general convenience and needs aspects of an application are consistent with approval of the application, even if the applicant plans to offer no new services or products. On the other hand, the Federal Reserve has found increases in services, greater loan limits, increased hours and, in particular, the reopening, or the assumption of the deposits, of a closed institution to be positive factors weighing in favour of approval of an application because of more effective service to the community.

Systemic risk

Under Dodd Frank, the Federal Reserve is also required to consider the impact of a bank acquisition on systemic risk. In assessing this factor, the Federal Reserve looks at five factors:

- the size of the combined company;

- the availability of substitute providers for the critical services offered by the combined company;
- the combined company's interconnectedness with the rest of the US financial system;
- the degree to which the combined company contributes to the complexity of the US financial system; and
- the extent of the combined company's cross-border activities.

The Community Reinvestment Act

In considering the convenience and needs of the community, the Federal Reserve is required under the Community Reinvestment Act (the CRA) to consider an applicant's record of serving the credit needs of its entire community, including low and moderate-income neighbourhoods, consistent with the safe and sound operation of the applicant. The CRA requires the federal banking regulators to 'encourage financial institutions to help meet the credit needs of the local communities in which they are chartered' and, to that end, the Federal Reserve is required to take an applicant's CRA record into account under section 3 of the BHC Act.

The CRA provides a four-Tier system for rating an institution's record of meeting community credit needs: 'outstanding', 'satisfactory', 'needs to improve' and 'substantial non-compliance'. Each bank's primary regulator performs periodic examinations of, and assigns a rating to, the bank's CRA performance.

An applicant's CRA record may be the basis for the denial of an application – although denials solely on CRA grounds are rare. The Federal Reserve takes into account both an institution's CRA rating and CRA evaluations in making its CRA determination in connection with an application. Of the few CRA-based denials of applications, most, if not all, have involved applicants having subsidiaries with low CRA ratings.

Control Act criteria

The appropriate agency may disapprove a proposed acquisition under the Control Act:

- if the acquisition would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolise or to attempt to monopolise the business of banking in any part of the United States;
- if the acquisition may have the effect in any section of the country of substantially lessening competition, unless the responsible agency finds that the anti-competitive effects of the proposed transaction are clearly outweighed by the convenience and needs of the community to be served;
- if the financial condition of any acquiring person is inadequate;
- based upon the competence, experience or integrity of any acquiring person or of any of the proposed management personnel;
- if any acquiring person neglects, fails or refuses to furnish the appropriate agency all the information required by it; or
- if the acquisition would adversely affect the Deposit Insurance Fund.

Bank Merger Act criteria

The Bank Merger Act provides that the responsible agency may not approve any proposed merger that:

- would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolise or to attempt to monopolise the business of banking in any part of the United States; or
- might have the effect in any section of the country of substantially lessening competition, unless the responsible agency finds that the anti-competitive effects of the proposed transaction are clearly outweighed by the convenience and needs of the community to be served.

In addition, the responsible agency is required to take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the communities to be served and the impact of the merger on systemic risk. The responsible agency must also take into consideration the effectiveness of any insured depository institution involved in the proposed merger in combating money laundering activities, including in overseas branches.

26 Describe the required filings for an acquisition of control of a bank.

In order to acquire a US bank, an application must be filed under the appropriate statute set forth in question 23. In general, the filings require detailed information regarding the acquirer, including all individuals who have the authority to participate in major policy-making functions. In addition, detailed personal information of individuals with the most senior decision-making authority must often be provided for the acquirer.

27 What is the typical time frame for regulatory approval for both a domestic and a foreign acquirer?

An acquisition of a bank or bank holding company differs from most other types of acquisitions by virtue of the often elaborate and extended regulatory approval process. In general, when a bank holding company or a financial holding company acquires more than 5 per cent of the voting shares of another bank or bank holding company, it must first receive Federal Reserve approval. Depending on the size and complexity of the proposal, the approval process can be as short as 30 days or longer than six months.

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