Banking Regulation

Contributing editor
Richard K Kim

2019

GETTING THE DEAL THROUGH

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Twelfth edition

Getting the Deal Through is delighted to publish the twelfth edition of *Banking Regulation*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Sweden.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Richard K Kim of Wachtell, Lipton, Rosen & Katz, for his continued assistance with this volume.

GETTING THE
DEAL THROUGH

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United States

Richard K Kim

Wachtell, Lipton, Rosen & Katz

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. In general, a US-banking organisation's obligations to its depositors takes precedence over its obligations to its shareholders. Following the global financial crisis of 2008, US bank regulatory policy has also been focused on reducing systemic risk, the risk that the failure of one or more large financial institutions will jeopardise the stability of the financial system. Financial stability considerations have led to capital requirements that increase as a bank grows in size and complexity. The pendulum now appears to be swinging in the opposite direction and US bank regulators are considering how to make bank regulation less burdensome without exposing the financial system to increased risk. Much of the focus has been on reducing the regulatory burden for community and regional banks. The largest banks – those deemed globally systemically important banks (commonly referred to as G-SIBs) – have yet to receive any significant reductions in regulatory burdens. US G-SIBs include Bank of America, Bank of New York, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, State Street and Wells Fargo.

2 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 (FDIA), which provides for federal deposit insurance and vests the Federal Deposit Insurance Corporation (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 (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 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 (commonly referred to as 'non-member banks'). 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.

The Consumer Financial Protection Bureau (also known as the Bureau of Consumer Financial Protection), formed in 2011, has broad responsibilities to enforce federal consumer protection laws over both banks and non-banks engaged in financial services activities.

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. As a temporary measure in response to the 2008 global financial crisis, from 31 December 2010 to 31 December 2012 all non-interest-bearing transaction accounts were fully insured, regardless of the balance of the account, at all FDIC-insured institutions. This was an unprecedented action by the FDIC and the unlimited insurance coverage has now expired.

A non-interest-bearing transaction account is essentially a checking account, 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 2008 global financial crisis 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 more than US$200 billion in TARP funds. Since that time, as the US banking industry has returned to health, virtually all 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. The Federal Reserve's Regulation W (12 CFR Part 223) is the implementing regulation. 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;
- that is under common control with the bank or thrift;
- with a majority of interlocking directors with a bank or thrift; or
- 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. Notably, largely for political reasons, real estate brokerage and development are not permissible. Non-financial activities, such as manufacturing or retailing, are also not permissible. In recent years, there has been little movement by Congress or the regulators to broaden the range of permissible activities. Some activities perceived as overly risky, such as proprietary trading or investing in private equity and hedge funds, have been significantly cut back.

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

Much US banking-industry focus has been to adjust to heightened supervision by the bank regulators in the aftermath of the 2008 global financial crisis. Pre-crisis, bank regulators focused on ensuring that individual banks had sufficient capital to avoid failure but did not consider systemic implications. Consequently, the same capital requirements applied to both small and large banks. Post-crisis, the US bank regulators adopted a 'macroprudential' perspective and expanded their focus to ensure that the financial system avoids failure. For this reason, capital requirements now increase the larger and more complex that a bank grows. In addition, activities deemed overly risky, such as proprietary trading, are being limited or banned altogether. The regulators have also instituted annual stress tests in which banks are required to demonstrate to their regulators that they would retain an adequate amount of capital even under extremely adverse hypothetical economic scenarios. In addition, a broad spectrum of legislators attributed part of the blame for the financial crisis to a lack of comprehensive and rigorous regulatory supervision and a breakdown in culture, ethics and risk management on the part of the affected financial institutions. A net effect was a wave of sweeping enforcement actions that continued through 2017, including enormous financial penalties, primarily focused on the largest banks. More broadly, the policy debate whether to 'break up' the largest banks in order to prevent another financial crisis continues to this day. Ironically, at the same time, the heavier compliance burden resulting from the increase in regulation has incentivised banks to expand their revenue base via acquisitions to bear the incremental costs.

The Trump administration has pledged to roll back a significant portion of the regulations adopted post crisis. The US Treasury has issued policy papers detailing how the regulation should be reformed. As Trump appointees assumed control of federal bank regulatory agencies, they slowly began to implement this reform. On 24 May 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was signed into law and provides regulatory relief for all but the largest banks. A brief overview of its principal provisions follows.

Banks with less than US$3 billion in assets:

- qualify for the Federal Reserve's Small Bank Policy Statement, which was previously limited to banks with less than US$1 billion in assets (Basel III exempt and possess greater flexibility to use debt in acquisitions); and
- qualify for an 18-month examination cycle if well managed and well capitalised.

Banks with less than US$10 billion in assets:

- are Volcker Rule exempt;
- originated and retained mortgage loans are 'qualified mortgages' for Truth in Lending Act purposes;
- can opt into a community bank leverage ratio (to be set by the regulators between 8 per cent and 10 per cent), which would replace all other capital and leverage ratios;
- the Durbin cap on debit card interchange fees remain intact; and
- company-run stress tests (eg, DFAST) are not required until a bank crosses the US$250 billion threshold.

Banks with less than or equal to US$20 billion in assets:

- federal savings associations can elect to operate with the same powers as a national bank without converting their charters; and
- following such election, the Qualified Thrift Lender test would no longer apply and federal savings associations would be able to engage in commercial lending on the same footing as commercial banks.

Banks with less than US$50 billion in assets:

- the 'SIFI threshold' (eg, the Federal Reserve's enhanced prudential standards – most notably the CCAR stress test as well as heightened risk management and liquidity standards) would be increased from US$50 billion to US$250 billion;
- bank holding companies with total assets between US$50 billion and US$100 billion would be exempt immediately;
- bank holding companies with total assets between US$100 billion and US$250 billion would be exempt 18 months after enactment (unless exempted earlier by the Federal Reserve);
- the Federal Reserve has the authority to impose SIFI limitations on a case-by-case basis; and
- the Federal Reserve is required to conduct a periodic supervisory stress test.

7 Are banks subject to consumer protection rules?

US banks are subject to extensive consumer protection rules at both the federal and state level. At the federal level, they are primarily enforced by the CFPB. Since its formation in 2011, the CFPB has rapidly become a powerful regulator and has been notably active both in issuing regulations and in bringing investigations and enforcement actions against a wide variety of financial companies including:

- banks;
- credit card companies;
- credit reporting companies;
- debt collection agencies;
- mortgage brokers;
- mortgage lenders;
- mortgage insurers;
- debt relief companies (including law firms); and
- student loan companies.

Banks with assets of US$10 billion or less are examined by their primary bank regulators but need to comply with CFPB rules. Banks with assets in excess of US$10 billion are subject to examination by the CFPB.

Although auto dealers are exempt by statute from CFPB regulation, the CFPB has used its authority over banks engaged in indirect auto lending to address alleged discriminatory mark-ups and similar dealer practices through enforcement activity and by imposing monitoring requirements on the banks conducting the indirect lending. Much of the CFPB's early rulemaking has focused on mortgage lending and servicing, including an important rule, issued in early 2013, requiring lenders to ensure that prospective buyers have the ability to repay their mortgages. Other areas of current CFPB focus include consumer protections for:

- prepaid cards;
- payday lending;
- debt collection;

- overdraft protection services; and
- privacy notices.

Virtually all consumer protection functions of the Federal Trade Commission, the Department of Housing and Urban Development, the Federal Reserve and other federal banking regulators have been moved to the CFPB in connection with its formation. Accordingly, the CFPB has the authority to enforce numerous FTC regulations as well as more than a dozen federal consumer protection statutes, including:

- the Home Owners Protection Act;
- the Fair Debt Collection Practices Act;
- the Home Mortgage Disclosure Act;
- the Real Estate Settlement Procedures Act;
- the Truth in Lending Act; and
- the privacy protections of Gramm-Leach-Bliley.

States may also enact their own consumer protection law; the CFPB's position is that federal consumer protection statutes set the floor and do not pre-empt more rigorous state laws.

To date, the CFPB is very much in a state of flux. Under the Trump administration, the agency has softened its approach to the industry. As time progresses and the senior staff changes over, we expect to see the CFPB continue to moderate its approach to supervision and enforcement.

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 during the 2008 global financial crisis have resulted in more rigorous regulation that has cut across the industry. Post-crisis, the regulatory pendulum has swung sharply to more extensive and burdensome regulation as well as more frequent and severe enforcement actions. Increased capital requirements have been accompanied by a greater emphasis on higher quality forms of capital, with a focus on common equity and the tier 1 common equity ratio. It is the federal banking regulators' position that common equity should constitute a majority of a banking firm's tier 1 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. At the same time, the regulators have been pressuring the banking industry to decrease its level of risk. The combination of more extensive regulation, higher capital requirements and lower risk has deeply impaired the profitability of the industry.

The Trump administration has pledged to roll back a significant portion of the regulations adopted post-crisis and the pendulum has begun to slowly swing in the other direction. As 2019 progresses, we expect a rollback of regulation to continue. The administration has completed its process of appointing a new slate of senior-most bank regulators who have the ability to profoundly impact the regulatory environment.

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. Large banks have teams of regulators resident in their offices in order to facilitate continuous monitoring. Based on these examinations, the authorities issue detailed confidential written reports articulating their concerns.

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

Federal bank regulators have a formidable array of enforcement mechanisms. Set out 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 strictly 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

enter into an agreement to make, or to actually 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?

The years following the 2008 global financial crisis have witnessed some of the largest ever enforcement actions in the US. Remarkably, in 2014, two of the world's biggest banks took the almost unprecedented step of pleading guilty to criminal violations in the US and agreed to pay staggering fines: BNP paid US$8.9 billion to resolve criminal and civil investigations into violations of US sanctions law and Credit Suisse paid US$2.6 billion to resolve a criminal federal income tax investigation. Separately, a number of large financial institutions have paid billions of dollars in fines, penalties and disgorgement in connection with alleged attempted manipulation of foreign exchange benchmark rates. Governmental settlements have continued to arise out of the financial crisis, notably in connection with mortgage-backed securities, with a number of financial institutions agreeing to pay tens of billions of dollars.

For regional and community banks, the most common enforcement issue has been Bank Secrecy Act (BSA) anti-money laundering (AML) compliance. Following the terrorist attacks on 11 September 2001, enforcement actions requiring that banks strengthen their BSA and AML compliance programmes became particularly widespread. Then, during the 2008 global financial crisis, BSA and AML concerns took a back seat to more fundamental concerns by the US bank regulators centring on capital adequacy, asset quality, managerial competence and risk management. Post-crisis, regulatory enforcement actions have focused again on BSA and AML. Enforcement actions often have a direct impact on a bank's ability to expand via acquisitions and often result in them being put into a 'penalty box' while the enforcement action is pending. The enforcement actions are typically very lengthy and it can take years to complete the work required to the satisfaction of the regulators. During that time, the bank is not permitted to make any acquisitions. Consumer compliance has also remained a common area of enforcement.

While the pace of large enforcement actions against banks has generally decelerated under the Trump administration, on 2 February 2018, the Federal Reserve issued an unprecedented enforcement action barring Wells Fargo from increasing its total assets and mandating substantial corporate governance and risk management actions. The Federal Reserve also publicly released three supervisory letters publicly censuring Wells' board of directors, former Chairman and CEO and a past lead independent director. These actions are a sharp departure from precedent, both in their severity and their public nature.

Resolution

12 In what circumstances may banks be taken over by the government or regulatory authorities? How frequent is this in practice? How are the interests of the various stakeholders treated?

The FDIC may acquire control of a bank if the bank becomes insolvent or is in danger of becoming so. The primary regulator of the bank (eg, the OCC in the case of national banks) has the formal responsibility of closing the bank and appointing the FDIC as receiver. Once appointed, the FDIC is charged with selling or liquidating the bank while at the same time minimising the cost of the failure to the Deposit Insurance Fund. Depositors are paid by the FDIC up to the maximum amount of deposit insurance coverage. The FDIC then uses the remaining proceeds of the receivership, if any, to repay creditors. Shareholders do not receive any payments from the FDIC in return for their equity stock in the bank.

Prior to the passage of the Dodd-Frank Act, the FDIC's resolution authority was limited to banks or thrifts whose deposits were insured by the FDIC. The FDIC's resolution authority did not extend to the parent holding company or other non-bank affiliates of an insured depository institution. Now, the Federal Reserve and the FDIC may recommend that, based on an assessment of systemic risk, the Secretary of the Treasury appoint the FDIC as receiver for a 'financial company'. 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 US;
- 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 US;
- 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.

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'. The FDIC issued a final rule with respect to its orderly liquidation authority in July 2011. Among other things, the final rule provides that compensation paid to a senior executive or director deemed by the FDIC as 'substantially responsible' for a financial company's failure may be clawed back if the executive or director acted negligently.

13 What is the role of the bank's management and directors in the case of a bank failure? Must banks have a resolution plan or similar document?

In the event of a bank failure, bank management and directors typically have very little involvement. Members of management may be employed by the acquirer of the failed bank but do not play a meaningful role in the seizure of the bank. US banking regulations require that large banks and bank holding companies have a resolution plan in place.

14 Are managers or directors personally liable in the case of a bank failure?

Bank failures are often followed by lawsuits by the FDIC against the bank's managers and directors alleging mismanagement and seeking money damages. The FDIC has filed a large number of these lawsuits following the wave of bank failures that occurred in 2008 and 2009.

15 Describe any resolution planning or similar exercises that banks are required to conduct.

Prior to 24 May 2018, all bank holding companies and insured depository institutions with US$50 billion or more in assets and non-bank financial companies supervised by the Federal Reserve were required to submit periodically to the Federal Reserve and the FDIC a 'living will' for the company's rapid and orderly resolution in the event of material financial distress or failure. The passage of the Economic Growth, Regulatory Reform, and Consumer Protection Act raised the threshold so that firms with less than US$100 billion in total consolidated assets are no longer subject to the resolution plan requirements. The Federal Reserve is in the process of determining which firms with more than US$100 billion but less than US$250 billion in total consolidated assets will be subject to the resolution plan requirements moving forward. Living wills are highly elaborate, lengthy documents that contain a great amount of detail about a company's legal structure, the legal regimes to which it is subject around the world, how its business operations map to its legal entities, internal and external contractual relationships and dependencies and a good deal more. Enhanced reporting is required, including periodic reports about credit exposure to other significant financial institutions.

The Federal Reserve and the FDIC may determine that a living will is not credible or would not facilitate an orderly resolution of the company. If they do, they are empowered to jointly impose enhanced prudential standards or require divestitures. Development of these documents is an iterative process and institutions may be encouraged by the regulators to rearrange existing contractual and other arrangements that might complicate the separation of the institutions' various business and legal entities in the event of financial distress. In orders involving bank acquisitions by larger institutions, the Federal Reserve has made it clear that the quality of an institution's living will, and the resulting view of how difficult a company may be to resolve in the case of financial distress, is a significant factor in assessing the potential impact on risks to the stability of the US financial system posed by the transaction.

Under FDIC living will guidance, a covered institution must provide a fully developed discussion and analysis of a range of realistic resolution strategies. Each institution should include in the discussion and analysis at least one strategy that primarily involves the separation and sale of the covered institution's deposit franchise, core business lines and or major assets to multiple acquirers, as well as an alternative strategy involving the liquidation of the firm, including a payout of insured deposits.

Capital requirements

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

In July 2013, the US federal bank regulators adopted final capital regulations implementing the Basel III capital framework established by the Basel Committee on Banking Supervision. The new capital regulations became effective on 1 January 2015 and became fully phased in on 1 January 2019. The regulations require that US banks and bank holding companies maintain capital sufficient to meet both a risk-based asset ratio test and a leverage ratio test on a consolidated basis. The risk-based ratio is determined by allocating assets and certain types of off-balance sheet commitments into risk-weighted categories, with higher weighting assigned to categories with greater risk. The risk-based ratio represents total capital divided by total risk-weighted assets. The leverage ratio is tier 1 capital (which includes common equity, certain types of perpetual preferred and other instruments) divided by total assets which are subject to adjustment but are not risk weighted. In addition, the regulations include a new minimum ratio of common equity tier 1 capital called 'tier 1 common' to risk-weighted assets and a tier 1 common capital conservation buffer of 2.5 per cent of risk-weighted assets. The regulations also include a minimum leverage ratio of 4 per cent. The following are the minimum Basel III regulatory capital levels in order to avoid limitations on capital distributions and discretionary bonus payments:

Basel III regulatory capital levels

	1 January 2015 (per cent)	1 January 2016 (per cent)	1 January 2017 (per cent)	1 January 2018 (per cent)	1 January 2019 (per cent)
Tier 1 common	4.5	5.125	5.75	6.375	7
Tier 1 risk-based capital ratio	6	6.625	7.25	7.875	8.5
Total risk-based capital ratio	8	8.625	9.25	9.875	10.5

17 How are the capital adequacy guidelines enforced?

For US banks, meeting the regulatory requirements to be deemed 'well capitalised' is critical to maintaining an institution's status and privileges as a financial holding company, making capital distributions that deviate from the institution's capital plan, engaging in interstate acquisitions, and receiving approval from a federal bank regulator to engage in a merger or acquisition. The well-capitalised percentages discussed below should be considered a starting point. The federal banking agencies have advised that institutions and their holding companies should maintain capital ratios well above the minimums for well-capitalised status. In addition, an institution's or its holding company's primary regulator may require additional capital based on the institution's size, complexity and risk profile. Weaker institutions are required to address their capital and operating deficiencies promptly or face regulatory-driven corrective actions, including a possible forced recapitalisation or merger.

Under the FDIA, the US federal banking regulators must take 'prompt corrective action' to resolve the problems of insured depository institutions. The prompt corrective action regulations establish five categories based on a depository institution's capital position:

- well capitalised institutions have a total risk-based capital ratio of more than 10 per cent, a tier 1 risk-based capital ratio of more than 8 per cent, a leverage ratio of more than 5 per cent, a common equity tier 1 ratio of more than 6.5 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 of more than 8 per cent, a tier 1 risk-based capital ratio of more than 6 per cent and a leverage ratio of more than 4 per cent and a common equity tier 1 ratio of more than 4.5 per cent;
- undercapitalised institutions are those which fail to meet the requirements of an adequately capitalised institution;
- significantly undercapitalised institutions are those with a total risk-based capital ratio of less than 6 per cent, a tier 1 risk-based capital ratio of less than 4 per cent or a leverage ratio of less than 3 per cent or a common equity tier 1 ratio of less than 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 that 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. Dodd-Frank mandates enhanced prudential standards for bank holding companies with US$50 billion or more in assets that become stricter as companies grow in size and complexity, and the federal supervisors' Basel III implementing rules adopted in 2013 require enhanced regulatory capital requirements for banking organisations of all sizes.

18 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 appointment of a receiver or conservator exist, requiring that the institution 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 out 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).

19 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 (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.

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

As noted in question 16, the US bank regulators adopted new Basel III capital guidelines in July 2013 that became effective in January 2015. In addition, Dodd-Frank requires the Federal Reserve to increase capital requirements the larger and more complex a banking organisation becomes. The Economic Growth, Regulatory Reform, and Consumer Protection Act, which was enacted on 24 May 2018, rolled back some of these requirements.

Ownership restrictions and implications

21 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 26 and obtain prior approval from the appropriate regulators. As discussed in question 26, 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.

22 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 27. Foreign acquirers should also be aware of filing requirements with the Committee on Foreign Investment in the US (CFIUS).

In February 2014, the Federal Reserve issued final regulations that substantially tightened the regulation of foreign banks operating in the US. Foreign banks with US$50 billion or more in US assets (excluding assets held in US branches and agencies) must form a US intermediate holding company (IHC) to act as the parent company of substantially all of the foreign bank's US subsidiaries. The IHC will be regulated by the Federal Reserve as if it were a domestic bank holding company and must comply with US regulatory capital requirements, stress testing, liquidity management requirements and a host of other regulatory requirements. Foreign banks were required to establish an IHC that is fully compliant with these regulations by 1 July 2016.

23 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. Non-financial companies are not, however, 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 was a moratorium on the ability of non-financial companies to acquire or establish industrial banks, which was imposed by Dodd-Frank in July 2010 and expired in July 2013. Although the moratorium has expired, no non-financial company has successfully acquired or established an industrial bank since that time. Recently, a few fintech companies have expressed interest in forming a bank or industrial bank and filed formal applications to do so.

24 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 was 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 18. 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 1 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.

25 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 because of mismanagement by the parent company or controlling individual, they typically pursue enforcement actions against members of management as well as lawsuits seeking reimbursement to the Deposit Insurance Fund.

Changes in control

26 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 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;
- 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 generally taken the view (except in certain 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 the 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 OCC is the responsible agency. In addition, a 'deposit transfer' application to the OCC 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:
- is one of the two largest holders of any class of voting stock;
- holds more than 25 per cent of total equity;
- holds more than 35 per cent of combined debt securities and equity; or
- is 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.

27 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; a foreign acquirer, however, raises some different considerations. Also, as noted in question 20, 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. As discussed in question 22, in February 2014, the Federal Reserve issued regulations that substantially tightened the regulation of foreign banks operating in the US and required the formation of US intermediate holding companies if certain size thresholds are met.

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 commit to making available such information on its operations and those of its affiliates that the Federal Reserve deems necessary.

28 What factors are considered by the relevant regulatory authorities in an acquisition of control of a 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 anticompetitive 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 (DOJ) 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 DOJ has not submitted adverse comments with respect to competitive factors), during which time the DOJ 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 DOJ 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 50 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 DOJ evaluates disaggregated product markets, including 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 round 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 affect 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 (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 anticompetitive 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 anticompetitive 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.

29 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 out in question 26. 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.

30 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 45 days or longer than six months.

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