The Costs and Benefits of the Bank Holding Company Structure

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Of all commercial banks headquartered in the Sixth District, approximately 76 percent exist under a holding company structure. On occasion, bank supervisors receive questions regarding the costs and benefits of a bank holding company (BHC) structure, particularly since a number of the historical benefits no longer remain. This article highlights some of the primary benefits of a BHC and summarizes the Federal Reserve's supervisory approach, which is scaled according to the size and risk profile of organizations and designed to be as efficient as possible. We should also be clear that using a BHC structure (or not) is solely a business decision.

Advantages of the BHC framework

The holding company framework offers options to facilitate growth and diversify and manage risks in ways that a bank charter alone does not. For example:

Sources of strength:

- Holding companies can issue debt, the proceeds of which can be used to improve a depository institution's capital position.
- Holding companies are also permitted to purchase problem assets from bank subsidiaries. During the financial crisis, many companies used this strategy to support their subsidiary banks.

Options for managing acquisitions:

- Holding companies' ability to buy stock in other financial institutions can help them acquire targeted institutions. Parent companies can also issue debt and use the funds to allow bank subsidiaries to assist with strategic acquisitions.
- Under the holding company framework, acquired banks may be merged or integrated with existing subsidiary banks or remain separate institutions. These options may permit a more deliberate integration of acquired institutions.
- Additionally, this structure may allow the transfer of acquired assets or activities to the holding company to comply with state laws.

Trust preferred securities (TPS):

- Previously issued grandfathered TPS, many with long maturities, remain an eligible form of tier 1 capital for holding companies with total consolidated assets of less than $15 billion.

Tax advantages:

- The holding company structure can provide certain tax advantages. Interest payments on debt issued at the parent company, with the proceeds contributed to the subsidiary bank as equity capital, can be a deductible expense at the holding company, reducing the overall consolidated tax liability in some instances.

Stock repurchases:

- In certain circumstances—state and national bank statutes permitting—Regulation Y allows for stock redemptions of up to 10 percent of a holding company's consolidated net worth (in the preceding 12 months) without prior approval. Banks are generally limited in their ability to make a market for their own stock.

Expanded permissible activities:

- BHCs and savings and loan holding companies that become financial holding companies can engage in broad range of activities and investments, including some not allowed at the bank or thrift level. For example, under certain conditions, unlimited broker-dealer operations, insurance underwriting, and merchant banking may be permitted at the holding company level.
- The holding company framework also provides opportunities to diversify risk and explore innovation. For example:
    - Captive insurance companies can be used for risk management to facilitate a broader range of underwriting of certain uninsured business risks.

- Holding companies may invest in up to 5 percent in any class of voting securities of any entity without prior regulatory approval. This power allows organizations to make small investments in innovative companies.

Small Bank Holding Company Policy Statement:
Smaller holding companies (currently, those with $1 billion or less in consolidated assets that meet qualitative factors) benefit from the flexibility provided by the Federal Reserve's Small Bank Holding Company Policy Statement. This statement exempts small BHCs from consolidated capital requirements and allows them to operate with higher levels of debt than would normally be permitted at larger holding companies or banks. Small BHCs are also exempt from many reporting requirements of larger holding companies.

Reducing the regulatory burden associated with the holding company framework

Regulatory simplification, and cost savings are cited as possible benefits of a holding company dissolution. The Federal Reserve recognizes there is potential for duplicative supervision in the current regulatory framework and is committed to ensuring efficient, effective holding company programs. To that end, the Fed has taken steps to reduce the regulatory burden and tailor supervision to the risk profile of institutions. For example:

Relying on the insured depository institution's primary regulator:
A longstanding tenet of the Federal Reserve's holding company supervisory approach is to rely on—and coordinate extensively with—the insured depository institution's primary regulator to reduce burden and duplicative efforts. The Board's SR Letter 16-4articulated and reinforced this approach.

In addition, for small, noncomplex holding companies, the Federal Reserve's supervision is largely completed offsite. The Federal Reserve's small holding company inspection scope and frequency requirements are enumerated in SR Letter 13-21.

Coordination of supervisory activities:
In the regional portfolio (from $10 billion to $50 billion in total consolidated assets), recent years have seen considerable efforts to align our supervisory planning schedule with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation's planning efforts.

Tailoring supervision

Efforts continue to tailor BHC supervision. For firms under $50 billion, the Federal Reserve issued SR Letter 16-11, which explicitly requires Federal Reserve examiners to consider an

institution's unique scope and complexity of activities to provide appropriate supervision and guidance.

Misconceptions regarding BHC dissolutions

There is merit in noting some misconceptions associated with BHC dissolutions:

Boards of directors: One of the advantages mentioned in reference to BHC dissolution is based on a misunderstanding that holding companies are expected to maintain two sets of directors. The Federal Reserve has no statutory or supervisory expectation that would prevent a holding company and its subsidiary bank from having identical board membership and/or holding joint meetings.

SEC registration: Although banks are exempt from Securities and Exchange Commission (SEC) registration and reporting requirements, many of these same reporting requirements would shift from the SEC to the bank's primary regulator if the holding company were dissolved.

Returning to the BHC framework: Although the Board is exploring ways to streamline the application process, attempting to expeditiously form a new holding company could prove challenging if financial conditions are under stress or statutory or other factors arise during the application process.

No "one size fits all" answer

Each firm has to decide which form of organization makes the most sense for its business model and strategy. Pros and cons exist for each option. Though organizational structure is purely a business decision, at the Fed, we value our supervisory connection to holding companies. Given our broad responsibilities for monetary policy, financial stability, payments systems, and operation of the discount window, a direct connection to—and ongoing dialogue with—BHCs is beneficial and instrumental to making sound national policy decisions. We remain mindful of the regulatory burden and continue to explore ways to refine supervision to provide the maximum benefit to the firms we regulate.

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