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To **Grow** Or **Not to Grow**

Regulatory burdens increase as banks get bigger.

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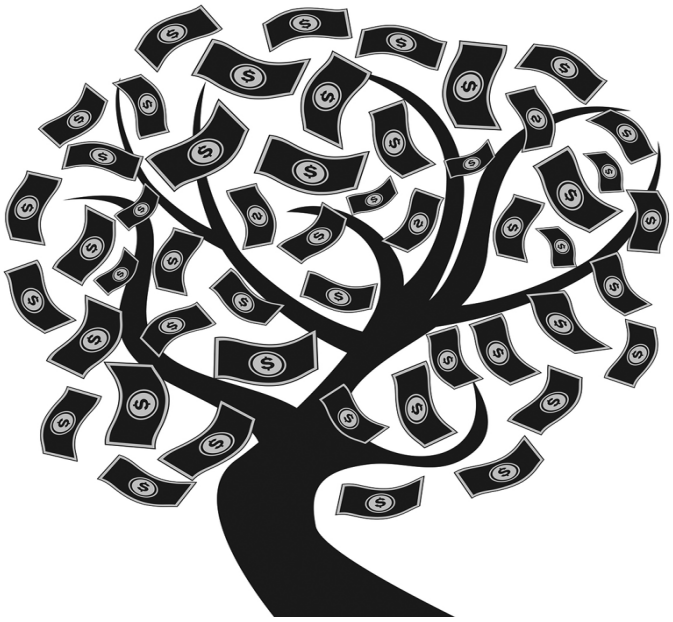
We have not seen significant analytical consideration of one of the central themes underlying the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which seeks to limit risk in the banking system by imposing escalating regulatory requirements on banking organizations based on their size.

This "growth tax" is imposed not only on large banks that may be deemed systemically important, but also on community banking organizations. As a result, all banks must now consider the regulatory implications of growing larger, either organically or through acquisitions, against the revenue growth and operational efficiencies that growth often seeks to achieve. Indeed, investors in the equity and debt of such institutions are sure to do so when making their investment and pricing decisions.

Banking organizations will experience ever escalating regulatory requirements and costs that may impact their life, death and profitability as they pass the $500 million, $1 billion, $10 billion, $50 billion and $250 billion consolidated asset thresholds. These costs will be imposed in a variety of ways, including through higher capital requirements, additional assessments and fees, and enhanced regulation and supervision, raising the question of whether it makes sense to grow or not.



The $500 Million Bank

The Federal Reserve Board (FRB) has historically exempted small bank holding companies (BHCs), i.e., those with less than $500 million in total consolidated assets, from capital requirements at the holding company level. Dodd-Frank reaffirmed this exemption. Thus, BHCs that cross the $500 million asset threshold will need to consider the impact on their operations of becoming subject to holding company capital requirements, in addition to capital requirements at the subsidiary bank level.

The small BHC exemption is not available to small savings and loan holding companies (SLHCs).

The $1 Billion Bank

One of the perceived abuses that led to the financial crisis was incentive compensation arrangements that encouraged management of financial institutions to take inappropriate risks. As mandated by Dodd-Frank, the federal financial regulators have proposed restrictions on incentive compensation arrangements on financial institutions with greater than $1 billion in consolidated assets, prohibiting them, for example, from maintaining incentive compensation arrangements that provide management with excessive compensation or encourage individuals to take inappropriate risks that could cause material loss. Even more stringent limits on incentive compensation would apply to institutions with greater than $50 billion in consolidated assets.

The $10 Billion Bank

Banking organizations that cross the $10 billion threshold become part of the big league of regulation and oversight.

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First, they become subject to the examination and enforcement jurisdiction of the Consumer Financial Protection Bureau with respect to a wide array of compliance with consumer protection laws and regulations.

Second, FRB rules implementing Dodd-Frank's Durbin Amendment cap interchange fees that banking institutions of this size may charge to merchants on debit card purchases at 21 cents per transaction, plus .05 percent of the transaction amount, and an additional 1 cent for issuers that have fraud prevention standards in place. This represents a substantial reduction in interchange fees that such banking institutions typically charged prior to the adoption of the FRB rules.[1]

Third, these BHCs and SLHCs must conduct an annual stress test. Stress tests will be used by regulators to evaluate the capital adequacy of institutions and must be publicly disclosed beginning in June 2015. More extensive stress testing requirements apply to depository institutions with greater than $50 billion in consolidated assets.

Fourth, the FRB's proposed enhanced prudential standards require publicly traded BHCs of this size to establish a risk committee that includes at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

Fifth, the Federal Deposit Insurance Corporation (FDIC) has modified how an insured depository institution's assessment base is calculated for purposes of determining FDIC insurance premiums. Rather than the amount of its domestic deposits, an institution's assessment base is now calculated by subtracting its average tangible equity from its average consolidated assets. As a result, the assessment base of many larger institutions that substantially rely on funding sources other than domestic deposits has increased significantly relative to smaller institutions.

The FDIC has also modified its methodology for calculating assessment rates for these institutions, utilizing a "scorecard" that combines CAMELS ratings and certain forward-looking financial measures. Institutions that cross the $10 billion threshold could see their insurance premiums rise depending on the calculation of their assessment rate under the new scorecard methodology.

The $15 Billion Bank

Banking institutions with $15 billion or more in consolidated total assets as of Dec. 31, 2009 must phase out trust preferred securities (TruPS) from Tier 1 capital by 2016. Institutions below the $15 billion threshold are permanently grandfathered and may continue to include TruPS in their Tier 1 capital calculations.

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However, if a grandfathered-institution crosses the $15 billion threshold as a result of an acquisition transaction (as opposed to organic growth), the resulting institution would lose its grandfathered-status. Such an institution's TruPS would no longer qualify as Tier 1 capital and would have to be phased-out by 2016. As a result, institutions contemplating a merger transaction that would result in a greater than $15 billion institution must consider the costs of losing Tier 1 capital treatment if the combined institution would have TruPS on its balance sheet.

The $50 Billion Bank

These banking organizations (Large BHCs) are considered systemically significant under Title I of Dodd-Frank and become subject to substantial additional regulation, including enhanced prudential standards.

Most importantly, Large BHCs must submit annual capital plans to the FRB. Plans must include a BHC's expected uses and sources of capital over a nine-quarter planning horizon and a description of how the BHC will maintain sufficient capital, under expected and stressful conditions. A Large BHC generally may not make any capital distributions until the FRB issues a notice of non-objection to its capital plan.

Second, Large BHCs must submit annual resolution plans (or living wills) to the FRB and the FDIC setting forth in great detail a company's strategy for "rapid and orderly" resolution in the event of material financial distress or failure. In creating a living will, an institution must map its core business lines and critical operations to material legal entities and provide integrated analyses of its corporate structure, credit and other exposures, funding, capital and cash flows. An institution that fails to submit an acceptable living will to the regulators will be subject to more stringent capital and liquidity requirements and operating restrictions.

Third, Large BHCs are subject to an annual supervisory stress test conducted by the FRB that is intended to assess a company's capital adequacy and ability to absorb losses under stressed market conditions. Large BHCs are also required to conduct their own "company-run" stress tests on an annual and mid-year basis. Supervisory and company-run stress tests must evaluate a company's capital adequacy under baseline, adverse and severely adverse economic scenarios. Based on the stress test results, the FRB may require a company to raise additional capital to support its operations. The FRB and the company must publicly disclose summary results of the supervisory and company-run stress tests, respectively.

Fourth, Large BHCs would be subject to additional enhanced prudential standards under a December 2011 proposed rule issued by the FRB. That proposal is expected to be finalized by early 2014. As described by the FRB, the proposal would "provide incentives for covered companies to reduce their systemic footprint." Proposed enhanced prudential standards include the following:

- **Liquidity Management:** Large BHCs would be required to conduct internal stress tests on a monthly basis to measure their liquidity needs during times of financial instability and to hold a "liquidity buffer" of unencumbered highly liquid assets sufficient to meet projected net cash outflows for 30 days over a range of liquidity stress scenarios. Companies would also be required to adopt policies for managing liquidity stress events. Under a separate proposal issued by the FRB in October 2013, Large BHCs and SLHCs with assets greater than $50 billion would be required to satisfy a "liquidity coverage ratio" requirement, albeit one that is less stringent than the requirement that would apply to banking organizations with greater than $250 billion in consolidated assets.
- **Risk Committees:** In addition to establishing a risk committee that includes at least one risk management expert, a Large BHC must also employ a chief risk officer

who reports directly to both the risk committee and the CEO of the company and has the appropriate independence, expertise and stature to implement robust enterprise-wide risk management practices.

• **Single Counter-Party Credit Limits:** Large BHCs would be prohibited from having aggregate net credit exposure to any, one unaffiliated counterparty that exceeds 25 percent of the Large BHC's capital. A more stringent 10 percent limit would apply to very large BHCs (in excess of $500 billion in assets) with respect to their credit exposure to other very large institutions. The compliance burden associated with this rule is substantial as companies must submit a report to the FRB on a monthly basis demonstrating their daily compliance with the credit limits.

Fifth, under the proposed incentive compensation rule issued by the federal financial regulators, financial institutions with greater than $50 billion in consolidated assets must defer at least 50 percent of an executive officer's incentive-based compensation for at least three years. Amounts deferred must be adjusted for the actual losses of the covered financial institution, or other measures or aspects of performance that are realized or become better known during the deferral period. The ability to claw-back deferred compensation in the event of poor performance is intended to protect the institution by aligning the incentives of employees with the risks being undertaken.

Sixth, Large BHCs, SLHCs with consolidated assets greater than $50 billion and nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the FRB are subject to annual assessments equal to the amount of total expenses that the FRB estimates are necessary to carry out its supervisory and regulatory responsibilities with respect to these companies. In other words, these companies are required to pay for their own enhanced supervision on a pro-rata basis. Thus, as a company grows larger, it will be assessed a greater percentage of the FRB's total expenses.

Large BHCs may also be subject to assessments by the FDIC to pay for costs of the receivership of a failed financial company that was placed into receivership by the FDIC pursuant to Title II of Dodd-Frank. Title II grants the FDIC the power to serve as receiver for failed financial companies that pose a significant risk to the financial stability of the United States.

Seventh, the final capital rules adopted by the agencies in July 2013 require that Large BHCs make public disclosures about their regulatory capital on an annual and quarterly basis. Such disclosures must include quantitative and qualitative information.

The $250 Billion Bank

Banking organizations at this level are subject to additional capital and liquidity requirements that are intended to address the added complexity of such institutions and reduce systemic vulnerabilities.

First, they must comply with the Basel III "Advanced Approaches" methodology for computing risk-based regulatory capital. In addition to minimum capital requirements and a capital conservation buffer applicable to all banking organizations, Advanced Approaches banking organizations are subject to a countercyclical capital buffer of up to 2.5 percent of total risk-weighted assets. The countercyclical capital buffer may be activated by the regulators based on a range of financial and supervisory factors indicating an increase in systemic risk. Advanced Approaches organizations are also subject to a 3 percent supplementary leverage ratio.

Second, in October 2013, the federal bank regulators proposed a "liquidity coverage ratio" requirement for banking organizations with $250 billion or more in total assets consistent with the international liquidity requirements adopted by the Basel Committee, with certain modifications. A covered company would be required to maintain "high quality liquid assets" in an amount no less than 100 percent of its total net cash outflows over a prospective 30-day period. A company would be required to calculate its liquidity coverage ratio on a daily basis and to notify its regulator on any day that its liquidity coverage ratio is less than 100 percent. The rule is intended to enhance the ability of a covered company to meet its liquidity needs during acute short-term liquidity stress scenarios.

The $500 Billion Bank

BHCs at this level are subject to more stringent single counter-party credit limits that restrict the net credit exposure of these organizations to an unaffiliated counterparty of similar size to 10 percent of the BHC's capital and surplus. This restriction is intended to limit the interconnectedness of systemically important financial institutions and reduce the impact that the failure of any single large financial institution would have on other institutions and the financial system as a whole.

The $700 Billion Bank

Despite the Dodd-Frank reforms, the perception continues to exist in the marketplace that certain institutions are "too big to fail." To offset the potential advantages that these institutions might enjoy, the federal bank regulators proposed in July 2013 to increase the leverage capital requirements on banking organizations with greater than $700 billion in consolidated assets or $10 trillion in assets under custody (Very Large BHCs).[2] If adopted, such requirements may constrain the growth of these institutions or possibly result in their downsizing.

Specifically, federal bank regulators have proposed a rule to require insured depository institution subsidiaries of Very Large BHCs to meet a 6 percent "supplementary leverage ratio" to be considered "well capitalized" for purposes of the prompt corrective action (PCA) rules. Failure to be deemed "well capitalized" under the PCA rules could have various adverse effects on an institution.

The FRB has also proposed a new Tier 1 "leverage buffer" for Very Large BHCs of at least 2 percent above the minimum supplementary leverage ratio requirement of 3 percent applicable to banking organizations with $250 billion or more in assets. Failure to satisfy the new leverage buffer would subject Very Large BHCs to restrictions on discretionary bonus payments and capital distributions.

Conclusion

From our perspective as lawyers who evaluate mergers and acquisitions of, and controlling and noncontrolling investments in financial institutions, the "growth tax" imposed by Dodd-Frank and the bank regulators becomes an important consideration in both the economic realities and the regulatory implications and approvability of such transactions. Banks grow at their own risk now, understanding that the rules in place today can become even more punitive in the future. Whether restraining growth through additional regulation reduces or increases risk in the banking system remains to be seen. But the dynamics put in place create a new playing field for the banks on it and investors watching from the sidelines.

1. In July 2013, the Federal District Court for the District of Columbia struck down portions of the FRB's rule on interchange fees, stating that the statute contemplated an even lower fee cap. The FRB has appealed the decision.
2. The proposal indicated that there are 8 Very Large BHCs.