FEDERAL RESERVE AND COMPTROLLER ISSUE REGULATIONS PURSUANT TO THE GRAMM-LEACH-BLILEY ACT

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On January 19, 2000 the Board of Governors of the Federal Reserve System (the "Board") issued interim regulations concerning the qualifications and procedure for becoming a "financial holding company" (the "FHC Regulations").[1] The following day the Office of the Comptroller of the Currency (the "Comptroller") issued proposed regulations, concerning "financial subsidiaries" (the "Financial Subsidiary Regulations").[2] The regulations are discussed below.

THE FHC REGULATIONS

The Gramm-Leach-Bliley Act (the "GLBA") amended Section 4 of the Bank Holding Company Act of 1956 (the "BHC Act") to permit a bank holding company or a non-U.S. bank that qualifies as a financial holding company to engage, pursuant to new Section 4(k) of the BHC Act, in a broader range of financial activities, including insurance underwriting, banking, securities underwriting and dealing, and merchant banking activities, than may be engaged in by bank holding companies and non-U.S. banks that do not qualify as financial holding companies.[3] The FHC Regulations address the qualifications and procedures for becoming a financial holding company. The FHC Regulations do not address any of the other aspects of the GLBA, such as the parameters of the merchant banking activities contained in new Section 4(k) or the prescribed contents of the after-the-fact notice required in connection with acquisitions made pursuant to Section 4(k).

The FHC Regulations are "interim" regulations. Normally, the Board would issue proposed regulations for public comment and, after the comments are received, issue final regulations. The Board evidently did not believe that it would have sufficient time to complete this entire process by March 11, 2000, the effective date of the financial holding company provisions in the GLBA. The FHC Regulations will take effect on March 11, 2000, but the Board

1. *Bank Holding Companies and Change in Bank Control*, 65 Fed. Reg. 3785 (Jan. 25, 2000).

2. *Financial Subsidiaries and Operating Subsidiaries*, 65 Fed. Reg. 3157 (Jan. 20, 2000).

3. A detailed discussion of GLBA is provided in this Firm's memo, "The Gramm-Leach-Bliley Act" (November 17, 1999).

is soliciting comments until March 27, 2000 and it is likely to revise the FHC Regulations in response to such comments.

REQUIREMENTS FOR BECOMING A FINANCIAL HOLDING COMPANY

U.S. Banking Organizations

In general, the GLBA provides that a bank holding company may become a financial holding company if all its U.S. depository institution subsidiaries are well capitalized, well managed and have at least a satisfactory record of compliance with the Community Reinvestment Act of 1977 ("CRA"). In the case of U.S. banking organizations, there was little interpretation required by the Board in establishing requirements for becoming a financial holding company. A U.S. depository institution is well capitalized if it has a tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10%, and a leverage ratio of at least 5%. A U.S. depository institution is well managed if it received at least a satisfactory composite rating and at least a satisfactory rating for management and compliance at its most recent examination.

Non-U.S. Banks

The Board's treatment of non-U.S. banks in the FHC Regulations is surprising in two respects, both unfavorable. The GLBA instructed the Board to establish for non-U.S. banks that wish to be financial holding companies capital and management standards comparable to those that apply to U.S. bank holding companies, "giving due regard to the principle of national treatment and equality of competitive opportunity". Because most non-U.S. banks do not have a U.S. depository institution subsidiary, operating instead through U.S. branches and agencies, such comparable standards necessarily apply to the non-U.S. bank itself. With regard to the "well capitalized" standard, the FHC Regulations provide that a non-U.S. bank, at the time that it files for financial holding company status, must have a tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10%, in each case under the risk-based capital rules established by its home country regulator pursuant to the Capital Accord of the Basel Committee on Banking Supervision (the "BIS Guidelines").

One of the surprises in the FHC Regulations is that the Board also will require non-U.S. banks that wish to become financial holding companies to have a leverage ratio of at least 3%. The leverage ratio is calculated by dividing tier 1 capital by total (on-balance sheet) assets. The BIS Guidelines do not contain a leverage requirement and many non-U.S. banks are not subject to leverage ratio requirements under the rules of their home country regulator. Although the 3% leverage ratio requirement is less than the 5% leverage ratio that is required in order for a U.S. depository institution to be considered well capitalized, in the past the Board has not applied a leverage requirement in determining whether a non-U.S. bank has capital equivalent to what would be required for a U.S. bank holding company. For example, the leverage standard has not been applied to non-U.S. banks that have applied to establish a Section 20 subsidiary. The inclusion of a leverage ratio is somewhat surprising and it is possible that the

Board, after receiving comments on the interim regulation, will drop the leverage ratio requirement. However, for the moment at least, it is one of the requirements that a non-U.S. bank must meet in order to be considered "well capitalized" for purposes of the FHC Regulations.

Even if a non-U.S. bank meets all of the above requirements, the Board must still make a determination that the non-U.S. bank's capital is "otherwise comparable to the capital that would be required of a U.S. bank owned by a financial holding company".

The well managed criterion is satisfied by a non-U.S. bank if the U.S. branches and agencies of the non-U.S. bank have received at least a satisfactory composite rating from the U.S. regulators. In addition, the home country regulator must also consider the overall operations of the non-U.S. bank to be satisfactory.

Although a holding company for a non-U.S. bank may file to become a financial holding company, the well capitalized and well managed criteria apply only to the non-U.S. bank itself. The criteria do not apply to one or more holding companies that control a non-U.S. bank. However, if the non-U.S. banking organization has more than one non-U.S. bank that has a branch or agency in the United States, then each such non-U.S. bank must be well managed and well capitalized for either non-U.S. bank or their holding company to qualify as a financial holding company.

The second surprise in the Board's treatment of non-U.S. banks is that a non-U.S. bank that is a bank holding company because it has a U.S. bank subsidiary is not treated the same as a U.S. bank holding company. Instead of requiring only that the U.S. depository institution subsidiary be well capitalized and well managed, which is the case for U.S. bank holding companies, a non-U.S. bank that has a U.S. depository institution subsidiary must meet the standards at both levels: not only must its U.S. depository institution be well capitalized and well managed, but the non-U.S. bank itself must be well capitalized and well managed. In our view, this approach is not consistent with the GLBA requirement that the Board give "due regard to the principle of national treatment and equality of competitive opportunity".

THE PROCESS FOR BECOMING A FINANCIAL HOLDING COMPANY

The procedure established in the FHC Regulations for becoming a financial holding company is for the bank holding company or non-U.S. bank to file a written declaration that it elects to be a financial holding company, together with a certification that it (or its depository institution subsidiaries, if applicable) meets the relevant standards. The FHC Regulations provide that an election by a U.S. bank holding company to become a financial holding company is effective unless the Board determines, within 30 days, that a depository institution subsidiary of the company is not well capitalized, well managed, or does not have a satisfactory CRA record. In the case of non-U.S. banks, the election to become a financial holding company is not effective until the Board informs the non-U.S. bank that it meets the standards for becoming a financial holding company. Except for the CRA criterion, no waiting period is

contemplated by the GLBA. For many U.S. banking organizations, the thirty day waiting period will not have any practical significance because the Board will accept financial holding company certifications now and will attempt to act on certifications filed on or before February 15, 2000 in time for such filers to commence activities and acquisitions on March 13, 2000, the effective date of the financial holding company provisions in the GLBA. It remains to be seen how promptly the Board will act on filings by non-U.S. banking organizations to become financial holding companies. The Board's extreme slowness in the first few years after passage of the Foreign Bank Supervision Enhancement Act of 1991 to act on applications from non-U.S. banks to establish U.S. offices may be an inauspicious precedent.

The FHC Regulations also provide that the Board may restrict or limit the activities of, or acquisitions by, a financial holding company if it believes that the holding company lacks the financial or managerial strength to engage in such activities or make such acquisitions. This is consistent with the GLBA in that financial holding companies are bank holding companies and the Board has authority under Section 5 of the BHC Act to supervise (including the establishment of capital requirements for) bank holding companies. However, the use of this authority is in tension with the general approach of the GLBA, which bases financial holding company status on whether the depository institution subsidiaries of a bank holding company, not the holding company itself, meet the relevant standards.

CEASING TO QUALIFY AS A FINANCIAL HOLDING COMPANY

A financial holding company that no longer meets all of the requirements for that status is required to inform the Board of the nature of the deficiency. Within 45 days of such notification (or of being notified by the Board of such a deficiency), a financial holding company is required to enter into an agreement with the Board to take the steps necessary to remedy the deficiency. During the period of noncompliance, a financial holding company may not engage in any additional activity or make any additional acquisitions pursuant to Section 4(k), although it is not precluded from seeking the prior approval of the Board to make acquisitions or engage in an additional activity pursuant to Section 4(c)(8), the authority under which banking organizations that are not financial holding companies engage in nonbanking activities. If the condition in question is not corrected within 180 days, the company may be required to divest its depository institution subsidiaries or (within the 180 days) cease to engage in activities or make acquisitions that are permissible only for financial holding companies.

The consequences of a depository institution subsidiary failing to retain at least a satisfactory CRA record are less severe. During the period in which the subsidiary does not have a satisfactory CRA record, the financial holding company may continue to make additional investments as part of its merchant banking, investment banking or insurance company investment activities. Such a company is not permitted to make other acquisitions or engage in new activities pursuant to Section 4(k) or Section 4(n) of the BHC Act, but it is not required to terminate any such activities commenced (de novo or by acquisition) prior to the time it received a less than satisfactory CRA rating.

THE FINANCIAL SUBSIDIARY REGULATIONS

INTRODUCTION

As discussed in detail in this Firm's November 17, 1999 memo regarding the GLBA, one of the key compromises that allowed the passage of the GLBA concerned the ability of national banks to engage in financial activities that are not permissible for the bank itself through "financial subsidiaries". As discussed in detail in our prior memorandum, the GLBA permits well managed and well capitalized national banks with investment grade long-term debt outstanding to establish financial subsidiaries to engage in the financial activities permissible for financial holding companies, except for insurance underwriting, real estate investment and development, and merchant banking activities. A financial subsidiary is required to be insulated from the parent bank in a number of ways: investments by the bank in the financial subsidiary are limited and loans by the bank to the financial subsidiary are virtually prohibited as a result of treating the financial subsidiary as an "affiliate" of the bank for purposes of Section 23A of the Federal Reserve Act;[4] the bank's investment in the financial subsidiary is deducted from the tangible capital of the bank for purposes of capital adequacy calculations; the bank must implement procedures and policies that preserve the separate corporate identity and limited liability of the bank from its financial subsidiaries.

The GLBA did not eliminate "operating subsidiaries", which are not subject to any of the restrictions described in the preceding sentence, but it did eliminate the Comptroller's authority to permit operating subsidiaries to engage in activities in which the parent bank is not permitted to engage.

THE PROPOSED REGULATIONS

In drafting the Financial Subsidiary Regulations the Comptroller closely tracked the relevant provisions in the GLBA, which were intended to give the Comptroller very little discretion in determining the types of activities that may be conducted in financial subsidiaries and operating subsidiaries and in establishing the conditions and restrictions that apply to financial subsidiaries. These activity limitations, conditions, and restrictions are described in detail in our November 17, 1999 memorandum and will not be repeated here.

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4. The GLBA broadens the restrictions of Section 23A to also specify that any purchase of, or investment in, the securities of a financial subsidiary by a bank's affiliates will be treated as a direct purchase or investment by the bank itself; and the Board may determine to treat any extension of credit to a financial subsidiary by a bank's affiliates as a direct extension of credit by the bank itself. The effect of these provisions is to place a bank financial subsidiary at a disadvantage compared to a subsidiary of a financial holding company, since the latter will not be subject to any limitations on funding or other transactions with its non-depository affiliates.

However, there are a few points worth noting. First, the procedures proposed by the Comptroller are not burdensome. A national bank that wants to establish a financial subsidiary need only provide the Comptroller with five days prior notice (as compared to the 30 day Board review of financial holding company certifications).

Second, the treatment of insurance agency activities does not appear to be consistent with the GLBA. It is clear that the GLBA permits financial subsidiaries of national banks to engage in insurance agency activities. It is also clear that the GLBA does not affect the authority of national banks to engage in insurance agency activities pursuant to 12 U.S.C. §92 in "any place the place the population of which does not exceed 5,000 inhabitants", an exemption that the Comptroller has interpreted broadly enough so that it can be used to conduct a nationwide insurance business. Consistent with the GLBA, the Financial Subsidiary Regulations provide that a national bank may only engage in activities through an operating subsidiary (which are not subject to the funding and capital restrictions that apply to financial subsidiaries) only in activities that are permissible for the parent national bank to engage in directly and only subject to the same terms and conditions as apply to the parent bank. However, the Financial Subsidiary Regulations permit operating subsidiaries to engage in insurance agency activities without the "town of 5,000" restrictions that apply if such activities are engaged in by the parent bank.

The third noteworthy aspect of the Financial Subsidiary Regulations is the following request for comments:

> . . . while as a matter of corporate law a subsidiary of a branch or agency of a foreign bank would technically be a subsidiary of the parent bank, for regulatory purposes the company could be treated as if it were a subsidiary of the branch or agency itself, provided the company is in fact operated in that manner. Thus, the OCC also seeks comment on whether national treatment principles would be furthered if Federal branches and agencies of foreign banks are authorized (as are national banks) to invest in financial and operating subsidiaries, and, if so, how the applicable qualification standards would be applied.[5]

In addition to constituting a reversal of an existing Comptroller staff opinion that a U.S. branch or agency cannot have a subsidiary, the proposal raises a regulatory jurisdiction issue. The Board considers U.S. subsidiaries of non-U.S. banks to be subject to Section 4 of the BHC Act. It is likely that the Board will continue to assert jurisdiction over such subsidiaries and to require all applicable BHC Act approvals to be obtained by them, regardless of how the Comptroller treats such subsidiaries.

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5. 65 Fed. Reg. 3160.

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