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Zions to Shed Its Holding Company – Will Others Follow?

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This blog post lays out the pros and cons that boards and senior management of regional and community banking organizations should consider in light of the Zions decision to shed its bank holding company.[1] Some have suggested that directors of BHCs now have a fiduciary duty to consider shedding their holding company structure. This is too strong a recommendation in our view. There are many pros and cons to eliminating a BHC, and whether doing so makes sense for any given banking organization will depend upon its business model, range of securities and insurance activities, number of beneficial owners, potential need to raise capital in the near future and current supervisory relationships.

While we do not think that size alone is a determinant, Zions Bancorporation, at $66 billion in total assets, is the largest BHC to merge into its bank subsidiary. Previous banking organizations that have done so, such as Bank of the Ozarks at $22 billion in total assets, are much smaller. Both Zions and Ozarks, however, share the classic community bank business model with very limited securities, insurance or merchant banking activities. The largest publicly traded standalone bank is First Republic Bank, a state-chartered bank that is not a member of the Federal Reserve System, which had $87.8 billion in total assets as of December 31, 2017. First Republic has a different business model, that of wealth management, but it does not engage in corporate debt or equity underwriting. Neither Zions nor Ozarks engages in any significant corporate debt or equity underwriting.

The pros and cons that ought to be considered by a banking organization include:

- **The organization's future need to raise more capital.**
    - The number of BHCs that are publicly traded companies dwarfs the number of standalone banks that are publicly traded. As a result, the market for standalone bank securities is generally less developed and

may be less deep than the market for BHC securities. This may adversely affect the liquidity and pricing of securities issued by standalone banks compared to those issued by BHCs. Of course, family owned banking groups or those with thinly traded equity or fewer than 2,000 beneficial owners may not find the relative depth of the overall markets to be a meaningful factor for them, whether they are headed by a BHC or a standalone bank, since the market for them is thin under either alternative. Moreover, many of these banking groups may be exempt from Securities Exchange Act registration under the JOBS Act.

- Public offerings of securities issued by a national bank, as opposed to those issued by a BHC, are subject to the public offering and periodic reporting rules of the OCC (Part 16 and Part 11, respectively, of the OCC's regulations) and OCC oversight rather than the rules and oversight of the SEC. The OCC has far less experience than the SEC in overseeing public offerings and periodic reporting requirements, and its body of interpretations and guidance is far less developed. As result, it typically has been more cumbersome and time-consuming to obtain answers to questions from the OCC for disclosure, accounting and other issues that arise in the public offering or periodic reporting areas than from the SEC.
- The same is true for state member and nonmember banks, which are subject to the securities offering rules – such as they are – and oversight of the Federal Reserve and the FDIC, respectively, instead of the rules and oversight of the SEC. The FDIC, like the OCC, has adopted securities rules, but the Federal Reserve, whose rules apply to state nonmember banks, has not even published securities offering regulations.[2]

- A BHC that is not subject to CCAR is not generally required to obtain Federal Reserve approval prior to raising new capital; a national bank of any size must receive OCC approval prior to increasing its permanent capital in certain cases, such as issuing shares for non-cash consideration or receiving a material non-cash contribution. Whether state-chartered member or nonmember banks need approval to increase their capital is a function of the laws of the state in which it is chartered.

- **OCC or FDIC as primary Federal regulator.** Shedding a bank's holding company parent can simplify the firm's regulatory oversight and remove the firm from Federal Reserve supervision entirely. While there may be some benefits to this approach, boards and senior management should also consider the nature and risks of any alternative primary regulator. For a banking organization with a national bank subsidiary, merging the holding company into the national bank would result in the OCC becoming the firm's primary banking regulator. For a banking organization with a state nonmember bank subsidiary, merging the holding company into the state nonmember bank would result in the FDIC becoming the firm's primary Federal banking regulator. The board and senior management should take into account that the Comptroller will change with Presidential administrations while the FDIC Chairman and Directors, Federal Reserve Governors, and state banking regulators do not change with changes in Presidential administrations or change more slowly. The political risk for a national bank therefore has the potential to be more volatile, for better or worse, than for a state-chartered bank, depending upon the state in which it is chartered.
- **Limitations on securities activities.**
  - A BHC that qualifies as a financial holding company (FHC) under the Gramm-Leach-Bliley Act may have broker-dealer subsidiaries. Without a holding company structure, however, federal and state laws and regulations severely limit or make difficult the securities activities of banks and their subsidiaries. A large number of BHCs, 488 as of 2015, have chosen to become FHCs.[3] Any board or senior management reconsidering whether it wants to keep its BHC needs to evaluate the pros and cons of the expanded authorities under the Gramm-Leach-Bliley Act.
    - Smaller BHCs without any broker-dealer activities or that have solely bank-eligible broker-dealer activities may find shedding their BHC more attractive. We discuss the pros and cons of a financial subsidiary below.
    - But larger community or regional banks that have a business model that includes underwriting and dealing in corporate debt and equity will find that shedding the BHC means a choice between giving up those activities or using the rarely chosen financial subsidiary option discussed below.

- Merchant banking investments and, if the Volcker Rule regulations are relaxed, venture capital investments via venture capital funds would be unavailable. While these activities are not key to the business models of many small community banks, we believe that local and regional investments are important to larger community and regional banks.
- Most FinTech investments and partnerships ought to be unaffected.

- Another option that might permit shedding the BHC is to use a financial subsidiary under the bank. A financial subsidiary is permitted to engage in a broader range of securities activities, such as underwriting corporate debt and equity, than those permitted in the bank itself. It is rarely chosen, however, because it is capital expensive. A bank must deduct the amount of its investment in any financial subsidiary from its regulatory capital. This is not the case for a broker-dealer held by a BHC outside the bank ownership chain. It is thus more costly from a capital perspective to have a broker-dealer that can engage in a broader range of securities activities held by a bank than by a BHC outside the bank ownership chain.
- Even if a bank's broker-dealer subsidiary engages solely in bank-eligible securities activities, the top-tier bank parent company generally consolidates the assets of any of its broker-dealer subsidiaries on its balance sheet and for regulatory capital purposes. These assets, and any fluctuations in the value of these assets, would directly affect the bank's financial condition and regulatory capital ratios. The business impact of consolidating the broker-dealer's assets on the bank's balance sheet will depend upon the size of the broker-dealer and the composition of its assets.

- **Insurance activities.** A BHC that qualifies as an FHC may also have insurance company subsidiaries that engage in the full range of insurance underwriting and brokerage activities. The insurance activities of a standalone bank are generally much more limited.
- **EGRRCPA.** For regional banking organizations, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) – which was enacted after Zions announced its plan to merge its holding company into its national bank subsidiary – should also be considered. EGRRCPA immediately raised the threshold for systemic importance from $50 billion to $100 billion in

> assets and thus reduced the regulatory costs for BHCs in this range by exempting these BHCs from most of the Federal Reserve's EPS. The Act will raise the systemic threshold still further to $250 billion in assets effective 18 months after enactment, except to the extent the Federal Reserve provides otherwise for BHCs with assets in this range.[4] Of course, even a BHC exempt from the Federal Reserve's EPS under the newly raised asset thresholds is still subject to Federal Reserve supervision.

At the end of the day, each community and regional BHC board and senior management will need to examine whether escaping the Federal Reserve's supervisory embrace is a sufficient advantage in light of its capital raising needs and whether its business model includes any of the expanded securities underwriting and insurance powers granted under Gramm-Leach-Bliley. Our sense is that while the boards and senior management of many BHCs may look at the topic, those with the simplest business models and limited needs for future capital raising will find the option most attractive.

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[1] On September 12, the FSOC **formally determined** that when Zions Bancorporation – Zions' BHC – merges into its national bank subsidiary – ZB, N.A. – the surviving national bank parent company will be exempt from the Federal Reserve's enhanced prudential standards (EPS), including stress testing, resolution planning and other requirements. These EPS technically apply to large BHCs and nonbank financial companies designated by the FSOC to be subject to Federal Reserve supervision but, with minor exceptions, not to other financial companies such as banks. Section 117 of the Dodd-Frank Act provides that any entity that was a BHC with $50 billion or more in total consolidated assets at the time it received federal funds through the Troubled Asset Relief Program (or TARP, established during the financial crisis), and any successor entity to such an entity, will continue to be subject to the Federal Reserve's EPS as a nonbank financial company, even if the entity later ceases to be a BHC, unless the FSOC determines otherwise. Zions Bancorporation took TARP funds, so the firm's surviving national bank parent company would have remained subject to EPS without the exemption from FSOC. Any firm that either did not receive TARP funds or was under $50 billion in assets at the time it took TARP funds would not need to obtain a similar exemption from FSOC to escape EPS if it shed its holding company.

[2] First Republic Bank has publicly issued securities and submitted periodic reports for many years under the rules and subject to the oversight of the FDIC instead of the SEC.

[3] Michael S. Barr, Howell E. Jackson, Margaret E. Tahyar, Financial Regulation: Law and Policy at 699 (2nd Ed. 2018).

[4] The FSOC's determination exempting Zions from Section 117 of the Dodd-Frank Act was almost certainly influenced heavily by the recent enactment of EGRRCPA, which would have exempted Zions from EPS had it kept its BHC because the firm has less than $100 billion in assets.