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filed via e-mail

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: FRB Docket No. R-1235; Proposed Revision of the Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors; 70 Federal Register 53320; September 8, 2005

Dear Ms. Johnson:

The Federal Reserve Board (the Board) has proposed to update its 1980 Small BHC Policy Statement on Assessment of Financial and Managerial Factors (the Policy Statement). The existing Policy Statement applies only to bank holding companies (BHCs) under \$150 million that are (i) not engaged in any nonbanking activities involving significant leverage; (ii) not engaged in any significant off-balance sheet activities; and (iii) not with a significant amount of outstanding debt held by the general public. Such small BHCs are allowed to maintain a higher debt leverage ratio and a longer period for repayment of the debt, reduced regulatory requirements for some applications, and other adjustments for these smaller, less risky BHCs. The Board now proposes to raise the threshold for small BHCs to \$500 million, subject to proposed revised restrictions. The majority of ABA members and their bank holding companies are under \$500 million in assets. The American Bankers Association, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country.

General Comments

The American Bankers Association (ABA) has urged the Board to raise the threshold to \$500 million several times over the last nine years. For example, in 1999, ABA wrote to Governor Meyer:

“The majority of ABA's members are community banks. Over the last few years, ABA has increasingly heard from these members that they believe that the Board's Policy needs to be updated. They have suggested not only that the limit needs to be increased but also that the debt-to-equity ratio for small BHCs should also be increased, particularly in light of the increased share prices for community banks, if

the Policy is to provide meaningful assistance to community banks in making acquisitions and other shareholder transactions, as it was intended to do.”¹

ABA believes that is even more true now in 2005, and therefore ABA strongly supports the Board’s proposal. However, the proposal makes some significant changes in the conditions that prohibit a bank holding company from using the Policy Statement, and ABA believes that these restrictions should be modified to better effectuate the Board’s purposes in imposing these conditions.

ABA Recommendations to Revise the Proposed Conditions

In order for a small BHC qualify for treatment under the Policy Statement, the Board proposes to require that it:

- (i) is not engaged in significant nonbanking activities, either directly or through a nonbank subsidiary;
- (ii) does not conduct significant off-balance sheet activities, including securitizations or managing or administering assets for third parties, either directly or through a nonbank subsidiary; or
- (iii) does not have a material amount of debt or equity securities (other than trust preferred securities) outstanding that are registered with the Securities and Exchange Commission.

Additionally, the Board proposes to require that trust preferred securities be treated as debt under most of the requirements of the Policy Statement.

Is not engaged in significant nonbanking activities, either directly or through a nonbank subsidiary. The Policy Statement currently provides that a small BHC is eligible if it is “not engaged in any nonbanking activities involving significant leverage.” ABA believes that this change may have an unnecessarily restrictive effect upon community banks and their holding companies. We have heard from several members that they are concerned that the bank’s affiliated insurance agency, a purely agency activity, may generate significant revenue to the holding company that could be interpreted by the Board’s staff as a “significant nonbanking activity.” We believe that the Board should provide that purely agency nonbanking activities should not be deemed to be a disqualifying significant activity.

The Board writes that the reason for these changes is the increased authority for bank holding companies to engage in new activities that may pose significant operational risk, even though the activity is not significantly leveraged. “The more limiting reference to significantly leveraged nonbanking activities would be deleted, since nonleveraged activities may also entail significant risk, such as operational risk. The examples provided—securitizations and managing or administering assets for third parties—highlight two areas of offbalance sheet activities that may involve substantially larger operations and risk than balance sheet measures would indicate. These examples are not intended to be exclusive and other activities may well present similar concerns.”² While we understand and agree with the Board’s intentions, we believe that the actual formulation of the condition will disqualify some community BHCs that in fact have significant nonbanking activities but which activities do not pose significant operational risks, such as with an insurance agency.

ABA notes that the Federal Deposit Insurance Corporation (FDIC) is required by law to not allow a state nonmember bank to engage in any activity not allowed for a national bank unless it has determined that the activity does not pose a significant risk to the insurance funds. The FDIC has regulations imposing these limits on activities of state banks (Part 362 of the FDIC’s regulations), but the FDIC exempts activities conducted by the bank as agent. ABA urges the Board to make a similar exception in its conditions for such agency activities. At a minimum, ABA urges the Board to except purely insurance agency activity from being considered a significant activity that would bar use of the Policy Statement.

¹ ABA Letter to Governor Meyer from James McLaughlin, dated July 23, 1999.

² 70 FR 53321.

Does not conduct significant off-balance sheet activities, including securitizations or managing or administering assets for third parties, either directly or through a nonbank subsidiary. ABA members have asked whether this would include assets of the bank's trust department, a traditional banking activity. ABA staff have consulted with Board staff and have been told that assets under management in a trust department of the bank would not be directly managed by the BHC and would, since in the bank's trust department, not be through a nonbank subsidiary. Therefore, bank trust assets would not be counted toward this restriction on significant off-balance sheet activities. ABA supports this interpretation, but requests that the Board add a clarification to the regulation making this plain.

However, ABA is still concerned that a small BHC might own a separately chartered trust company that does not take deposits. Under the Bank Holding Company Act, a "bank" does not include such an institution that functions solely in a trust or fiduciary capacity. Such a trust company might hold sufficient assets so as to be a significant off-balance sheet activity, yet it could pose no significant operational risk. The Board apparently does not provide for any mechanism for a small BHC to request that it be allowed to use the Policy Statement if it can show that, while it does not meet the conditions of the Policy Statement, nonetheless, the significant nonbank activities it conducts do not pose any significant operational risk. ABA recommends that the Board add a provision allowing a BHC to request such a determination from the appropriate Federal Reserve District Bank. If the Federal Reserve District Bank's supervisory determination is that the nonbank activity did not pose significant operational risk, then the BHC would qualify for use of the Policy Statement.³

Does not have a material amount of debt or equity securities (other than trust preferred securities) outstanding that are registered with the Securities and Exchange Commission. The Board writes that "The revision of the final criterion to exclude from the Policy Statement any BHC that has outstanding a material amount of SEC-registered debt or equity securities reflects the fact that SEC registrants typically exhibit a degree of complexity of operations and access to multiple funding sources that warrants excluding them from the Policy Statement and subjecting them to consolidated capital requirements." Thus it is clear that the Board is trying to restrict eligibility for the Policy Statement to small, noncomplex BHCs with access to multiple funding sources. However, SEC registration can be triggered by just an increase in the number of shareholders to 500 or more. Any subsequent issuance of debt or equity likely would have to be registered with the SEC, and this might well disqualify the BHC from being eligible for the Policy Statement.

ABA is concerned that this inadvertently will exclude small BHCs that should not be excluded. Several community BHCs have experienced such shareholder increases arising solely or primarily from intergenerational transfers. Banks over 100 years old may well have had their shareholder list expand just through inheritance, generation after generation, from an initial 20 or 30 to 500 or 1000 or more. Most of these institutions in fact will not exhibit the degree of complexity of operations or access to multiple funding sources that the Board believes should disqualify them. The Board needs to provide a mechanism for such an institution to petition for a supervisory determination that, despite having SEC registered debt or equity, the institution should qualify for the Policy Statement because it is neither complex in operation nor easily able to access the capital markets.

The inclusion of trust preferred securities (TPS) as debt in calculating the debt limits. Trust preferred securities as a funding mechanism for additional capital was not approved by the Board until some 15 years after the Policy Statement was issued. Currently under the Policy Statement, such subordinated debt as TPS on the parent company balance sheet is not treated as debt. However, the cash-flow impact of the subordinated debt is included in the review of the financial condition of a BHC. The Board is proposing to address TPS by providing that such subordinated debt would be included as debt in determining whether (i) a qualifying small BHC's acquisition debt is 75 percent or less of the purchase price; or (ii) a qualifying small BHC's debt-to-equity ratio is greater than 1.0:1 (the ratio above which a qualifying small BHC is subject to dividend restrictions and is not permitted to use the expedited applications processing procedures or obtain a

³ ABA notes that the Board provides that it may deny the use of the Policy Statement on a case-by-case basis "regardless of asset size, if such action is warranted for supervisory purposes." ABA suggests that the Board should provide for the reverse situation, where denial of the use of the Policy Statement is not warranted for supervisory purposes.

waiver of stock redemption filing requirements under Regulation Y). However, a qualifying small BHC may exclude from debt an amount of subordinated debt associated with trust preferred securities equaling up to 25 percent of a small BHC's equity (as defined in the Policy Statement), less parent company goodwill in determining compliance with these requirements. Further, the Board is proposing to provide for a five-year transition period during which subordinated debt associated with trust preferred securities issued on or prior September 8, 2005, would not be considered debt under the Policy Statement.

ABA has consulted with a number of community BHCs that have issued TPS as to whether this proposed restriction would be unduly constraining on them. None of them reported that they thought that it would, at least in part because of the long transition period proposed by the Board. However, all of the bankers consulted were concerned that this was but a first step by the Board in disallowing the use of TPS for Tier 1 capital. All of them expressed the belief that this would be a serious mistake and a significant loss of a major financial resource for community BHCs and their banks. ABA therefore wishes to echo their concerns and urge the Board to clarify the TPS is not debt and will continue to be eligible for Tier 1 capital treatment.

Conclusion

ABA appreciates the opportunity to comment on this proposal, and commends the Board for seeking to update the Policy Statement. ABA supports the proposal, but recommends that the Board adjust the conditions that would unnecessarily bar use of the Policy Statement by some BHCs. In particular, ABA recommends that the Board allow some mechanism for a supervisory review of a BHC to determine whether there are any operational risks or complexities of operation that should bar the BHC from use of the Policy Statement. If not, then the BHC should be allowed the benefits of the Policy Statement. If the staff has any questions about this letter, please call the undersigned.

Sincerely,

A handwritten signature in cursive script that reads "Paul Alan Smith".

Paul Smith
Senior Counsel