

Transcript of Open Board Meeting

April 23, 2019

CHAIR POWELL. Good afternoon everyone. I'd like to welcome our guests here at the Fed, and also our online viewers. Today, we will consider seeking public comment on a proposal to substantially increase the transparency around how the Board of Governors determines whether a company controls a bank, and thus becomes subject to Federal Reserve supervision and regulation.

The Board's framework for determining what constitutes control has developed over many years through an accumulation of complex precedence that can be difficult for the public to understand and to apply with confidence.

The proposal before us sensibly lays out publically the factors and thresholds that the Board would consider to determine if a company has control over a bank. The factors include, among other things, total equity and voting stock investments, director and employee interlocks, and the scope of business relationships between the company and the bank.

Our proposal recognizes that different combinations of each factor may result in control of a bank. If a company wishes to make an investment in a bank, but does not want to be in control, the proposal clearly shows the combinations that would and would not trigger control.

This proposal is an important step forward in our ongoing efforts to enhance the Board's transparency and accountability. Providing all stakeholders with clearer rules of the road for control determinations will responsibly reduce regulatory burden. As a result, it will be easier for banks, particularly community banks to raise capital to support lending and investment.

I look forward to hearing the staff presentations, and will now turn it to my colleague Vice Chair Quarles.

VICE CHAIR FOR SUPERVISION QUARLES. Thank you. Thank you Mr. Chairman, good afternoon everyone. First, let me start by thanking the staff here for their work on this important project to update a fundamental area of the Board's regulatory framework for bank holding companies, and savings

and loan holding companies. It really has been excellent work, excellent working with this group of people here in front of us.

The concept of control is a threshold issue for the Board because it determines the perimeter of the Board's supervisory and regulatory authority over depository institution holding companies. Under the Bank Holding Company Act and the Home Owners Loan Act, the board is charged with oversight over companies that control a bank or a savings association. And companies that control a bank or savings association are bank holding companies, or savings loan holding companies, and thus subject to the Board's supervision and regulation.

The Board's control regime has developed over many decades through a common law process, and has become of the more ad hoc and complicated areas of the Board's regulatory administration. The Board's control regime has developed over many decades through a common law process and has become a little more ad hoc and complicated areas of the Board's regulatory administration. The complexity and relative lack of transparency of the Board's case-by-case approach to control can impose a substantial compliance and uncertainty burden on both banking organizations and investors in banking organizations.

The proposal being considered today is intended to enhance the predictability, simplicity, and transparency of the Board's framework for evaluating control. Historically, the Board has decided most questions of control based on the specific facts and circumstances presented by each particular case. And as a consequence it has too often been difficult for banking firms and investors in banking firms to determine in advance whether a particular proposed investment could give rise to control concerns. This proposal would improve the predictability and simplicity of the Board's control framework by establishing a broadly applicable and uniform set of rules to address the large majority of control fact patterns.

Equally unsatisfactory, many of the control doctrines of the Board and staff have been unwritten, or have been written but not well publicized, or in some cases even disseminated. And as a result, the practical determinants of when the Board will deem one company to control another, can in some cases not be discovered except through supplication to a small handful of people who have spent a long

apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco.

Another result is that most of the control doctrines of the Board and staff also have never gone through the crucible of a public comment process. The proposal would improve the transparency of the Board's control framework by placing substantially all of the Board's control positions into a comprehensive public regulation and putting that regulation out for public comment to improve their content and consistency.

The substance of the control standards set forth in this proposed regulation generally would be consistent with the Board's current control framework, although the proposal contains a number of policy adjustments that staff will describe in greater detail.

I very much look forward to public feedback on the proposed rule. And I'll now turn it over to Mark Van Der Weide of the general counsel, to kick off the staff presentations.

MARK VAN DER WEIDE. Thank you Vice Chair Quarles. As the mezzanine tranche speaker today I will keep my remarks very short. Over the past 18 months or so the staff has performed a, what I like to call a revaluation of all control values at the Federal Reserve. And the project was a great team effort by staff and the legal division, but also from the Division of Supervision and Regulation, and Research and Statistics. And the proposal that you have before you today is the fruits of that interdivisional labor.

In short, I think the proposal will simultaneously improve compliance by banks and investors with our control rules, but also reduce compliance burden for banks and their investors, a win-win.

Let me turn now to Mark Buresh and Greg Frischmann to provide an overview of the architecture of the proposal.

MARK BURESH. Thank you Mark. The proposal that the Board is considering today would revise the Board's regulations to provide greater clarity and transparency to the Board's views on control

under the Bank Holding Company Act and the Home Owners Loan Act. The proposal would be open for comment for 60 days after publication in the Federal Register.

I will begin by describing the underlying statutory framework, and then by introducing the regulatory proposal. Greg Frischmann will then discuss the specifics of the proposal. Our colleagues will help answer questions following staffs' prepared remarks.

Under the Bank Holding Company Act, a bank holding company is defined as a company that controls a bank. Under the Home Owners Loan Act, a savings and loan holding company is defined as a company that controls a savings association. Control is therefore a key threshold question, because it determines what companies are bank holding companies and what companies are savings and loans companies?

Bank holding companies and savings holding companies are subject to the Board's supervision and regulation, as well as restrictions on certain activities. Moreover, any company that is controlled by a bank holding company or a savings and loan holding company must lend its activities to those permissible for a subsidiary of a regulated holding company.

The Bank Holding Company Act provides three tests for control, two of these tests are easy to apply bright-line tests. First, a company controls another company if it controls 25 percent or more of any class of voting securities of the other company. Second, a company controls another company if it controls the election of the majority of directors of the other company. The third test for control is a more -- is more complex, because it involves a fact-based determination by the Board. Under this third test, a company controls another company if the Board determines that it directly or indirectly exercises a controlling influence over the management and policies of the other company. The definition of control in the Home Owners Loan act is substantially similar.

The text and legislative history of the Bank Holding Company Act provides some guidance on what constitutes a controlling influence. On the one hand, it is clear that possession of a small amount of influence would not amount to a controlling influence. On the other hand, it is also evident that a company does not have to possess absolute control over another company in order to exercise controlling

influence. Therefore, a range of investments and other relationships in combination may raise controlling influence concerns if they produce substantial levels of control, but are short of absolute control.

In assessing whether one company has the ability to exercise a controlling influence over another company, the Board has been mindful of the congressional objectives of the definition of control. Congress sought to ensure that companies that control banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner. In addition, Congress sought to ensure that companies that control banking organizations have the capacity to serve as a source of strength to those organizations.

The statutory framework ties the potential upside benefits of having control over a banking organization to responsibility for the potential downside results of exercising that control. By tying control and responsibility together, the statutory framework ensures that companies not only have positive incentives to run a successful banking organization, but also bear the costs of their significant involvement in the banking organization's decision making process. This protects taxpayers from imprudent decisions by companies that control banking organizations.

Historically, the Board and staff have reviewed whether a company has a controlling influence over another company by assessing the facts and circumstances of the relationship between the two companies. These reviews frequently involve confidential business information and often are not issued publicly. Over time, review of controlling influence on a case by case basis led the Board and staff to develop general standards for common controlling influence questions. These general standards have not been included comprehensively in regulation.

Banking organizations may find it difficult to evaluate questions of control due to the lack of a comprehensive public statement describing the common features of investments that have raised controlling influence concerns. This has caused banking organizations and others to raise concerns about the fairness and transparency of the Board's current controlling influence framework.

Banking organizations have stated that the lack of transparency around the Board's current control framework causes difficulty for banking organizations seeking to raise capital. In addition, banking

organizations have stated that the lack of transparency causes difficulty for strategic investments in banks and non-bank companies. The downsides of this lack of transparency have been felt most acutely by community banks, which are more likely to rely on capital injections from a few significant investors.

The proposal is intended to clarify, streamline, and make transparent the Board's standards for when investments are likely to give rise to controlling influence concerns. Including these standards in the Board's regulations should help to facilitate investments in and by banking organizations. The core of the proposal is a tiered framework that is designed to reflect the major factors and thresholds that the Board historically has viewed as presenting controlling influence concerns.

In addition to the core tiered framework, the proposal would provide clarifications to important control related concepts, such as how to measure a company's total equity investment in another company. In general, the proposal would codify a significant portion of the Board's current standards with respect to controlling influence. The proposal also includes certain targeted adjustments that staff believes are appropriate, including related to the standards applicable to companies seeking to terminate an existing control relationship. I will now turn to my colleague Greg Frischmann who will discuss the proposal in greater detail.

GREG FRISCHMANN. Thank you Mark. Let me start by describing the tiered framework under the proposal. The proposal would significantly expand the existing presumptions of control in the Board's regulations providing a more holistic view of the Board's control standards. These standards will be organized to focus on two critical dimensions of control. First, the amount of voting securities controlled. And second, other specific relationships impacting control.

Under the proposal, these two dimensions of control, voting securities and other important relationships would be evaluated in combination. Effectively, these presumptions would create a matrix in which different combinations of voting securities and other relationships would meet the proposed standards for control.

The first dimension is control over voting securities. Control over voting securities is a critical conduit that a company may use to attempt to exercise a controlling influence over another company. And it has long been the central component of how the Board analyzed control.

The second dimension includes a set of other relationships that impact control. These factors include non-voting equity investments, rights to director representation, the use of proxy solicitations to elect directors. Management, employee, or director interlocks, agreements that allow a company to influence or restrict management decisions, and business relationships. These relationships -- these relationships may give a company additional incentives to exercise control, and provide additional avenues to do so.

The memorandum to the Board today includes a table showing how the control standards would apply across different ranges of voting ownership. Under the proposal, different standards would apply once a company's level of voting securities exceeds 5 percent, 10 percent, and 15 percent. Generally, as a company's percentage of securities increases, other relationships must decrease to avoid controlling influence concern.

To illustrate how this framework differentiates among these different levels of ownership, I will now refer to the table that appears in the appendix at the end of the Board memo. The top row of the table includes several tiers of ownership at the 5 percent, 10 percent and 15 percent thresholds. The left-hand side of the table is the number of the relationships that contributed to control. This table represents the proposed framework, and that you can find the applicable standards for a range of relationships, all based on the ownership percentage.

For example, the fourth row of the table describes limits on business relationships. Business relationships between two companies may provide both incentives and opportunities to exercise controlling influence. The proposal would measure the size of such relationships by looking at the revenues and expenses attributable to those relationships. As you will see, the framework imposes stricter limits as you move from lower to higher ownership percentages. Starting at no limits at the lowest tier, and moving to a 2 percent limit on revenues and expenses at the highest tier. Staff believe that the

presumptions articulated in this tiered framework adopt an appropriate approach consistent with longstanding Board practice, to evaluate a wide array of channels by which a company could exercise a controlling influence over another company.

In addition to the tiered framework I've just described, the proposals would amend certain definitions, and would provide greater detail as to how the control standards noted above would apply. I will now briefly describe a few of these more technical changes.

First, the proposal would clarify that a company with less than 10 percent of the voting securities of another company would be presumed to not control the second company, so long as the first company does not trigger one of the new regulatory presumptions of control. This new standard would be consistent with current Board practice.

Second, the proposal would clarify the Board's expectations with respect to a company seeking to demonstrate that its investments and relationships are no longer controlling, notwithstanding an earlier history of control. Historically, the Board has analyzed control differently in the context of a new investment as compared to a divestiture. For example, a company that had previously owned 100 percent of the shares of another company has been subject to more restrictive standards in demonstrating that it no longer has control, than a company that makes a new investment. The proposal would provide clear guidance about when the Board remains concerned about control in one of these divestiture fact patterns.

Finally, the proposal includes a number of other elements designed to implement the core tiered framework. These include provisions that clarify how to calculate one company's total equity investment in another, how to distinguish voting securities from non-voting securities, and what types of contractual rights may raise control concerns. Thank you, and we would be happy to address any questions you may have about the proposal.

CHAIR POWELL. Thanks very much Greg and Mark, and Mark. So, this directly addresses the question of -- whether a particular investment creates control or not. There are other important questions around investments such as, do they raise safety and soundness concerns? Do they raise competitiveness

concerns or even financial stability concerns? Does this new framework in any way limit our scope to address those other concerns?

MELISSA CLARK. Yeah, we don't know. Do not -- they -- this proposal addresses only the narrow issue of control and how its applied. And it doesn't change any of the roles related to safety and soundness, competitive, or financial stability. Those rules remain in effect and we expect to apply those rules as we have in the past.

CHAIR POWELL. That's great. Thank you. Question?

GOVERNOR BOWMAN. Oh, how does this proposal impact the ability of a banking organization to invest in a non-bank entity including a Fintech company?

BRIAN PHILLIPS. Sure. The proposal would provide a significant increase in clarity and transparency about the rules of the road for banking organizations to make investment in non-bank companies including Fintech companies. The proposal is generally consistent with the Board's past practice, and it would not fundamentally change the Board's control standards.

By articulating these standards in a publically available regulation, banking organizations would benefit from a significant increase in ex-ante certainty and transparency about how the Board views control. And this increase in certainty and transparency generally would make it simpler for firms to understand the Board's control rules. And through this increase in transparency it should have an incremental increase in the ability of a banking organization to make investments in other companies including Fintech companies by generally reducing the risk of unexpected control concerns.

GOVERNOR BOWMAN. Thank you.

CHAIR POWELL. Great. Thanks. If there are no more questions, I'm going to ask for positions on this question. And I'm going to start with Vice Chair Clarida.

VICE CHAIR CLARIDA. I support the proposal.

VICE CHAIR FOR SUPERVISION QUARLES. I support the proposal as well for the transparency reasons, and as well as the opportunity to get public comment on a number of these long standing positions, which I think will improve the way we had been administering this rule.

GOVERNOR BRAINARD. I support the proposal.

CHAIR POWELL. Great.

GOVERNOR BOWMAN. I consider this proposal a very good step forward toward transparency. And I think that as much clarity as we can provide toward these type of issues the better for the entities that we oversee and supervise. And so, I'm in favor of the proposal as well.

CHAIR POWELL. Great. Thank you, and I guess I should say I want to thank all of you for your hard work on this. And I too am in support of this proposal which seems to be a sensible way to reduce uncertainty and increase transparency, without undermining safety and soundness. So, I'll vote in favor of this as well, and I'll look forward to reviewing the comments we receive as always.

And we will -- so, we're now going to voting on the proposal to revise our control rules. I need a motion to approve a proposed rule making that would revise the Board's regulations related to determining whether one company controls another company. And staff to make minor -- any minor or non-substantive changes to prepare the documents for publication in the Federal Register.

VICE CHAIR CLARIDA. So moved.

CHAIR POWELL. And the second?

VICE CHAIR FOR SUPERVISION QUARLES. Second.

CHAIR POWELL. All those in favor.

VICE CHAIR CLARIDA. Aye.

VICE CHAIR FOR SUPERVISION QUARLES. Aye.

GOVERNOR BRAINARD. Aye.

GOVERNOR BOWMAN. Aye.

CHAIR POWELL. I guess that's it. Thanks everyone very much, and that concludes our meeting.
Nice job, thank you.