

Summary of the Section 622 Study and Recommendations Regarding Concentration Limits on Large Financial Companies, Released by the Financial Stability Oversight Council on January 18, 2011

Summary as of January 19, 2011

General Observations

As required by the Dodd-Frank Act, the Financial Stability Oversight Council (the “**FSOC**” or “**Council**”), has completed a study of the concentration limit imposed by Section 622 of the Dodd-Frank Act and issued a number of recommended modifications to it.¹ Section 622 by its terms requires the FSOC to make recommendations regarding any modifications to the concentration limit the Council determines would “more effectively” implement the provision, and requires the Federal Reserve Board (the “**Board**”) to issue regulations to implement the recommendations.

The FSOC generally takes a positive view of the concentration limit and its effect on financial stability, moral hazard, the efficiency and competitiveness of U.S. financial firms and financial markets, and the cost and availability of credit and other financial services in the United States. The FSOC’s specific recommendations focus on several practical issues raised by the implementation of the concentration limit. The recommendations relate to (1) the definition of “liabilities” for certain companies, which is relevant to the calculation of the concentration limit; (2) collection, aggregation and public dissemination of concentration limit data; and (3) extending the exception to the limit to any failing insured depository institution, not just failing banks. **These recommendations are subject to a 30-day comment period.**

The concentration limit has potentially broad application, impacting acquisitions by U.S. financial companies of any company, not just other financial companies, within the U.S. or abroad, as well as acquisitions by non-U.S. financial companies of U.S. companies. Moreover, the definition of “financial company” is broad enough to extend to companies that are not traditional bank holding companies, including commercial or retail companies that control limited-purpose credit card banks or industrial loan companies.

The Board is required to prescribe rules within 9 months that reflect the Council’s recommendations. The Board is also authorized to issue interpretations and guidance regarding application of the concentration limit to an individual financial company, or financial companies generally.

General Prohibition and Definitions

The concentration limit under Section 622 prohibits any financial company from merging or consolidating with, acquiring all or substantially all the assets of, or otherwise acquiring control of, another company if

¹ The study was released on January 18, 2011 and is available at <http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf>.

the total consolidated liabilities of the acquiring financial company, upon consummation of the transaction, would exceed 10% of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction. **The concentration limit does not apply to organic growth.**

- The concentration limit applies to the acquisition by a financial company of any company, not just other financial companies.
- A financial company is:
 - an insured depository institution (including savings associations, FDIC-insured limited purpose trust companies, limited-purpose credit card banks, and industrial loan companies),
 - a company that controls an insured depository institution,
 - a bank holding company,
 - a savings and loan holding company,
 - a nonbank financial company designated as systemically important under Title I of Dodd-Frank, and
 - a foreign bank or company that is treated as a bank holding company for purposes of the Bank Holding Company Act.
- The concentration limit is an amendment to the Bank Holding Company Act, and so terms used in the section have the meaning that they have under the Bank Holding Company Act. So, for example, “control” in this context has the meaning given to it under the Bank Holding Company Act.
- A commercial or industrial firm, such as a retailer or automobile company, that controls an insured depository institution (such an industrial loan company or a limited purpose credit card bank) is a “financial company” and will be subject to the concentration limit. In addition, its liabilities will be included in the calculation of the aggregate consolidated liabilities for all financial companies (i.e., the “denominator” of the calculation).
- Conversely, a company that may seem “financial,” such as an insurance company or securities firm, is not a financial company if it is not affiliated with an insured depository institution or a foreign bank with a U.S. banking office, unless the company is designated as systemically important under Title I of the Dodd-Frank Act.

Calculation of the Concentration Limit

Statutory Definition of Liabilities. Under the statute:

- With respect to a U.S. financial company, liabilities are defined as:
 - the total risk-weighted assets of the company (as determined under the risk-based capital rules applicable to bank holding companies), as adjusted to reflect exposures that are deducted from regulatory capital, less
 - the total regulatory capital of the company under the risk-based capital rules applicable to bank holding companies.
- For foreign-based financial companies, the risk-weighted assets and regulatory capital are limited to those of the United States operations of the financial company, and are calculated under applicable risk-based capital rules.

- For insurance companies and systemically important nonbank financial companies, liabilities are defined as such assets of the company as the Board shall specify by rule in order to provide for consistent and equitable treatment of such companies.
- During the FSOC meeting on January 18, 2011, at which the Section 622 study was approved, Board Chairman Ben Bernanke asked the staff how changes to the definitions of both risk-weighted assets and regulatory capital through the Basel III process would affect concentration limits and the calculations of the study. Staff responded by noting two potentially significant impacts:
 - Staff suggested that Basel III capital requirements would increase the risk weight of certain transactions that contribute more to the systemic footprint of a firm than others (e.g., derivatives, the trading book and credit exposures to large financial firms) and therefore would make the statutory definition of liabilities, which is based on risk-weighted assets, an even better measure of the systemic footprint of a firm.
 - Staff also responded that Basel III will likely result in an increase in capital requirements for the largest, most complex banking firms, compared to the banking sector as a whole, and so the general tendency will be to increase the restrictiveness of the limit for the largest U.S. financial firms.

Findings of the Study

- The FSOC concludes that the prohibition is likely to only restrict or otherwise affect acquisitions by Bank of America, J.P. Morgan Chase, Citigroup, and Wells Fargo in the short term.
- Acknowledging that it is not possible to produce an accurate estimate of the aggregate consolidated liabilities of all financial companies, the FSOC's initial rough estimate of total liabilities is \$14.3 trillion. Only these 4 firms hold more than 5% of that aggregate total.
- The FSOC concludes in its study that the concentration limit will have a positive impact on U.S. financial stability.
- The FSOC views the impact of the concentration limit on moral hazard, competition and credit availability to be "generally neutral" in the short- to medium-term, and that it will "enhance" the competitiveness of U.S. financial markets in the long term.
- The Council concludes that the concentration limit will be a more effective limit on growth than the Riegle-Neal deposit cap because it allows non-deposit liabilities and off-balance sheet exposures to be taken into account.

Finding #1. Effects on Future Financial Stability

- The FSOC concluded that restrictions on future growth by acquisition of the largest financial companies will prevent acquisitions that could make these firms harder for their officers and directors to manage, for the financial markets to understand and discipline, and for regulators to supervise.
 - The concentration limit can also cause the largest financial companies to either shed risk or raise capital to create room under the cap, which would tend to reduce the chance that the firms would fail.

Finding #2. Effects on Moral Hazard

- The FSOC expects the overall effect of the concentration limit on moral hazard to be small.

- According to the FSOC, the concentration limit will moderately decrease the moral hazard associated with the “too-big-to-fail” problem.
- The FSOC concluded that the concentration limit may slightly increase moral hazard in the sector by reducing the likelihood of hostile takeovers of large financial companies.
 - The concentration limit may ultimately reduce the number of potential acquirers for some smaller non-depository financial organizations by the small number of firms that approach or exceed the limit, but a large number of potential acquirers would remain for such firms.

Finding #3. Effects on the Efficiency and Competitiveness of U.S. Financial Firms and Markets

- According to the FSOC, the concentration limit is not expected to significantly affect the efficiency and competitiveness of U.S. markets in the near term because it will constrain the behavior of only a handful of firms that already operate at a very large scale and because the limit does not restrict organic growth by any firm.
 - Over the long run, the concentration limit may enhance the competitiveness of U.S. financial markets by preventing dominance by a small number of firms in those markets.
- **Potential Disparate Impact on U.S. and Foreign Financial Firms in the U.S. M&A Market.** The study acknowledges that the evidence of the impact on the competitiveness of U.S. financial firms is more mixed and cites the conflicting conclusions of the academic literature on the benefits of scale and scope for commercial banks. The FSOC acknowledges that the concentration limit could restrict the largest U.S. banking firms from large acquisitions of foreign firms or non-depository domestic organizations. The FSOC does express a concern that the limit introduces the potential for disparate regulatory treatment of mergers between the largest U.S. and foreign firms, depending on which firm is the acquirer or the target.
 - Because the statutory concentration limit includes the global consolidated liabilities of U.S. financial companies but only the liabilities of the U.S. operations of foreign firms, the concentration limit would allow large foreign-based firms with a small U.S. presence to acquire large U.S. firms, but would prohibit large U.S. firms from acquiring large foreign-based financial firms.
 - According to the FSOC, the disparity could increase the degree to which the largest firms operating in the U.S. financial sector are foreign-based.
 - It is not clear that this result was intended by Congress, or that moving forward regulators would want to treat acquisitions by foreign financial companies more favorably than similarly situated U.S. financial companies. A question on the disparate competitive impact was raised at the FSOC meeting, and the staff suggested that this issue would need to be corrected by a statutory amendment.
 - In this area, the FSOC recommends that the Board continue to monitor and report on these competitive dynamics and if the Council determines that there are any significant negative effects, it would then issue a recommendation to Congress to address adverse competitive dynamics.

Finding #4. Effects on the Cost and Availability of Credit and Other Financial Services

- The study concludes that in the short run, the concentration limit may marginally reduce the provisions of some financial services by the firms that are closest to the limit, if they restrict provision of these services in order to engage in an acquisition without violating the limit.

- The FSOC concludes that credit markets include large numbers of competitors, so it is not likely that the overall provision of financial services would be adversely affected by the concentration limit.

Study Recommendations

- The FSOC finds “substantial” challenges to implementing the concentration limit in the precise form in which it was enacted. As a result, the FSOC makes three recommendations relating to the implementation of the prohibition.

Recommendation #1. Modify the Statutory Definition of “Liabilities” for Certain Companies that do not Currently Calculate or Report Risk-Weighted Assets.

A number of companies included in the definition of “financial companies” do not calculate consolidated risk-based capital figures. As a result, it is not possible to apply the statutory definition of liabilities to all financial companies subject to the Section 622 concentration limit.

- The FSOC acknowledges that foreign-based companies do not, and are not required to, distinguish between assets and/or capital that are attributable to U.S. versus non-U.S. operations. The FSOC points out that the Board, as the appropriate Federal regulatory banking agency for those foreign banking organizations, has the authority to require such foreign banking organizations to compute risk-weighted assets and regulatory capital for their U.S. operations.
- The FSOC recommends that the Board issue rules to provide that, with respect to any financial company (other than an insurance company, a systemically important nonbank financial company, or a foreign bank or foreign-based financial company treated as a bank holding company), that is not subject to consolidated risk-based capital rules that are substantially similar to those applicable to bank holding companies, the “liabilities” of such a company be calculated pursuant to GAAP or, where GAAP is not applicable, other appropriate accounting standards applicable to such company.
- **Hybrid Approach.** The FSOC recommends an approach that will use the statutory definition of liabilities for those entities that currently calculate and report risk-weighted assets and regulatory capital figures determined under the risk-based capital rules, and GAAP liabilities for all other financial companies. A list of the treatment of different types of institutions is provided in [Annex A](#).
- **The Board, FDIC and OCC Should Collect Financial Information from Certain Insured Depository Institutions.** To ensure that appropriate financial information under applicable accounting principles is available for companies currently subject to risk-based capital rules, the FSOC encourages the Board, the FDIC and the OCC to collect this information by requiring each insured depository institution that is not controlled by a bank holding company, a company that is treated as a bank holding company, or a savings and loan holding company to report the total consolidated liabilities of its top-tier parent company as of the end of each calendar year based on the appropriate accounting standards and, to the extent possible, to use publicly reported data.

Recommendation #2. Modify the Calculation of Aggregate Financial Sector Liabilities to use a Two-Year Rolling Average Instead of a Single Year For Purposes of Calculating the Denominator of the Limit.

- The FSOC noted that the requirement that the concentration limit be applied using aggregate liabilities as of the “end of the year preceding the transaction” may make it difficult or impossible for the Board and any financial company to determine whether a transaction early in a calendar year would comply with the concentration limit because of delays in the reporting of data that would be necessary for calculating the limit.

- Also, the FSOC is concerned that applying the denominator for any given year as of a single date may introduce unnecessary volatility into the concentration limit and its application.
- The FSOC recommends that Section 622 be modified to use the average amount of aggregate consolidated liabilities of all financial companies as reported by the Board as of the end of the two most recent calendar years.
 - The Board would have to publicly report on an annual basis (and no later than July 1 of each calendar year) the final calculation of the aggregate consolidated liabilities of all financial companies as of the end of the preceding year.
- The FSOC also recommends that the Board make public an initial, nonbinding and estimated denominator amount in advance of the final figure.

Recommendation #3. Extend the Statutory Exception for Acquisitions of Failing Banks to Acquisitions of Other Failing Insured Depository Institutions.

- The statutory exception for an acquisition of a bank in default or in danger of default, subject to the prior written consent of the Board, only applies to a failing “bank” rather than a failing insured depository institution.
- The FSOC recommends that the concentration limit be modified to provide that, with written consent of the Board, it shall not apply to an acquisition of any type of insured depository institution in default or in danger of default.
- The study concludes that the important policy that supports the exception for acquisition of failing banks applies equally to insured depository institutions generally, and is not limited to “banks” as that term is defined in the Bank Holding Company Act.

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Definition of “Liabilities” for Certain Companies

As recommended by the Council, the following measures of liabilities would apply to financial companies subject to the concentration limit:

Section Reference ²	Type of Financial Company	FSOC Recommendation	Statutory Definition
12 U.S.C. §1852(a)(3)(A)	Stand-alone U.S. insured depository institutions	Existing statutory definition of liabilities	Risk-weighted assets less regulatory capital
12 U.S.C. §1852(a)(3)(A)	U.S. bank holding companies	Existing statutory definition of liabilities	Risk-weighted assets less regulatory capital
12 U.S.C. §1852(a)(3)(C)	U.S. nonbank financial companies designated systemically important by the Council	Existing statutory definition of liabilities	Such assets of the company as the Board shall specify by rule in order to provide for consistent and equitable treatment of such companies
	U.S. savings and loan holding companies, during transitional period before they are subject to risk-based capital rules	GAAP (or other applicable accounting standards) liabilities	
12 U.S.C. §1852(a)(3)(A)	U.S. savings and loan holding companies, once they are subject to risk-based capital rules	Existing statutory definition of liabilities	Risk-weighted assets less regulatory capital
	U.S. and foreign financial companies that own an insured depository institution but are not, and are not treated as, a bank holding company or savings and loan holding company	GAAP liabilities	
12 U.S.C. §1852(a)(3)(B)	Foreign-based companies that are, or are treated as, bank holding companies	Existing statutory definition of liabilities	Risk-weighted assets of the U.S. operations less regulatory capital of the U.S. operations

² Section 622 of the Dodd-Frank Act is adopted as a new Section 14 to the Bank Holding Company Act (12 U.S.C. § 1852).