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Bank Regulatory Law

Gramm-Leach-Bliley Act Making the New Rules Work for Your Bank Federal Law

- I. BANK HOLDING COMPANY - TRADITIONAL
 - A. Statutes and regulations, that existed prior to G-L-B, continue to apply, and limit, the activities of a traditional bank holding company that has determined not to elect to be a financial holding company.
 - B. A bank holding company, or a non-depository institution subsidiary, is allowed to sell insurance in a place of 5,000 people but *only* to those people located in that place.
- II. FINANCIAL HOLDING COMPANY — RELEVANT PROVISIONS OF G-L-B ACT
 - A. Gramm-Leach-Bliley Act amended Section 4 of the Bank Holding Company Act by adding a new subsection (k) that provides: "a financial holding company may engage in any activity, and may acquire and retain the shares of any company engaged in any activity, that the Federal Reserve Board ... determines ... to be financial in nature or incidental to such financial activity; or is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of the depository institutions or the financial system generally."
 - B. Section 4(k)(3) provides the factors the FRB is to consider when determining whether an activity is financial in nature or incidental to a financial activity.
 - C. Section 4(k)(4) lists activities that Congress deemed, as of the date of enactment of G-L-B Act, to be financial in nature. Paragraph (B) of this list states: "Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State."

- D. Section 4(k)(6) requires notification to the FRB no later than 30 days after commencing an activity listed under Section 4(k)(4) or determined by the FRB to be financial in nature or incidental to financial activity, but no prior approval is required.
- E. Section 4(l)(1) of the BHC Act prohibits a bank holding company from engaging in any activity under Section 4(k) unless:
 - 1. All the depository institutions of the bank holding company are well capitalized and well managed. *Note: The terms "well capitalized" and "well managed", with reference to bank holding companies, are not defined in G-L-B. Rather Congress left these definitions to be determined by the FRB in its regulations. See 12 CRR 225.2(r) and (s). By contrast, with respect to depository institutions (national and state), G-L-B sets forth definitions of these terms at 12 USC 24a(g)(5) and (6).*
 - 2. The bank holding company has filed with the FRB a declaration of election to be a financial holding company and a certification that it meets the requirements of being well capitalized and well managed
- F. Section 4(l)(2) authorizes the banking agencies to prohibit a financial holding company or insured depository institution from engaging in any new activity authorized under G-L-B Act if any insured depository institution has received a CRA rating of less than "satisfactory" in its most recent examination.
- G. Section 4(m) requires the FRB to give notice to any bank holding company that fails to meet the requirements of Section 4(l)(1) — well capitalized and well managed.
 - 1. Not later than 45 days after receipt of notice the financial holding company must execute an agreement with the FRB to comply with the requirements of Section 4(l)(1). Until conditions are corrected, FRB may impose such limitations on the financial holding company or any affiliate, as the FRB deems appropriate.
 - 2. If the condition is not corrected within 180 days after receipt of the notice, the FRB may require the financial holding company to divest control of any subsidiary depository institution or, at the election of the financial holding company, cease to engage in any activity permitted a financial holding company that is not permissible to a bank holding company under Section 4(c)(8).
 - 3. In taking any action under this section, the FRB must consult with the relevant Federal and state regulatory authorities.

III. FINANCIAL HOLDING COMPANY — FRB REGULATIONS — 12 CFR 225.81, et seq.

- A. Section 12 CFR 225.2 has been amended to add subsections (r) and (s)

that set forth the definitions of "well capitalized and "well managed".

1. 12 CFR 225.2(r) defines "well capitalized" as:
 - a. On a consolidated basis, the bank holding company maintains a total risk-based capital ratio of 10.0 percent or greater;
 - b. On a consolidated basis, the bank holding company maintains a Tier 1 risk-based capital ratio of 6.0 percent or greater; and
 - c. The bank holding company is not subject to an agreement, order, directive, or the like to meet and maintain specific capital level for any capital measure.
2. 12 CFR 225.2(s) defines "well managed" as:
 - a. At its most recent examination, the company or institution received:
 1. At least a satisfactory composite rating; and
 2. At least a satisfactory rating for management and for compliance, if such a rating is given; or
 - b. In the case of a company or depository institution that has not received an examination rating, the FRB determines, after review of the managerial and other resources of the company or depository institution and after consulting with the appropriate Federal banking agencies, that the company or institution is well managed.
- B. Section 225.81 defines a financial holding company as a bank holding company that meets the requirements of Section 225.81.
- C. To be a financial holding company, Section 225.81 requires a bank holding company to be well capitalized and well managed and it must have made an effective election to be a financial holding company.
- D. Section 225.82 details how to make the election to be a financial holding company. It requires a bank holding company to submit to the FRB:
 1. A declaration that the company elects to be a financial holding company and
 2. A certification that all of the depository institutions controlled by the bank holding company are well capitalized and well managed.
- E. Under Section 225.82, election will not be effective if FRB finds that, as of the date of the election is submitted to the FRB, not all insured depository institutions controlled by the bank holding company have been rated at least "satisfactory" at the most recent examination under the CRA.

- F. Section 225.83 spells out the consequences of failing to continue to meet capital and management requirements. As provided in G-L-B Act, the FRB has discretion to impose limitations on conduct or activities of any financial holding company that controls a depository institution that does not remain both well capitalized and well managed following its election to be a financial holding company. As noted above, if the financial holding company remains out of compliance 180 days after notice, the FRB may order divestiture of a subsidiary depository institution. The FRB noted in its rule notice that the authority granted to it by G-L-B is in addition to its existing authority under Section 8 of the BHC and Section 8 of the FDIC Act.
- G. Section 225.84 spells out the consequences of failing to maintain a satisfactory or better CRA rating. As required by G-L-B Act, the FRB prohibits a financial holding company from commencing any *additional* activities under new subsection 4(k) and 4(n) of the Bank Holding Company Act, or acquiring control of companies engaged in such activities, if any insured depository institution controlled by the bank holding company fails to maintain at least a satisfactory CRA rating. Prohibition remains in effect until each insured depository institution controlled by the financial holding company obtains at least a "satisfactory" CRA rating.
- H. Section 225.85 provides that no prior notice is required to carry on activities, or acquire a company that is engaged in the activities listed in Section 225.86.
- I. Section 225.86 lists the activities that are permissible for financial holding companies. Subsection (c) incorporates by reference the activities listed in Sections 4(k)(4)(A) through (E), (H) and (I) of the Bank Holding Company Act. Paragraph (B) of this Section 4(k)(4) lists: "Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State."
- J. Section 225.87 requires *post-commencement* notice of an activity, or acquisition of a company engaged in an activity, listed in Section 225.86 within 30 calendar days after commencing the activity or consummating the acquisition. Section 225.87 specifies that the notice must describe, as relevant, the activity commenced and the identity of each subsidiary engaged in the activity, or the identity of the company acquired and the activities conducted by the company.
- K. No notice is required under Section 225.87 to acquire shares of a company if, following acquisition, the financial holding company does not control the company.

IV. FINANCIAL SUBSIDIARIES OF NATIONAL BANKS — PROVISIONS OF G-L-B

- A. G-L-B created a new section 12 USC 24a which authorizes the a national bank to conduct, through a financial subsidiary, activities that are financial in nature or incidental to a financial activity.
- B. Under Section 24a(a)(2)(C), a national bank may control a financial subsidiary only if the national bank is well capitalized and well managed.
- C. Under Section 24a(a)(7), the OCC is required to prohibit a financial subsidiary from engaging in any new activity if the national bank has failed to receive a "satisfactory" rating in its most recent CRA examination.
- D. 12 USC 24a(b)(1) provides that an activity is financial in nature or incidental to such activity only if -
 - 1. the activity has been defined to be financial in nature or incidental to a financial activity for bank holding companies pursuant to Section 4(k)(4) of the Bank Holding Company Act, or
 - 2. the Secretary of the Treasury determines the activity is financial in nature or incidental to a financial activity in accordance with the procedure set forth in G-L-B.
- E. 12 USC 24a(c)(1) requires that, in determining compliance with applicable capital standards, the aggregate amount of the outstanding equity investment, including retained earnings, of the national bank in all financial subsidiaries shall be deducted from the assets and tangible equity of the national bank, and the assets and liabilities of the financial subsidiary shall not be consolidated with those of the national bank.
- F. 12 USC 24a(d) requires a national bank that establishes and maintains a financial subsidiary to assure that —
 - 1. it has appropriate procedures for identifying and managing financial and operational risks within the national bank and financial subsidiary to adequately protect the national bank from such risks; and
 - 2. the national bank has reasonable policies and procedures to preserve the separate corporate identity of the national bank and the financial subsidiary.
- G. 12 USC 24a(e) requires the OCC to give notice to a national bank or insured depository institution affiliate that fails to meet the requirements of 12 USC 24a(a)(2)(C) — well capitalized and well managed - and subsection (d) — appropriate procedures.
 - 1. Not later than 45 days after receipt of notice the national bank must execute an agreement with the OCC to comply with the requirements of subsection (a)(2)(C) and subsection (d). Until conditions are corrected, OCC may impose such limitations on the national bank or any subsidiary as the OCC deems appropriate.

2. If the condition is not corrected within 180 days after receipt of the notice, the OCC may require the national bank to divest control of any financial subsidiary.
 3. In taking any action under this section, the OCC must consult with the relevant Federal and state regulatory authorities.
- H. 12 USC 24a(g) contains the definitions applicable to this section, including "well capitalized" and "well managed".
1. Subsection (5) provides that the term "well capitalized" has the meaning given the term in Section 38 of the Federal Deposit Insurance Act. Section 38 of the FDIC Act simply states: "An insured depository institution is 'well capitalized' if it significantly exceeds the required minimum level for each relevant capital measure." 12 USC 1831o(b)(1)(A).
 2. Subsection (6) provides the term "well managed" means —
 - a. In the case of a depository institution that has been examined, unless otherwise determined in writing by the appropriate Federal banking agency —
 1. The achievement of a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System (or an equivalent rating under an equivalent rating system) in connection with the most recent examination or subsequent review of the depository institution; and
 2. At least a rating of 2 for management, if such a rating is given; or
 - b. In the case of any depository institution that has not been examined, the existence and use of managerial resources that the appropriate Federal banking agency determines are satisfactory.
- I. Sections 23A and B of the Federal Reserve Act have been amended to provide that "financial subsidiary" means any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under G-L-B. Further, for purposes of Sections 23 A and B, a financial subsidiary of a bank is deemed to be an affiliate of the bank and not a subsidiary of the bank. *This provision applies to both national banks and state chartered banks.*
- J. Section 106(a) of the Bank Holding Company Act — anti-tying — has been revised to provide that, for purposes of this section, a financial subsidiary of a national bank shall be deemed to be a subsidiary of a bank holding company and not a subsidiary of a bank.
- V. FINANCIAL SUBSIDIARIES OF NATIONAL BANKS — OCC REG. — 12 CFR 5.39

- A. 12 CFR 5.39 tracks provisions of G-L-B.
- B. Section 5.39(b) requires a national bank to file a notice, as prescribed by the section, prior to acquiring a financial subsidiary or engaging in the expanded activities, permitted by G-L-B, through a financial subsidiary. *However, if the financial subsidiary proposes to conduct activities permitted under Section 5.24, operating subsidiaries, the bank must follow the procedures of Section 5.34(e)(5) rather than Section 5.39(i), financial subsidiaries.*
- C. The term "financial subsidiary" is defined as a company controlled by one or more depository institutions, other than a subsidiary that engages solely in activities that a national bank may engage in directly.
- D. The terms "well capitalized" and "well managed" track the definitions contained in G-L-B.
- E. Section 5.39(e) sets forth the authorized activities of a financial subsidiary. These activities include:
 - 1. Activities that are financial in nature or activities incidental to a financial activity authorized pursuant to 12 USC 24a(a)(2)(A)(i). These activities include: "Engaging as agent or broker in any state for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, death, defects in title, or providing annuities as agent or broker."
 - 2. Activities that may be conducted by an operating subsidiary pursuant to Section 5.34.
- F. A financial subsidiary, however, is prohibited by G-L-B and the OCC regulations from engaging in real estate development, underwriting insurance, or engaging in merchant banking.
- G. Section 5.39(g), Safeguards, sets forth the provisions of G-L-B regarding the requirement of a national bank to deduct from capital its equity investment, including retained earnings, in the financial subsidiary and the requirement that it have the required policies and procedures in place to preserve the separate corporate identity and limit liability of the bank. Additionally, it must have in place procedures to identify and manage financial and operational risks.
- H. Section 5.39(i) sets forth the procedures to be followed to form a financial subsidiary.
 - 1. *At any time*, a national bank may file a "Financial Subsidiary Certification" with the appropriate district office listing the bank's depository institution affiliates and certifying that each of those affiliates is well capitalized and well managed. *Note: All of the bank's insured depository institution affiliates must meet these two standards.*

2. Thereafter, at such time that the bank seeks OCC approval to acquire control or hold an interest in a new financial subsidiary, or commence a new activity under G-L-B, the bank may file a written notice, labeled "Financial Subsidiary Notice", with the appropriate district office. This notice must state:
 - a. The bank's Certification remains valid;
 - b. Describe the activity to be conducted. *Note: Additional information is required if the activity relates to the initial affiliation of the bank with a company engaged in insurance activities. Specifically, the bank should describe the type of insurance activity, list for each state the lines of business for which the company holds, or will hold, an insurance license, indicating the state where the company holds a resident license or charter, as applicable.*
 - c. Cite the specific authority permitting the activity to be conducted by the financial subsidiary.
 - d. Certify that the bank will be well capitalized after making adjustments as required by the deduction of the equity investment in the financial subsidiary.
 3. A national bank may combine the certifications and notice required by 1. and 2. above.
 4. Under Section 5.39(i)(4), if a national bank has received less than a satisfactory rating in its most recent CRA examination, it cannot apply for authority to commence a new activity under the G-L-B Act.
- I. Section 5.39(j) requires a national bank *and its insured depository affiliates* to continue to meet the requirements that it is well capitalized and well managed, that for capital calculation purposes its equity investment in the financial subsidiary is deducted and that it has appropriate procedures to maintain a separate corporate identity, and to identify and manage financial risks.
1. If a national bank fails to continue to meet these requirements, the OCC must send the bank a notice to this effect.
 2. Not later than 45 days after receipt of the notice, the bank is required to execute an agreement with the OCC to comply with the requirements;
 3. The OCC may impose such limitations on the activities of the national bank or any subsidiary as OCC deems appropriate; and
 4. OCC may require divestiture if the bank does not correct the conditions within 180 days of receipt of the notice.
- J. Section 5.39(k) provides that the financial subsidiary is subject to

examination by the OCC.

VI. OPERATING SUBSIDIARIES OF NATIONAL BANKS — OCC REG. — 12 CFR 5.34

- A. Old rules — pre G-L-B - apply but with some new twists.
 - 1. Authority for activities of operating subsidiary derives, primarily, from 12 USC 24 (Seventh), rather than 12 USC 24a (G-L-B) the authority for financial subsidiaries.
 - 2. Activities permitted for operating subsidiaries — pre G-L-B — are still permitted post G-L-B, including selling insurance as an agent — under 12 USC 92. That is, a national bank located and doing business in a place with a population of 5,000 or fewer may act as agent for state-authorized insurance companies. The various guidelines and publications, issued by the OCC under this law, remain valid and applicable for national banks seeking to sell insurance under this authority. See, in particular, the lengthy letter to First Union Corporation, dated November 4, 1996, which discusses the authority of a national bank to sell insurance, as an agent, under this statute.
- B. On March 10, 2000, the OCC published in the Federal Register the new regulation for financial subsidiaries *and* a revised regulation for operating subsidiaries. Both of these rules became final on March 11, 2000.
- C. Under Section 5.34(e)(2), Operating Subsidiaries, a qualifying subsidiary is a company, limited liability company or similar entity if the national bank owns more than 50 percent of the voting interest. It does not include a financial subsidiary.
- D. Section 5.34(e)(5)(i)(A) requires, unless the rule provides otherwise, for a national bank to first submit an application to, and receive the approval of the OCC, to establish an operating subsidiary.
 - 1. As in the case of a financial subsidiary, if the application relates to the initial affiliation of the bank with a company engaged in insurance activities, the bank must describe the insurance activities, list for each state the lines of business for which the company holds, or will hold, an insurance license and indicate the state where the company holds a resident license or charter. *Additionally*, the application must state whether the operating subsidiary will conduct any activity at a location other than the main office or a previously approved branch of the bank.
 - 2. An application will always be required if the bank controls the subsidiary but owns 50% or less of the voting interest in the subsidiary.
 - 3. The OCC will review the proposal to determine that the activities are legally permissible and does not endanger the safety or

soundness of the parent national bank.

4. *If the activity is listed under Section 5.34(e)(5)(v)*, and the national bank is "well capitalized" and "well managed", the bank may file a notice with the appropriate district office within 10 days after acquiring or establishing the subsidiary or commencing the activity. This subsection specifies the information to be contained in the notice including, in the case of insurance, the same information required by (e)(5)(i)(A) described above. Any bank receiving approval by virtue of this notice provision is deemed to have agreed that the subsidiary will conduct the activity in a manner consistent with published OCC guidance.
 5. Among the activities listed under (e)(5)(v), eligible for notice treatment, are acting as an insurance agent or broker.
- E. Differences between a financial subsidiary and an operating subsidiary:
1. Financial subsidiary:
 - a. Must be well capitalized.
 - b. Must be well managed.
 - c. All insured depository institution affiliates must meet these requirements.
 - d. Cannot engage in any additional G-L-B activities if receive less than satisfactory CRA rating.
 - e. Equity investment, including retained earnings, must be deducted from capital of parent national bank.
 - f. Must adopt required procedures regarding separate corporate identity and management of risk.
 - g. Subject to automatic supervisory agreement 45 days after receipt of notice that the national bank, or any of its affiliate depository institutions, are less than well capitalized or well managed.
 - h. Subject to enforcement actions, including the divestiture of the financial subsidiary, if fail to remedy problem with 180 days of receipt of notice.
 2. Operating Subsidiary
 - a. Operating subsidiary selling insurance must be located in a place of 5,000 people or less (but sales can be made to persons outside this location and extensive marketing and operations can be located outside this location. See series of OCC interpretative letters on satellite offices for specifics.)
 - b. No requirement that it be well capitalized or well managed,

but if it is well capitalized and well managed, it can file a notice of activity within 10 days of commencing the activity rather than an application for approval to conduct the activity.

- c. No requirement that bank's investment in operating subsidiary be deducted from bank's capital.
- d. No negative consequence to authority or ability to conduct activity if fail to be well capitalized or well managed.

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