Term Sheet

Regulatory Relief and Accountability for Financial Holding Companies Engaged in Nontraditional Banking Activities

A Proposal by FDIC Vice Chairman Thomas M. Hoenig

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I. **PURPOSE.** To ensure that the public safety net is not expanded beyond the traditional banking activities that it was originally designed to support and to restore open market competition within the financial services industry. Traditional and nontraditional banking activities inside a Financial Holding Company (FHC) organization structure should be legally separated and capitalized[1], similar to the UK approach championed by John Vickers.

II. **SCOPE OF APPLICATION.** This term sheet would apply to banking organizations with one or more entities that are either:

a. Registered as a broker-dealer, an investment adviser, a securities-based swaps dealer, or a major securities-based swaps participant with the SEC;

b. Registered as a futures commission merchant, a commodity pool operator, a swaps dealer, or a major swaps participant with the CFTC;

c. An Edge Act or Agreement Corporation;

d. A merchant banking entity or a financial subsidiary controlled by one or more insured depository institutions;

e. A sponsor or manager of hedge funds, private equity funds, or securitizations the underlying assets of which are not loans (other than SBICs or Community Reinvestment Act vehicles);

f. An insurance underwriter (including reinsurance); or

g. An entity that provides similar services.

III. **EXCLUSIONS FROM SCOPE OF APPLICATION.** This term sheet would not apply to banking organizations that do not fall within the Scope of Application as defined above, or that would fall within the Scope of Application but for which the primary business purpose is to provide custodial services (Custody Banks).

IV. **EXCLUSION FROM SCOPE FOR TRADITIONAL BANKS.** For all other banking organizations (other than Custody Banks), please see the term sheet for Traditional Bank Regulatory

[1] There are a few banking organizations that engage in these activities, but which do not currently have a holding company. This term sheet should be read to apply to these organizations by imposing a requirement to establish a holding company structure that would contain separate IHCs.

Relief originally proposed in April 2015[2]. Generally a traditional bank would be eligible for regulatory relief if:

a. It holds no trading assets or liabilities (other than permissible derivatives);

b. It holds no derivative positions other than interest rate and foreign exchange derivatives;

c. The total notional value of all its derivatives exposures - including cleared and non-cleared derivatives - is less than $8 billion; and

d. It maintains a ratio of Generally Accepted Accounting Principles equity-to-assets of at least 10%.

V. SEPARATION OF TRADITIONAL AND NONTRADITIONAL BANKING ACTIVITIES. Traditional banking activities (TBA) would be allowed access to the current federal safety net but nontraditional banking activities (NTBA) would not have direct access and only limited, indirect access.

a. TBA would be limited to the "business of banking" (as traditionally conceived) but a discussion of TBAs would be necessary to ensure that appropriate depository, credit intermediation and payment systems services are conducted. In no case should TBA include activities associated with insurance underwriting, securities or swaps; and as such, should not include underwriting, market making, broker-dealer, futures commissions merchant (FCM), investment advisory, asset management, investment company, hedge fund/private equity investment, or swaps dealing activities;

b. Both TBA and NTBA affiliates would be structured underneath one or more separately capitalized intermediate holding companies of an FHC;

c. TBA would be conducted in the bank intermediate holding company (BIHC) and NTBA would be conducted in the nontraditional intermediate holding company (NIHC);

d. The BIHC would be the holding company for an insured depository institution and its subsidiaries;

e. The NIHC would be the holding company for all entities and affiliates conducting NTBA, including broker dealer, FCM, swap activities and all other non-traditional banking activities. All Edge Act and Agreement Corporations and their subsidiaries would be included in an NIHC.

VI. Nontraditional Intermediate Holding Company. Each NIHC would be a separate affiliate, which is separately managed and capitalized.

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[2] https://www.fdic.gov/about/learn/board/hoenig/relief.html

a. Each NIHC structure should be established in a manner deemed by the FHC board of directors to be a "resolvable entity"; that is, the entity could be resolved through the bankruptcy process;

b. Each NIHC would be capitalized in the form of tracking shares issued by the FHC, which perfectly track to gains/losses and other economics of the NIHC;

c. Each NIHC would be subject to independent liquidity requirements designed to (1) limit or eliminate access to the public safety net and (2) to ensure that in the event the NIHC were to be separated from the FHC it could continue to function as an operational entity;

d. No more than [20%] of the debt of NIHC's liabilities and debt would be held in aggregate by the FHC and any other affiliates;

e. The NIHC would be prohibited from engaging in speculative proprietary trading that would be controlled through trader mandates rather than the complicated measures of the Volcker Rule;

f. Each NIHC would be subject to a modified 23A/23B arrangement where the quantitative limits on transactions with affiliates is applied to the capital stock and surplus of the member banks as well as the capital stock and surplus of the NIHC affiliate.

VII. **Bank Intermediate Holding Company.** Each BIHC would be a separate affiliate, which is separately managed and capitalized.

a. The risk mitigating hedging requirements of the Volcker Rule, along with its prohibitions related to hedge fund/private equity investments would continue in force;

b. All other activities covered by the Volcker Rule would be considered NTBA, such as market making and underwriting.

VIII. **Governance.** Internal oversight would need to be reformed to ensure appropriate separation of management and to ensure an adequate internal control structure.

a. Management would not be allowed to serve on the Board of Directors;

b. An Independent "General Internal Auditor" (GIA) position would be required for each FHC;

i. The incumbent in this position would report directly and exclusively to the Board of Directors.

ii. The GIA would be in charge of the independent audit function of the FHC and all affiliates and would oversee the external audit of the firm.

iii. To ensure complete independence, the GIA should be prohibited from serving in any capacity at the FHC, or its subsidiaries or affiliates, for a period of 5 years following the end of his/her employment.

c. External auditors would be prohibited from providing any service other than traditional auditing services (e.g. no consulting or other "value-added" services) and must rotate at least every 5 years.

IX. Capital Reforms. The leverage ratio would be the primary measure of capital adequacy for regulatory purposes.

a. A 10% leverage ratio would be required at each BIHC and at each IDI subsidiary of a BIHC as well as any standalone IDIs;

b. A [10%] leverage ratio would be required at each NIHC;

c. A [10%] leverage ratio would be required at the FHC;

d. The leverage ratio requirements should be designed to ensure that all risks are generally captured: credit, operational, market, concentration, liquidity, interest rate, off-balance sheet and other risks;

i. As such, the leverage ratio should be appropriately expansive to incorporate the credit, counterparty and payment/liquidity risks associated with derivatives and other so-called level 2 and level 3 assets.

ii. One form could be the enhanced supplemental leverage ratio and another simpler and more direct form would be to recognize only payment netting for derivatives (as contemplated by IFRS).

X. Regulatory Relief. The structure described above and the leverage capitalization of the various entities should eliminate the need for many of the complex regulations under the Dodd Frank Act such as:

a. The comprehensive capital analysis and review (CCAR) exercise;

b. Dodd Frank Act Stress Testing (DFAST);

c. Regulatory risk-based capital (as a primary measure of capital adequacy);

d. Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR);

e. Title II and living wills; and

f. Other enhanced requirements under section 165 of the DFA.

XI. Prompt Corrective Action. PCA will need to be revised to:

a. Eliminate risk-based capital and to incorporate recognition of the higher Leverage Ratio requirements; and

b. Enhanced to include measures of deterioration in asset quality (such as the "Texas Ratio").

XII. Supervisory Expectations. Determinations of safety and soundness will include:

a. Internally calculated risk-based capital calculations and liquidity measurements should be a non-publically disclosed component of the supervisory assessment of safety and soundness;

b. Internal stress testing practices would remain as a management and supervisory tool; however, stress testing scenarios and assumptions should be designed by the banking organization (subject to board and supervisor approval) and should be commensurate with its own business model and risks rather than being developed by the agencies as a one-size fits all approach;

c. Supervisors will assess the adequacy and soundness of planned capital distributions; and

d. FHCs should be able to demonstrate that they have internally allocated their equity to absorb losses that could emanate from any risks.

XIII. Regulatory Oversight. There would be no change to the current structure of the prudential banking agencies or market regulatory agencies.

a. The primary regulator of the FHC, BIHC and NIHC would be the Federal Reserve;

b. Insured depository institutions subsidiaries of the BIHC would continue to be regulated based on charter affiliation;

c. Market regulators (SEC and/or CFTC) would oversee the subsidiaries of the NIHC.

XIV. Transition Periods. An appropriate period of time would be provided to allow for a gradual transition to ensure continued delivery of financial services to the economy.

a. Structural transitions should occur over a period not to exceed [3] years;

b. Capital requirements should be transitioned in over a period not to exceed [5] years.