<u>Term Sheet</u>

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.

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[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.

IV. **EXCLUSION FROM SCOPE FOR TRADITIONAL BANKS.** For all other banking organizations please see the term sheet for Traditional Bank Regulatory 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% (there is a 2 year transition period to meet this ratio).

Traditional Bank Regulatory Relief would include:

a. Exemption from all Basel capital standards and associated capital amount calculations and risk-weighted asset calculations;

b. Exemption from several entire schedules on the Call Report, including schedules related to trading assets and liabilities, regulatory capital requirement calculations, and derivatives;

c. Elimination of requirements to refer "possible fair lending violations to Justice" if judged to be de minimis or inadvertent;

d. Establishment of criteria that would exempt traditional banks from appraisal requirements;

e. Exemption of traditional banks, if applicable, from stress testing requirements under section 165(i)(2) of the Dodd-Frank Act; and

f. Require only an 18 month examination cycle as opposed to a 12 month cycle for traditional banks.

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;

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

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. Edge Act and Agreement Corporations and their subsidiaries engaged in any form of NTBA would be included in an NIHC.

VI. NONTRADITIONAL INTERMEDIATE HOLDING COMPANY. Each NIHC would be a separate affiliate, which is separately managed and capitalized.

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. SAFEKEEPING INTERMEDIATE HOLDING COMPANY. An FHC would be permitted to establish a special Safekeeping Intermediate Holding Company (SIHC) to conduct Safekeeping Banking Activities (SKBAs). SKBAs would be limited to the safekeeping of assets on behalf of customers under a safekeeping arrangement. Such activities would include custodial services, trust services, and central clearing on behalf of clients. If elected, each SIHC would be a separate affiliate, which is separately managed and capitalized.

a. Each SIHC 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. An SIHC would be allowed to contain a Safekeeping Bank, which would be defined as an insured depository institution, the assets of which would be limited to cash, deposits at the Federal Reserve, and short- term direct obligations of the United States government[3];

c. An SIHC would be the holding company for all entities and affiliates conducting SKBA, including any Safekeeping Bank, broker dealer, or FCM. Edge Act and Agreement Corporations and their subsidiaries engaged solely in SKBA would be included in a SIHC.

d. An SIHC would have access to the public safety net; as such, the safety net constraining requirements associated with the BIHC (i.e., independent liquidity requirements, limitations on interaffiliate debt holdings, tracking stock requirements, and modified 23A/23B arrangements) would not apply to the SIHC.

IX. 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.

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[3] The asset holding limitation applies to all economic exposures both on and off balance sheet, including assets borrowed or lent.

X. 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 on a consolidated basis and at each IDI subsidiary of a BIHC as well as any standalone IDIs.

b. An 8% leverage ratio would be required at each NIHC on a consolidated basis.

c. A 5% leverage ratio would be required at each SIHC on a consolidated basis and at each Safekeeping Bank.

d. A 10% leverage ratio would be required at the FHC on a standalone basis.

e. 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).

XI. 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.

XII. 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”).

XIII. 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.

XIV. 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, NIHC, and SIHC would be the Federal Reserve;

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

c. Entities within the NIHC and entities other than the Safekeeping Bank within the SIHC would be regulated by the current applicable regulator.

XV. 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.