

Tweaking a Definition

Small bank holding company proposal could pose significant effects



By Bill Sammon



On Sept. 1, 2005, the Board of Governors of the Federal Reserve System issued a proposal to change the definition and certain aspects of the treatment of a Small Bank Holding Company (SBHC). The most important proposed change increases the maximum amount of consolidated assets for qualifying small bank holding companies from \$150 million to \$500 million. According to Fed calculations, approximately 4,400 bank holding companies would fall under the SBHC umbrella pursuant to this proposal, compared with roughly 2,800 currently.

When this column was written the 60-day comment period had concluded but no final policy had been enacted. Here are a few insights on how the proposed changes might affect community banks.

Historical Perspective

The goal of the original Small Bank Holding Company policy, issued in 1980, was to allow small bank holding companies to use more leverage when growing the organization through acquisitions. The Fed realized that in many cases it was difficult for small bank holding companies to have access to equity to finance those transactions.

Given the 25 years since this policy has been updated, the Fed acknowledges the \$150 million-asset threshold has lost much of its relevance due to inflation, consolidation and general growth in the industry.

An important benefit of being treated as a small bank holding company is that capital requirements are only administered and monitored at the bank subsidiary level. This allows the holding company to operate with significantly lower levels of equity

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and other Tier One capital as long as the organization complies with certain debt-to-equity ratio guidelines.

Companies already operating under this umbrella are familiar with the practice of borrowing funds at the holding company level to be down-streamed to a bank subsidiary to keep the subsidiary in compliance with regulatory capital guidelines. Under the proposal, bank holding companies with up to \$500 million of consolidated assets would enjoy the same flexibility.

Included in the policy statement are other requirements for consideration as a small bank holding company. First, the bank holding company may not be engaged in any non-banking activity involving significant leverage. Second, the bank holding company may not be engaged in any significant off-balance sheet activity. Finally, the holding company may not have any outstanding debt that is held by the general public.

While these requirements are important, only a handful of bank holding companies need to concern themselves with these restrictions.

This new policy has the potential to create significant change in the financing of mergers and acquisitions for community banks. Bank holding companies considering acquisitions which would result in consolidated assets remaining below \$500 million would be able to use a

greater proportion of debt financing under the new proposal.

Qualifying small bank holding companies may use debt to finance up to 75 percent of the purchase price of the acquisition. For banks to make acquisitions in this manner there are a number of ongoing requirements which should be considered closely.

The key requirements for ongoing compliance require a bank to:

- Reduce its parent company debt so that all debt is retired within 25 years of being incurred;
- Reduce its debt to equity ratio to .30:1 or less within 12 years of the debt being incurred;
- Ensure that each of its subsidiary insured depository institutions is well capitalized; and
- Refrain from paying dividends until such time as it reduces its debt to equity ratio to 1.0:1 or less.

Going Private

Another area of interest for community banks where this new policy could have an important impact is the “going private” transaction. As many know, more than 60 banks have completed “going private” transactions since 2002. These banks have used many different methods to reduce their shareholder number below the 300 shareholder threshold and

de-register with the SEC.

The new policy would allow greater flexibility when financing a going-private transaction for banks under \$500 million in assets. While many banks have used trust-prefereds to finance these transactions and will continue to do so, this new Small Bank Holding Company policy, at a minimum, should cause community banks to revisit current plans.

These potential policy changes may not have immediate relevance, although it is important to understand the impact these changes could have on an institution’s ability to grow and acquire in the future. All bank holding companies with consolidated assets of less than \$500 million should review their capital plans in light of this proposal. Specifically, any such company with plans to issue new Tier 1 capital in any form should re-evaluate those plans.

This new proposal has the potential to be a significant plus for community banks through lower overall borrowing costs and less restrictive consolidated capital requirements. Any policy that creates more flexibility and gives more opportunities for growth for the independent community banks of this country is welcome. **ib**

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