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Holding companies as a 'source of strength'

Dodd-Frank puts new emphasis on long-standing doctrine

By John Yanish

In response to the recent financial crisis, Congress passed the Dodd Frank Act (DFA), a wide ranging body of law designed to address a myriad of issues. While many matters addressed in the DFA are new, such as the creation of the Consumer Financial Protection Bureau, the statute also took an important step in addressing a long-standing staple of the banking regulatory framework: the requirement that a bank holding company serve as a "source of strength" for its subsidiary bank(s), a principle sometimes referred to as the source of strength doctrine.

To understand the significance of the source of strength provisions within the DFA, it is useful to revisit some of the history regarding the doctrine. The Bank Holding Company Act of 1956 doesn't specifically mention source of strength, but directs the Federal Reserve Board of Governors to "take into consideration the financial and management resources and future prospects" of a company that applies for the Board's approval to become a bank holding company. In 1978, the United States Supreme Court interpreted this provision to mean that the Board could deny an application to become a bank holding company if it determined the company "would not be a sufficient source of financial and managerial strength to its subsidiary Bank."

The source of strength doctrine gained momentum in the 1980s. The Federal Reserve amended its Regulation Y in 1984 to state that a "bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner." Then, in 1987, the Board published a policy statement making plain its view that source of strength was not merely a factor for consideration when a company sought to become a bank holding company. The policy states that a bank holding company "should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress." Failure of a bank holding company to do so on an ongoing basis is deemed an "unsafe and unsound" practice.

The Board's approach reflected in the policy, asserting a bank holding company must provide ongoing financial support to its subsidiary banks, drew criticism from some quarters and was addressed in litigation. In 1991, a federal court of appeals considered source of strength requirements and determined that the Board did not have statutory authority to order a bank

holding company to transfer its funds to its troubled subsidiary banks. That same year, the United States Supreme Court reversed the appeals court decision on procedural grounds, but did not give an opinion on the scope of source of strength. While this resulted in a victory for the Board in that case, it arguably left some uncertainty as to the appropriate scope of source of strength requirements.

In light of this history, the new DFA provisions are a significant clarification of the law in this area. The DFA makes clear that a bank holding company's obligation to serve as a source of strength is a substantial ongoing obligation. The DFA provides that the "appropriate Federal banking agency for a bank holding company or savings and loan holding company shall require the [holding company] to serve as a source of financial strength for any subsidiary of the bank holding company or savings and loan holding company that is a depository institution." It further provides that such a company may be compelled to file reports, under oath, for the purposes of assessing the company's compliance with this obligation.

This strong statement in the DFA bolsters the Board's policy and long standing interpretation of the source of strength doctrine. Significantly, it also directs the Board and other banking regulators to adopt regulations to carry out the statutory provisions. This rulemaking is underway and will be completed in coming months. Proposed rules have not been published at this point so the content is presently uncertain. That being said, topics to be addressed may include further details regarding (1) what it means for a bank holding company to be a source of financial strength, (2) the circumstances under which a holding company may be called to provide such support to a subsidiary, and (3) the extent of ongoing reporting requirements.

Interested parties should follow the development of the regulations closely, as the interagency regulations will likely have a substantial impact on the nature and scope of a bank holding company's obligations in this area.

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