Insight

Not So Passive? FDIC Proposes Increased Hurdles for Asset Managers Holding Stakes in Banks

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Executive Summary

- The Federal Deposit Insurance Corporation has approved a notice of proposed rulemaking that would make it more difficult for asset managers to hold large stakes in U.S. banks.
- Existing law requires investors to obtain approval and pass certain tests before acquiring more than 10 percent of a bank; asset managers have traditionally enjoyed a waiver from this requirement – which the proposed rulemaking would revoke – due to the supposedly "passive" nature of their investment.
- The proposed rule enjoys bipartisan support, with policymakers concerned about both market consolidation and the ability of third parties to direct banking agendas; industry however has noted the impact of the increased cost of compliance and the potential disincentives to investment.

Introduction

For several months the Federal Deposit Insurance Corporation (FDIC) has grappled with how to better hold to account large investment companies, most notably asset managers, on their promises not to influence or control the banks in which they hold significant stakes. On Tuesday the FDIC approved a notice of proposed rulemaking that represents the results of bipartisan negotiation. Under the proposal asset managers would no longer have access to a waiver exempting them from aspects of the Change in Bank Control Act, making it more difficult for asset managers to acquire significant stakes in banks without first demonstrating that they are not seeking to influence that bank's management.

The Proposed Rule

Under the Change in Bank Control Act, no person may acquire control of a bank (defined as the power to directly or indirectly influence management or the policies of a bank, or vote 10 percent or more of any class of voting securities) without at least 60 days written notice to the appropriate federal banking agency. At the FDIC, current practice is to forgo these notification requirements where the investor has made a "passivity commitment"; in effect a rebuttal to the charge that the acquisition has granted the investor control, which may include promises, for example, to not seek representation on the bank's board of directors. The FDIC currently has four passivity agreements in place with three asset management companies, most notably Vanguard Group.

While the FDIC notes "It has long been the policy of the FDIC that any passivity commitments executed in connection with an acquisition of voting securities must be tailored to the facts and circumstances of each situation," until now, the FDIC has relied on these large investors to self-certify whether they are in fact meeting the requirements of the passivity agreement.

The new proposed rule would eliminate asset managers' effective exemption from notification and approval requirements when obtaining control over banks; in addition, the FDIC would no longer rely exclusively on self-certification, instead requiring investors to pass a test administered by the FDIC to prove that they are not seeking to influence the banks they invest in.

Implications

Over the last few decades, there has been "exponential growth" in index mutual funds and exchange-traded funds. As index investments have grown, so too have investors' investment in the stock that make up these indexes. As a result, large asset managers are frequently the largest shareholder of a bank, which puts them in a privileged position to actively or passively impact the operations of the bank, voting on products, mergers, and governance.

It is becoming increasingly clear that self-policed commitments to passivity are not the best way to regulate these interactions. Rohit Chopra, director of the Consumer Financial Protection Bureau (CFPB) and board member of the FDIC contends that it is "highly inappropriate for the FDIC to abdicate the responsibility Congress entrusted to us to safeguard the ownership and control of the banks we supervise".

In addition to simply bringing asset managers into alignment with existing Bank Control Act requirements, the proposal would give the federal banking regulators more insight into the nature of the interactions between the banks they oversee and their large institutional investors, allowing the regulators to better ensure the independence of banks and in particular bank management. For some, it is simply enough to throw up a few common-sense hurdles in the way of increasing industry consolidation amid antitrust concerns.

Support for the rule notably does not extend into the institutional investment community. Critics of the rule have noted the increased costs of compliance that will inevitably be passed to consumers, and the likely result of disincentivizing investment to be a reduction of available capital at the banks the FDIC regulates.

Conclusions

As the FDIC notes in its proposed rule, the character of regulation no longer matches the character of the investor interactions it oversees. Even if it were appropriate for a regulator to continue to rely solely on the gentlemanly assurances of institutional investors that their involvement in the banks over which they exert significant control will be invisible (it probably isn't), the sheer scale of growth in the index fund market and commensurate power asset managers can exert over the nation's banks is a problem that can no longer be ignored. A low-touch regulatory fix removing certain actors' exemption to an existing law feels like an elegant solution to the problem.