Boston University School of Law

# Fundamentals of Banking Law

Boston University School of Law
765 Commonwealth Avenue
Boston, Massachusetts
June 24 – 26, 2024

BOSTON UNIVERSITY

# COURSE AGENDA

## DAY ONE: Basic Bank Structure, Supervision and Enforcement

| Start Time | Tab | Session | Faculty Member |
|---|---|---|---|
| 8:00 | | Welcome and Introductions; Summary of Course | K. Sparks |
| 8:30 | A | Overview of Bank Regulatory Structure, Themes and Law | K. Sparks |
| 9:30 | | Break | |
| 9:45 | B | Examination and Supervision | J. Silvia |
| 11:00 | C | Enforcement | K. Handly |
| 12:15 | | Luncheon with speaker | |
| 1:45 | D | Building the Banking Organization: Structural Choices and Powers of Banks | J. Buchman/ H. Conroy |
| 3:15 | E | Bank Holding Companies and Concepts of Control | S. Alvarez |
| 4:15 | | Break | |
| 4:30 | F | Mutuals and Conversions | K. Handly |
| 5:30 | | Reception | |

## DAY TWO: The Business of Banking

| | | | |
|---|---|---|---|
| 8:00 | G | Understanding a Bank through its Financial Statements | K. Sparks |
| 9:00 | H | Capital and Liquidity Requirements | H. Conroy |
| 10:15 | | Break | |
| 10:30 | I | Restraints on Lending | J. Buchman |
| 11:30 | J | Affiliate Transactions | J. Silvia |
| 12:30 | | Luncheon | |
| 1:30 | K | Deposit Products and Issues | S. Kelsey |
| 2:45 | L | Privacy, Cyber and Data Security | J. Johnson |
| 4:00 | | Break | |
| 4:15 | M | Regulation of Fintech | S. Elliott |
| 5:30 | | Adjourn | |

## DAY THREE: Regulatory Process, Bank Failure and Ethics

| | | | |
|---|---|---|---|
| 8:00 | N | M&A and the Application Process | S. Alvarez |
| 9:15 | 0 | The Role of the Banking Sector in preventing Money Laundering and Terrorism Financing (AML-BSA) | J. Geiringer |
| 10:30 | | Break | |
| 10:45 | P | Bank Failures and Orderly Resolution | S. Kelsey |
| 12:00 | Q | Ethical Issues Facing Lawyers Representing Banking Institutions | Alvarez, Geiringer, Buchman |
| 1:00 | | Adjourn | |

**Fundamentals of Banking Law**
June 24-26, 2024

**Faculty**

**Scott G. Alvarez, retired General Counsel, Board of Governors of the Federal Reserve System**

Scott was an attorney in the Legal Division of the Board of Governors of the Federal Reserve System for 36 years, including serving as the General Counsel of the Board and the Federal Open Market Committee for 13 years. As the chief legal officer for the Board of Governors, he provided legal and policy advice on a wide range of regulatory, administrative, organizational, legislative and other issues related to the duties, operations and other matters of interest to the Federal Reserve Board, Federal Reserve System, and FOMC. He drafted regulations, legislation, testimony and legal and policy memoranda for the Board of Governors and senior officers of the Federal Reserve, and managed the Legal Division, which was comprised of 95 attorneys and 25 staff. Scott testified more than a dozen times before Congress on various issues related to banking regulation and the Federal Reserve and before the Financial Crisis Inquiry Commission and the Congressional Oversight Panel regarding the financial crisis of 2007-2009. He also served as a representative of the Federal Reserve on the Financial Stability Oversight Council. Throughout his career, Scott provided legal, drafting and technical assistance to Congress on various legislative matters, including the Dodd-Frank Act, the Gramm-Leach Bliley Act, FDICIA, FIRREA, the Federal Reserve Act, the Bank Holding Company Act, the FDI Act, the Community Reinvestment Act, the Truth in Lending Act and various other banking and consumer laws. Since his retirement, Scott has served as a guest lecturer on central banking, banking regulation and the financial crisis at Boston University Law School, New York Law School and the Yale School of Management. He holds a degree in economics from Princeton University and a JD from the Georgetown University Law Center.

**John A. Buchman, Lecturer in Law, USC Gould School of Law**

John A. Buchman a member of the adjunct faculty at USC's Gould School of Law where he has co-taught a Financial Regulation course since 2019. Previously, from 1991 to 2015, John was a member of the adjunct faculty at GW Law School, where he taught Banking Law and financial regulatory reform seminar classes. From 2010 to 2015, John served as the first Chair of the Advisory Board of GW Law's Center for Law, Economics and Finance. John has also guest lectured on Dodd-Frank at Berkeley Law School. From December 2015 to January 2024, John was Director, Research and Reference Attorney and an Attorney specializing in bank regulatory matters for Charles Schwab & Co. Inc. From 2013 to 2015, John was Executive Counsel, Regulatory Affairs with GE Capital in Norwalk, CT, and prior to that was Vice President, General Counsel, and Corporate Secretary of E*TRADE Bank in Arlington, VA for over 12 years. Mr. Buchman previously was a partner with Holland and Knight, LLP and Alston & Bird LLP and served as an Assistant General Counsel in the Corporate and Securities Division of the Federal Home Loan Bank Board and the Office of Thrift Supervision. Mr. Buchman is a member of the American Bar Association's Banking Law and Consumer Financial Services Committees and the Exchequer Club. Mr.

Buchman received a law degree from Harvard Law School and a bachelor's degree from the Georgetown University School of Foreign Service.

**Hugh C. Conroy, Jr., Partner, Cleary Gottlieb Steen & Hamilton LLP**

Hugh C. Conroy Jr. is a partner at Cleary Gottlieb Steen & Hamilton LLP based in the New York office. He is distinguished as one of the leading financial services regulation lawyers by IFLR 1000: The Guide to the World's Leading Law Firms, The Legal 500 U.S. and Chambers USA. Mr. Conroy's practice focuses on bank and bank holding company regulatory issues. Mr. Conroy currently devotes a significant portion of his practice to advice and advocacy regarding the Dodd-Frank Act and rules promulgated thereunder, including rules related to capital, liquidity, the Volcker Rule and banking regulation of derivatives and securities financing transactions. In the last few years, he has expanded into providing advice on digital assets and specialty entity charters. Mr. Conroy has presented on bank regulatory issues at conferences sponsored by the American Bar Association, the Financial Markets Association, and the Securities Industry and Financial Markets Association, and has been a guest lecturer on bank regulatory matters at Columbia University School of Law and New York University School of Law. Mr. Conroy is a former vice-chairman of the American Bar Association Banking Law Committee (2014-2017) and a former vice-chair (2006-2009) and chair (2009-2012) of the Banking Law Committee's Securities, Capital Markets and Derivatives sub-committee.

Mr. Conroy co-authors (with Derek M. Bush) a chapter entitled "U.S. Regulation of International Activities of U.S. Banking Organizations" (Regulation of Foreign Banks & Affiliates in the United States, Ninth Edition, 2016). Mr. Conroy is also a co-author (with Robert L. Tortoriello and Derek M. Bush) of the Guide to Bank Underwriting, Dealing & Brokerage Activities (ThomsonReuters, 22nd ed., 2018). From 2004 to 2011, Mr. Conroy served as associate general counsel and managing director in Citigroup's Bank Regulatory Office. From 1996 to 2004, he was an associate in Sullivan & Cromwell LLP's Banking Group practice. He received a J.D. degree from Columbia University School of Law in 1996 and an undergraduate degree, summa cum laude, from the College of William and Mary in 1992.

**Sarah Elliott, Independent Director, Anchorage Digital Bank; former General Counsel and Chief Compliance Officer, ONE; Vice Chair, Banking Law Committee of the American Bar Association**

Sarah is an Independent Director on the board of Anchorage Digital Bank NA, the first federally chartered digital asset bank, and a Senior Advisor at FS Vector, a strategic consulting firm in the fintech space. She is a guest lecturer in banking and fintech law at law schools across the US, and serves as an advisor to various venture funds and private companies. Previously, from inception until acquisition by Walmart and Ribbit Capital in 2022, Sarah was the GC and CCO at ONE, a retail banking platform that integrated spending, saving, borrowing, and sharing in one account using one card. Sarah was also the first GC and CCO at Azlo, a small business banking platform, and the first lawyer and Head of Compliance at Blend, a loan application platform for banks and mortgage lenders. In 2017, Sarah founded the 94104 Exchange, a San Francisco-based forum for fintech lawyers and compliance professionals that facilitated "the unregulated exchange of ideas." Prior to that, in Washington, DC, Sarah was an attorney at the OCC and at BuckleySandler LLP, and a Principal at Promontory Financial Group. Sarah earned her JD at GW Law and holds Bachelor's and Master's degrees in Music.

**John M. Geiringer, Partner, Barack Ferrazzano Kirschbaum & Nagelberg LLP**

As the Regulatory Section Leader of the Financial Institutions Group at Barack Ferrazzano Kirschbaum & Nagelberg LLP law firm in Chicago, John concentrates his practice on regulatory, governance, and investigative matters involving financial institutions. He is a frequent speaker and author in the financial institutions area on issues surrounding banking regulations, examinations, and enforcement actions, as well as on national security issues.

John is active in the financial industry and has served as a leader at various organizations involved with financial services law, including as a Vice-Chair of the American Bar Association's Banking Law Committee. Working at the forefront of banking law and regulation, John is a thought leader in the field, primarily through teaching, writing, and frequent media interviews. Some of these contributions include being the editor of Banking Law Essentials and a contributor to Keys to Banking Law: A Handbook for Lawyers.

John also devotes significant time to anti-money laundering and related national security issues. In this regard, he lectures and advises institutions around the country, engages with relevant organizations, and has published on the subject. He is the Editor of Countering the Financing of Terrorism: Law and Policy and serves as the founding Co-Director of the Center for National Security and Human Rights Law at Chicago-Kent College of Law, where he teaches courses in banking, national security, and the Holocaust.

Prior to joining the Firm in 1999, John worked as a bank regulator and also as a compliance consultant. He served as legal counsel for the Illinois bank regulatory agency, now the Illinois Department of Financial and Professional Regulation. John also obtained practical experience with respect to bank operations and compliance issues as a regulatory consultant with a regional accounting firm, performing compliance reviews and training for a variety of financial institutions.

**Kevin J. Handly, Director, Graduate Programs in Taxation and Banking and Financial Law, Principal, bostonbankinglaw.com**

Kevin Handly has taught financial institutions mergers and acquisitions law in the Graduate Program at Boston University School of Law for over 20 years. In January 2023 Kevin was appointed Director of the Law School's Graduate Programs in Taxation and Banking and Financial Law. Kevin is the founder and principal of bostonbankinglaw.com, an independent source of financial regulatory advice and representation. From 1995 through 2013, Kevin helped a number of major Boston law firms, including Goodwin Procter, Nixon Peabody and Goulston & Storrs, establish bank corporate and regulatory practices. Prior to entering private practice, Kevin was a senior litigation and enforcement attorney at the Board of Governors of the Federal Reserve System in Washington DC. Kevin earned his litigation legs an Assistant District Attorney in Brooklyn, New York. During law school, Kevin reviewed national bank branch applications, summarized comments on proposed banking regulations and helped investigate Bert Lance as a Law Clerk at the Office of the Comptroller of the Currency. Kevin was selected by his peers for inclusion in the 2024 edition of The Best Lawyers in America© in the areas of Bank and Finance Law and Financial Services Regulation Law. Kevin received a BSFS in International Economic Affairs from Georgetown's School of Foreign Service and a JD from Georgetown University Law Center.

**Jay Johnson, Deputy Chief Counsel – Privacy, Cybersecurity and AI | TC&B Legal Group, Charles Schwab**

Jay Johnson is Managing Director and Deputy Chief Counsel in the Technology, Contracts, and Brand Awareness legal group at Charles Schwab and oversees privacy, cybersecurity, and artificial intelligence for the company's legal team. He also is an adjunct professor at the SMU Dedman School of Law, where he developed and teaches the school's flagship class on data privacy and cybersecurity law. Jay previously was a partner in Jones Day's Cybersecurity, Privacy, and Data Protection practice group and an Assistant U.S. Attorney in the Eastern District of Texas. At the U.S. Attorney's Office, he coordinated the U.S. Attorney's efforts to investigate and prosecute cyber crime and IP theft, and he served as the primary internal resource for the district's prosecutors on issues related to the collection and use of electronic evidence. At the outset of his career, Jay clerked for federal judges in the District of Kansas and at the Court of Appeals for the Federal Circuit. He received a bachelor's degree in mechanical engineering from Kansas State University, a law degree from the University of Iowa College of Law, and an MBA from the MIT Sloan School of Management.

**Sara A. Kelsey, Former General Counsel of the FDIC and former Adjunct Professor, New York University Law School and New York Law School. Currently, Solo Practitioner.**

Ms. Kelsey established her solo practice in 2012, specializing in bank regulatory law. She advises on legislative and regulatory developments and restructuring, resolution, compliance and enforcement matters affecting bank and nonbank financial firms. Most recently, Ms. Kelsey was counsel in WilmerHale's Regulatory and Government Affairs Department and a member of the firm's Financial Institutions Group. In early 2007, she was appointed General Counsel of the Federal Deposit Insurance Corporation and served in that capacity until late 2008. Before that, she served as Deputy Superintendent and General Counsel of the New York State Banking Department (now part of the NYSDFS) from 1998-2007. Previously, she was counsel in the Financial Institutions Regulatory and Enforcement Group at Skadden, Arps, Meagher & Flom. Prior to that, she was regulatory counsel with a predecessor bank to JPMorgan Chase Bank, NA. She began her career at the Federal Reserve Board. She received a JD from New York University School of Law and a BA in Sociology from the University of California, Berkeley.

**Joseph E. Silvia, Partner, Dickinson Wright PLLC**

Joseph E. Silvia is a Partner in the Chicago office of Dickinson Wright PLLC. Joe's clients seek out his guidance on a variety of matters including mergers & acquisitions, strategic transactions, governance, international banking, payments systems, anti-money laundering and sanctions, and private equity and venture capital investments. He advises financial institutions, fintech companies, and corporations regarding risk and compliance, third party vendor management, consumer protection, digital currencies, affiliate transactions, privacy, and retail and commercial banking, including handling significant drafting and negotiation of vendor agreements and agreements between financial institutions and their customers and members.

Joe handles matters for his clients concerning banking and financial services regulation, including state and federal regulation with respect to licensing, retail banking, consumer credit, cannabis, anti-money laundering and OFAC compliance, and more. Having previously served as counsel to the Federal Reserve Bank of Chicago, where he focused on the supervision and regulation of banks, bank holding companies, and savings and loan holding companies as well as consumer finance and compliance matters, Joe has a unique perspective on all aspects of the banking system.

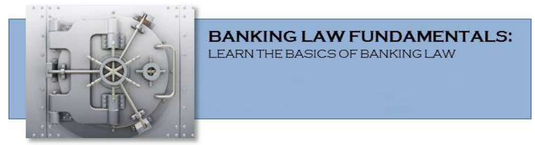
Joe is an adjunct professor at Chicago-Kent College of Law, where he teaches a course on Consumer Banking Law.

**Karol K. Sparks, Senior Counsel, Barack Ferrazzano Kirschbaum & Nagelberg LLP**

Karol K. Sparks is Senior Counsel in the financial institutions practice group of Barack Ferrazzano Kirschbaum & Nagelberg LLP, Chicago, Illinois. Her practice concentration relates to general bank regulatory matters and mergers, acquisitions, and corporate activities of financial institutions, with special emphasis on non-traditional bank products and services, including insurance and broker-dealer activities, licensing, and acquisitions, and commercial and consumer deposit and payment products. Karol attended Sweet Briar College, holds a B.A. degree from Butler University and a J.D. degree (1979) from Indiana University School of Law. She is a member of the Illinois, New York, Indiana (inactive), and California (inactive) Bars.

An active member of the Banking Law Committee of the Business Section of the American Bar Association since 1984, Karol was promoted to its leadership and served as its chair from August of 1998 until August of 2002. Following her term as chair of the committee, she was appointed to a four-year term on the Council of the Business Section of the ABA in 2004, where she served on the Finance Committee. Thereafter, she served as a member of the Publications Board of the Business Section, was appointed its vice chair in 2010-2011 and, for a two-year term that ended in August of 2014, she chaired the Publications Board.

Karol's most recent, and most basic, book, Banking Law Essentials, was just published by the American Bar Association in 2022. She is also the author of The Keys to Banking Law, A Hand Book for Lawyers (now in its Third Edition), published by the Business Law Section, and the legal treatise Insurance Activities of Banks (now in its second edition), published by Wolters Kluwer in 1998 and updated annually, as well as numerous articles on bank acquisitions and activities. From 2009 until 2013, she was an Adjunct Professor at Wake Forest University School of Law, having previously taught at the University of Iowa College of Law as an Adjunct from 2001-2007. From January of 2014 until she retired in April of 2018, she was a Lecturer in Law in the Graduate Program in Banking and Financial Law of the Boston University School of Law. She is a member of the founding faculty of Banking Law Basics, an ABA-CLE course offered in June and October of each year from 1998-2011, and its successor course, Banking Law Fundamentals, which began in 2012.



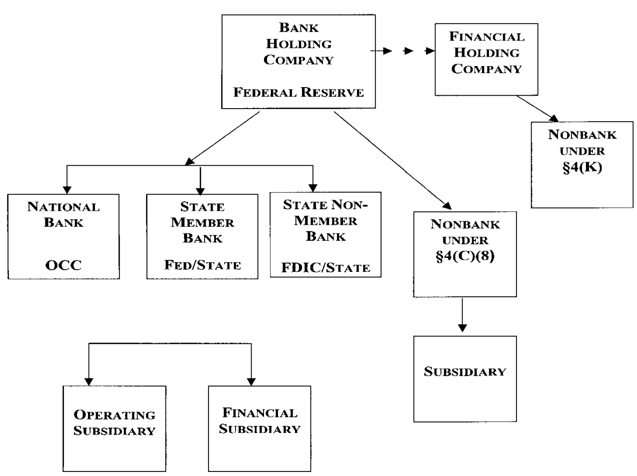

# Overview of Bank Regulatory Structure and Law

Karol Sparks

1

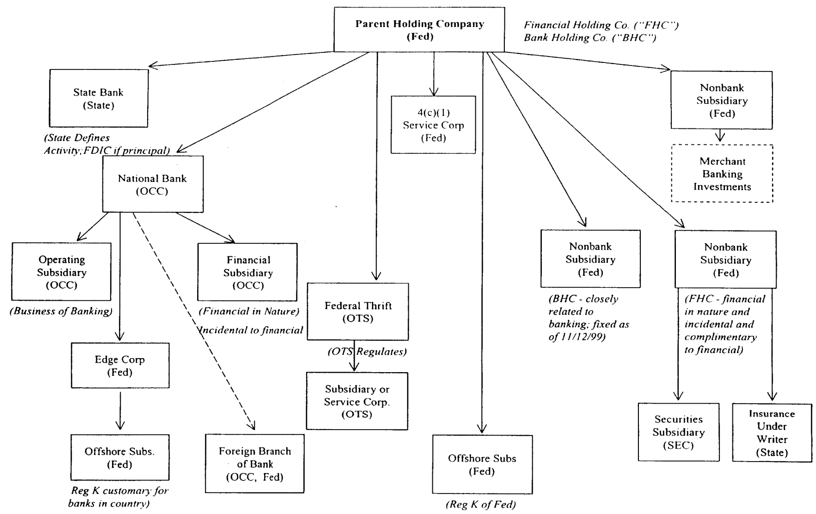


# Introduction to the Bank Family




2

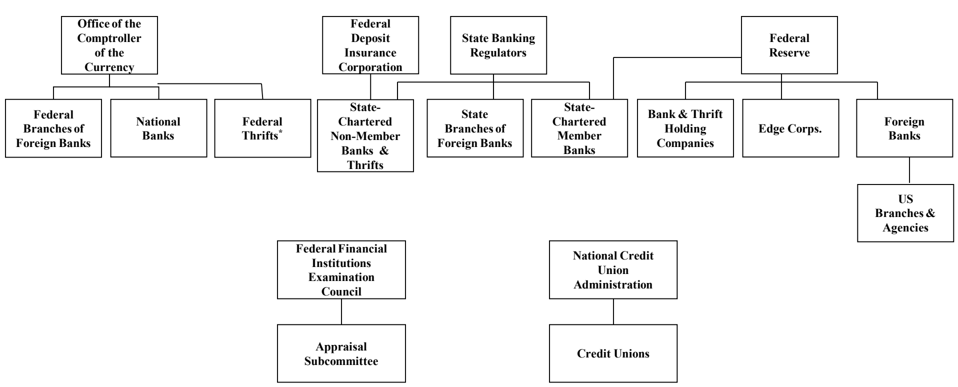
# FUNCTIONAL REGULATION AFTER GRAMM-LEACH-BLILEY







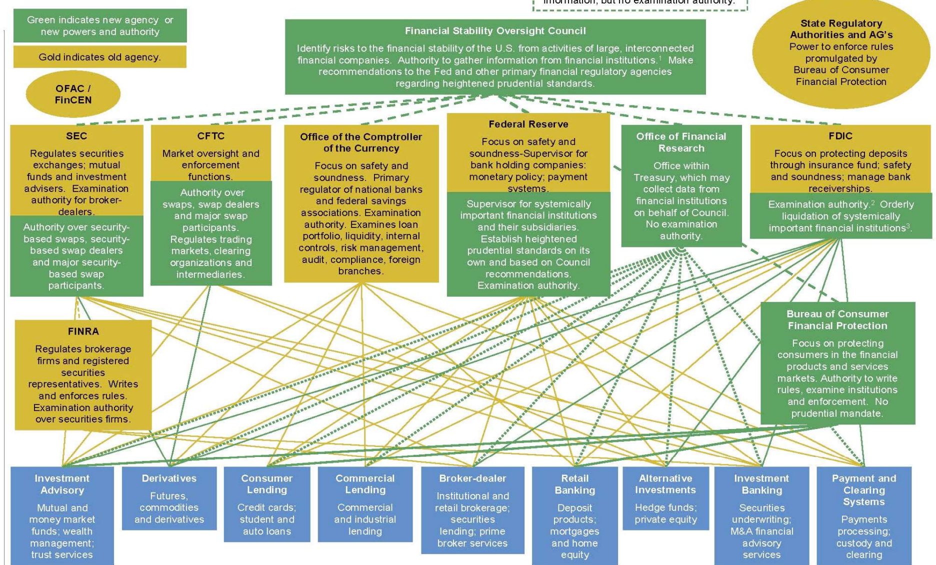

# STRUCTURE OF U.S. BANKING SYSTEM




* A thrift is a savings and loan association or a savings bank.

…but this is not the optimal way to run a robust financial system – oversight needs to be simple, transparent, coordinated and consistent

Dotted line indicates authority to request information, but no examination authority.




This chart assumes these activities are conducted in a systemically important bank holding company (BHC)
[1] The Council, through Office of Financial Research, may request reports from systemically important BHCs
[2] FDIC may conduct exams of systemically important BHCs for purposes of implementing its authority for orderly liquidations, but may not examine those in generally sound condition
[3] The Dodd-Frank Act expanded the FDIC's authority when liquidating a financial institution to include the bank holding company, not just entities that house FDIC-insured deposits

19

Note: Green lines from SEC and CFTC represent enhanced authority over existing relationships

JPMORGAN CHASE & CO.

## Banking Fundamentals

**WHY?????**

*"The answer to this is obvious: the current bank regulatory structure offends all of our aesthetic and logical instincts. It's complicated; it's irrational; it probably has inefficiencies; and it takes a great deal of explaining.*

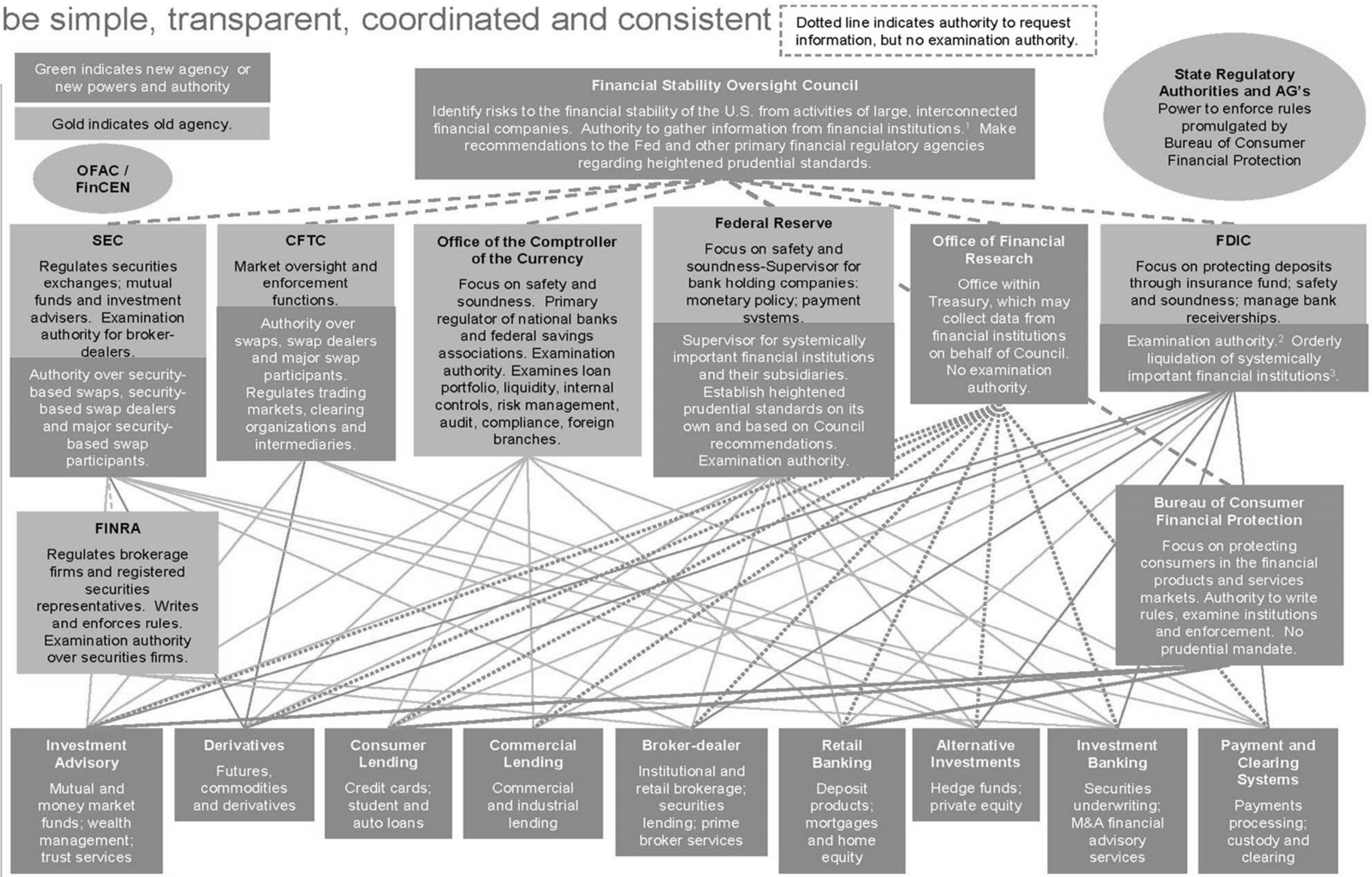
*"It's the product of historical accident, improvisation, and expediency, rather than a methodically crafted plan.*

*"It reflects the accretion of legislative enactments, each passed at a very different time –and under different circumstances – in our history."*

John D. Hawke, Jr., Comptroller of the Currency, April, 2003

6

## …but this is not the optimal way to run a robust financial system – oversight needs to be simple, transparent, coordinated and consistent




This chart assumes these activities are conducted in a systemically important bank holding company (BHC)

[1] The Council, through Office of Financial Research, may request reports from systemically important BHCs

[2] FDIC may conduct exams of systemically important BHCs for purposes of implementing its authority for orderly liquidations, but may not examine those in generally sound condition

[3] The Dodd-Frank Act expanded the FDIC's authority when liquidating a financial institution to include the bank holding company, not just entities that house FDIC-insured deposits

Note: Green lines from SEC and CFTC represent enhanced authority over existing relationships





JPMORGAN CHASE & CO.

*The "accretion of legislative enactments" began as our country began:*





## AFTER THE REVOLUTIONARY WAR:

There were state banks organized under the authority of various state legislatures

- Deposit takers and short-term commercial lenders
- Issued notes backed by gold/silver/customer notes
- Bank of New York (1784/1791); Manhattan Company (1799)
- No state supervision until 1829 (New York)
- 88 state banks by 1811

## After the Revolutionary War:

Two attempts at a bank of the U.S., operating as a central bank and modeled after the Bank of England, failed after 20-year stints.

- First Bank of the United States (1791-1811)– tension between Jefferson and Hamilton
- Second Bank of the United States (1816-1836) – riddled with insider abuse and a campaign issue for the presidential run by Andrew Jackson





## Civil War -1863

## IMPORTANT BANKING LEGISLATION

**National Bank Act of 1864**
(Chapter 106, 13 STAT. 99).

In response to the civil war financing needs, the NBA established a national banking system and the chartering of national banks; established the Office of the Comptroller of the Currency (OCC).



## BANKING FUNDAMENTALS

## PANIC OF 1907

# THE GREAT DEPRESSION- 1928



## IMPORTANT BANKING LEGISLATION

**Home Owners Loan Act of 1932**.

Established the thrift charter, with focus on retail saving and home ownership. Created the Federal Home Loan Bank Board (FHLBB) as the federal regulator.

## IMPORTANT BANKING LEGISLATION

### Banking Act of 1933

(P.L. 73-66, 48 STAT. 162).

**Also known as the Glass-Steagall Act.**

The first major post-depression legislation, Glass-Steagall, established the FDIC as a temporary agency. Separated commercial banking from investment banking, establishing them as separate lines of commerce.





## IMPORTANT BANKING LEGISLATION

### Banking Act of 1935

(P.L. 74-305, 49 STAT. 684).

Established the FDIC as a permanent agency of the government.

# LET THE GOOD TIMES ROLL - INNOVATION – 1950'S



## IMPORTANT BANKING LEGISLATION

### Bank Holding Company Act of 1956 (BHCA)

(P.L. 84-511, 70 STAT. 133) (and Amendments of 1970).

Required Federal Reserve Board approval for the establishment of a bank holding company. Prohibited bank holding companies headquartered in one state from acquiring a bank in another state.

Only multiple bank holding companies covered in 1956; one bank holding companies covered in 1970 amendments.

## IMPORTANT BANKING LEGISLATION

**Savings and Loan Holding Company Act of 1959**

Established the regulatory framework for holding companies that owned more than one thrift, creating the exception for "unitary thrift holding companies" to engage in any activity .



## BANKING FUNDAMENTALS

**THRIFT CRISIS – 1979** much higher interest rates, culminating in crisis in late 1980's

## Important Banking Legislation

**Depository Institutions Act of 1982**
(P.L. 97-320, 96 STAT. 1469).

**Also known as Garn-St Germain.**

Expanded FDIC powers to assist troubled banks. Established the Net Worth Certificate program. Expanded the powers of thrift institutions and limited the insurance powers of bank holding companies.





## Important Banking Legislation

**Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)**
(P.L. 101-73, 103 STAT. 183).

- FIRREA's purpose was to restore the public's confidence in the savings and loan industry. FIRREA abolished the Federal Savings & Loan Insurance Corporation (FSLIC), and the FDIC was given the responsibility of insuring the deposits of thrift institutions in its place. The FDIC insurance fund created to cover thrifts was named the Savings Association Insurance Fund (SAIF), while the fund covering banks was called the Bank Insurance Fund (BIF).
- FIRREA also abolished the Federal Home Loan Bank Board. Two new agencies, the Federal Housing Finance Board (FHFB) and the Office of Thrift Supervision (OTS), were created to replace it.

## IMPORTANT BANKING LEGISLATION

### Federal Reserve Act of 1913

(P.L. 63-43, 38 STAT. 251, 12 USC 221).

In response to a financial panic and the need for a central bank, the FRA established the Federal Reserve System as the central banking system of the U.S. Created 12 Reserve Banks and the Board of Governors.





## IMPORTANT BANKING LEGISLATION

**To Amend the National Banking Laws and the Federal Reserve Act** (1927)

(P.L. 69-639, 44 STAT. 1224).

**Also known as The McFadden Act.**

Prohibited interstate banking of national banks, unless permitted for state banks.

# Important Banking Legislation

## Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

(P.L. 102-242, 105 STAT. 2236).

- FDICIA greatly increased the powers and authority of the FDIC. Major provisions recapitalized the Bank Insurance Fund and allowed the FDIC to strengthen the fund by borrowing from the Treasury. **The act mandated a least-cost resolution method and prompt resolution approach to problem and failing banks and ordered the creation of a risk-based deposit insurance assessment scheme.** Brokered deposits and the solicitation of deposits were restricted, as were the non-bank activities of insured state banks. FDICIA created new supervisory and regulatory examination standards and put forth new capital requirements for banks. It also expanded prohibitions against insider activities and created new Truth in Savings provisions.

- FDICIA also limited the authority of state banks and their subsidiaries to act as principal in activities prohibited to national banks without approval of the FDIC and prohibited insurance underwriting through state banks, except to the extent permitted to national banks.





# LET THE GOOD TIMES ROLL - INNOVATION – 1990's

# Important Banking Legislation

## Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

(P.L. 103-328, 108 STAT. 2338)

Permits adequately capitalized and managed bank holding companies to acquire banks in any state one year after enactment. Concentration limits apply and CRA evaluations by the Federal Reserve are required before acquisitions are approved. Beginning June 1, 1997, allows interstate mergers between adequately capitalized and managed banks, subject to concentration limits, state laws and CRA evaluations. Extends the statute of limitations to permit the FDIC and RTC to revive lawsuits that had expired under state statutes of limitations.





# Important Banking Legislation

## Gramm-Leach-Bliley Act of 1999 (GLBA)

(P.L. 106-102, 113 STAT 1338)

- Repeals last vestiges of the Glass Steagall Act of 1933. Modifies portions of the Bank Holding Company Act to allow affiliations between banks and insurance underwriters. While preserving authority of states to regulate insurance, the act prohibits state actions that have the effect of preventing bank-affiliated firms from selling insurance on an equal basis with other insurance agents. Law creates a new financial holding company under section 4 of the BHCA, authorized to engage in: underwriting and selling insurance and securities, conducting both commercial and merchant banking, investing in and developing real estate and other "complimentary activities." There are limits on the kinds of non-financial activities these new entities may engage in.

- Restricts the disclosure of nonpublic customer information by financial institutions. All financial institutions must provide customers the opportunity to "opt-out" of the sharing of the customers' nonpublic information with unaffiliated third parties. The Act imposes criminal penalties on anyone who obtains customer information from a financial institution under false pretenses.

# GLOBAL FINANCIAL CRISIS - 2008



## IMPORTANT BANKING LEGISLATION

### Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank" or "DFA")

Pub. Law 111-203 (2010)

- DFA boasted 16 titles and created 13 new Federal offices, including the **Financial Stability Oversight Council (FSOC)** with its principal mission to prevent systemic risk from threatening the financial system. In so doing, the Oversight Council fills gaps in supervision, monitors financial market developments, identifies emerging risks in firms and market activities, and facilitates coordination of interagency policy and resolution of disputes.
- The Federal Reserve was tasked with creating a single point of accountability over financial firms, the failure of any of which could pose a threat to financial stability, regardless of whether they own banks. This included nonbank firms designated by the Council, as well as all bank holding companies with total consolidated assets equal to or greater than $50 billion (increased to $250 billion).

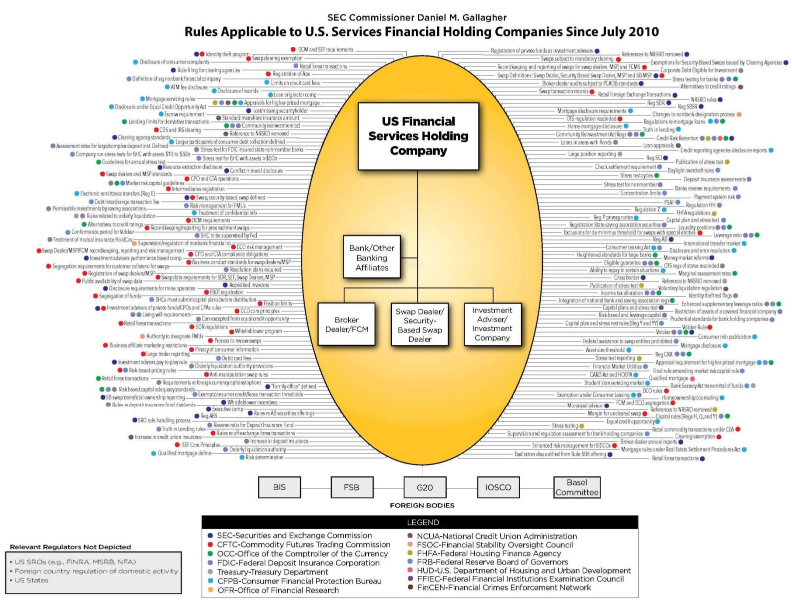
# Important Banking Legislation

## Dodd-Frank Continued:

- Eliminated the OTS by merging it into the OCC and gave the Federal Reserve jurisdiction over thrift holding companies.
- Title VI eliminated GLBA functional regulation, removing Section 10A from the Bank Holding Company Act, which limited the Federal Reserve's rulemaking and enforcement over functionally regulated affiliates.
- In order to protect consumers, Title X of Dodd-Frank created the **Bureau of Consumer Financial Protection (CFPB)** housed independently within the Federal Reserve that has supervisory, examination, and enforcement authority over consumer-related financial services offered by financial entities. These services include mortgages and other credit or payment products.
- Required BHC capital rules, limited mergers to well-capitalized institutions, broadened de novo branching, subjected derivative and repo exposure to 23 A and B, …

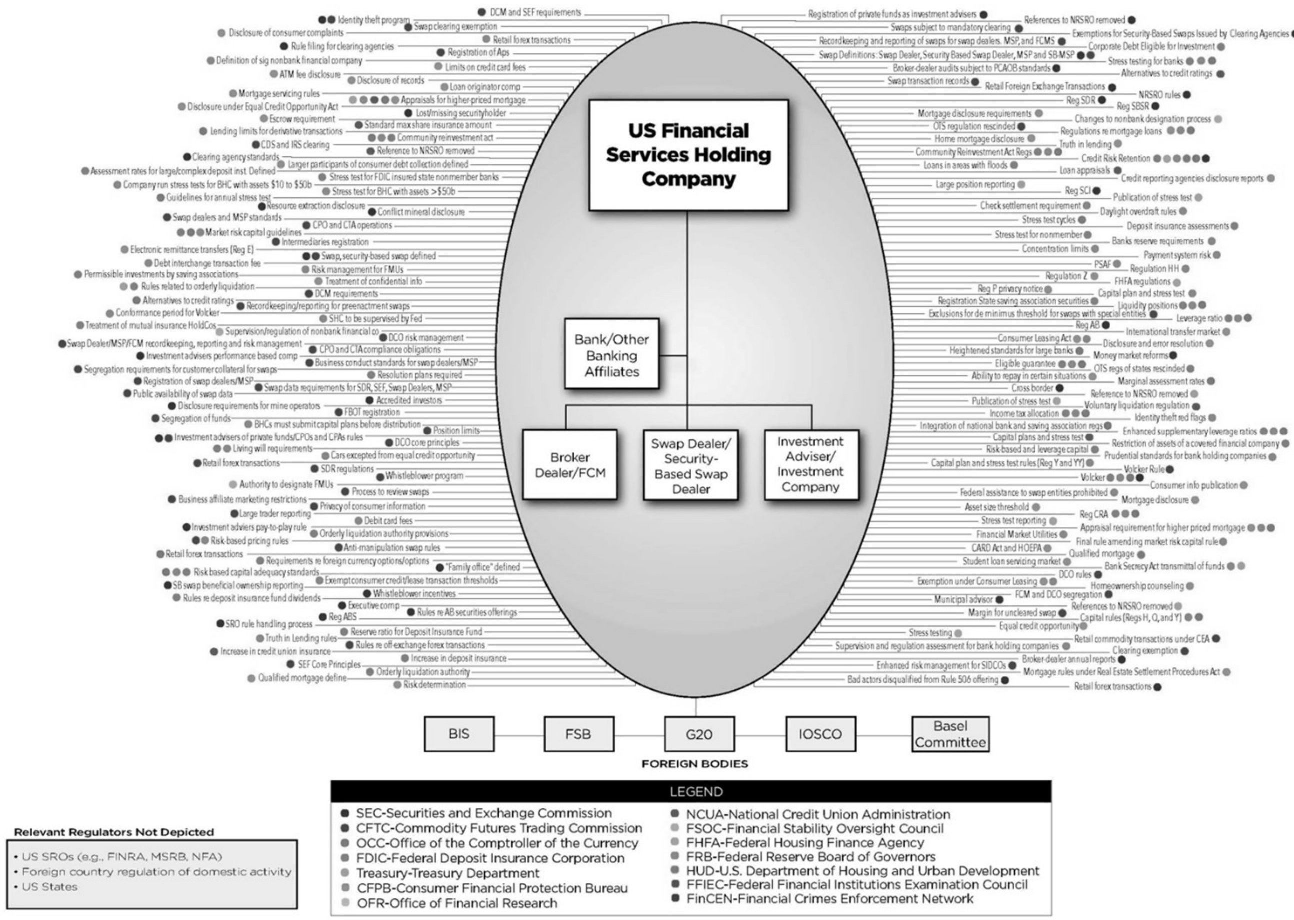






SEC Commissioner Daniel M. Gallagher

## Rules Applicable to U.S. Services Financial Holding Companies Since July 2010



# LET THE GOOD TIMES ROLL – 2018???



## Important Banking Legislation

### Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 (“Reg Relief” or “Crapo”).

Roles back a number of Dodd-Frank provisions, especially dealing with community and regional banks.

- SIFI test increased to $250 billion (from $50 billion);
- $100 billion up to $250 billion subject to tailoring; between $50 billion and $100 billion exempt from enhanced prudential standards (resolution planning, stress tests, single party credit limits) immediately and no longer subject to stress testing;
- Less than $10 billion generally exempt from Volcker Rule and risk committee requirement; less than $10 billion may adopt leverage ratio only (CBLR) (off-ramp for Basel III) of 9%;
- Small BHC rules may apply to $3 billion and less.

## WHERE TO FIND THE LAW?

**Statutes:**

| | |
|---|---|
| **National Bank Act 1864 (NBA)** | **12 U.S.C. § 1** |
| **Federal Reserve Act of 1913** | **12 U.S.C. § 241** |
| McFadden Act 1927, 1933 | |
| **Home Owners' Loan Act** | **12 U.S.C. § 1462** |
| **Federal Credit Union Act** | **12 U.S.C. § 1752** |
| Glass-Steagall Act 1933 | |
| **Federal Deposit Insurance Act 1935, 1950 (FDIA)** | **12 U.S.C. § 1811** |
| **Bank Holding Company Act of 1956, 1970 (BHCA)** | **12 U.S.C. § 1841** |





## WHERE TO FIND THE LAW?

Community Reinvestment Act of 1978

**International Banking Act of 1978** **12 U.S.C. § 1301**

Garn-St Germain Act 1992

Money Laundering Control Act of 1986

Competitive Equality Act of 1987

Financial Institutions Reform, Recovery & Enforcement Act of 1989

Federal Deposit Insurance Corporation Improvement Act of 1991

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

Gramm-Leach-Bliley Act of 1999

Emergency Economic Stability Act of 2008

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Economic Growth, Regulatory Relief and Consumer Protection Act of 2018

## WHERE TO FIND THE LAW?

**Regulations:**

12 CFR 1-199 Comptroller of the Currency

12 CFR 200's (A, B) Federal Reserve System

12 CFR 300's FDIC

12 CFR 500's Office of Thrift Supervision

12 CFR 700's National Credit Union Authority

12 CFR 1000's Bureau of Consumer Fin'l Protection





## WHERE TO FIND THE LAW?

**Federal Reserve:**

- Federal Reserve uses letters of the alphabet based on the order in the alphabet – Regulation D is 12 CFR § 204 ($4^{th}$ letter of the alphabet)

**CFPB:**

- Codified former Fed regulations the same way, except in the 1000's – Regulation E is now 12 CFR § 1005 ($5^{th}$ letter of the alphabet)

## Where to Find the Law?

### Interpretations, guidelines, bulletins, etc:

www.occ.treas.gov

www.federalreserve.gov

www.fdic.gov

www.ncua.gov

www.consumerfinance.gov





## Where to Find the Law?

### Case Law?

Not much common law

Seminal cases are typically woven into the regulatory framework – provide texture

- Challenges on preemption, interest rate exportation, bank powers
- Enforcement and bank failures

# Examination and Supervision

## Banking Law Fundamentals

June 24, 2024

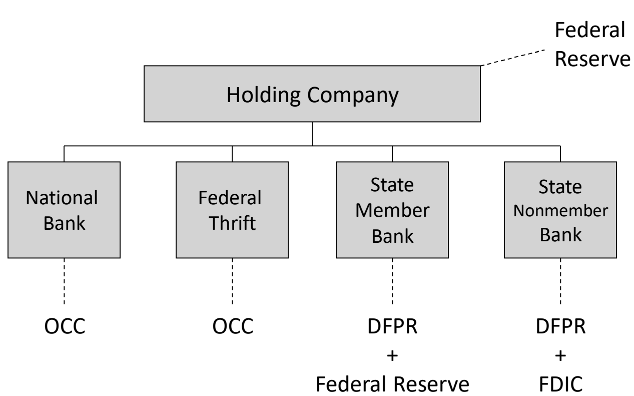
**JOSEPH E. SILVIA**
312.377.7870
jsilvia@dickinsonwright.com

# EXAMINATION ISSUES

# Overview

- Overview of Banking Regulators
- Characteristics of Examinations
- Types of Examinations
- Examination Strategies

# Overview of Banking Regulators



## Characteristics of Examinations

- 12 – 18 month cycles
- Exam team (with home office support)
- Document review and interviews
- Exit meeting
- 1 – 5 rating (1 is strongest)
- Issuance of examination report

## Types of Examinations

- Safety and Soundness
- Bank Secrecy Act
- Compliance
- Trust
- Information Technology
- Community Reinvestment Act
- Holding Company Inspection

# SAFETY AND SOUNDNESS EXAMINATIONS

Safety and Soundness Examinations

## Uniform Financial Institutions Rating System (objective and subjective elements)

- C apital adequacy
- A sset quality
- M anagement
- E arnings
- L iquidity
- S ensitivity (to interest rates)

# Capital Adequacy

| Capital Category | Total Risk-Based Capital Ratio | Tier 1 Risk-Based Capital Ratio | Common Equity Tier 1 Risk-Based Capital Ratio | Tier 1 Leverage Ratio |
|---|---|---|---|---|
| Capital Conservation Buffer | ≥ 10.5% | ≥ 8.5% | ≥ 7% | N/A |
| Well Capitalized | ≥ 10% | ≥ 8% | ≥ 6.5% | ≥ 5% |
| Adequately Capitalized | ≥ 8% | ≥ 6% | ≥ 4.5% | ≥ 4% |
| Undercapitalized | < 8% | < 6% | < 4.5% | < 4% |
| Significantly Undercapitalized | < 6% | < 4% | < 3% | < 3% |
| Critically Undercapitalized | Tangible equity to total assets ratio is ≤ 2% regardless of other capital ratios | | | |

# Capital Adequacy (cont.)

Maintain capital commensurate with:

- Nature/extent of risk to Bank
- Ability of management to identify, measure, monitor and control risks

## Capital Adequacy (cont.)

- Level/quality of capital and overall financial condition of Bank
- Ability to obtain additional capital
- Nature, trend, volume of problem assets/adequacy of ALLL
- Balance sheet composition:
  - Nature/amount of intangible assets
  - Market risk
  - Concentration risk
  - Nontraditional activities

## Capital Adequacy (cont.)

- Quality/strength of earnings
- Reasonableness of dividends
- Prospects/plans for growth and past experience in managing growth
- Access to capital markets and other sources of capital, including holding company support

## Asset Quality

Quantity of existing/potential credit risk associated with loan and investment portfolios, OREO, and other assets -

- Adequacy of underwriting, soundness of credit administration and appropriateness of risk identification
- Level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, nonperforming assets
- Adequacy of ALLL

## Asset Quality (cont.)

- Diversification/quality of loan and investment portfolios
- Asset concentrations
- Adequacy of loan/investment policies, procedures and practices
- Ability of management to properly administer assets, including timely identification/collection of problem assets
- Adequacy of internal controls and management information systems
- Volume/nature of credit documentation exceptions

## Management

Capability of Board/management to:

- Identify, measure, monitor and control risks of Bank's activities
- Ensure Bank's safe, sound and efficient operation in compliance with applicable laws/regulations
- Level/quality of oversight and support of Bank activities by Board/management

## Management (cont.)

- The ability of Board/management to plan for, and respond to, risks arising from changing business conditions or initiation of new activities/products
- Adequacies of, and conformance with, appropriate internal policies and controls addressing operations/risks of significant activities
- Accuracy, timeliness and effectiveness of management information/risk monitoring systems appropriate for Bank's size, complexity, risk profile

## Management (cont.)

- Adequacy of audits/internal controls to:
  - Promote effective operations and reliable financial and regulatory reporting
  - Safeguard assets
  - Ensure compliance with laws, regulations and internal policies
- Compliance with laws and regulations
- Responsiveness to recommendations from auditors/regulators
- Management depth/succession

## Management (cont.)

- Dominant influence or concentration of authority
- Reasonableness of compensation policies and avoidance of self-dealing
- Willingness to serve banking needs of community
- Overall performance of Bank and its risk profile

## Earnings

Quantity/trend of earnings, and factors that may affect sustainability/quality of earnings -

- Level of earnings, including trends/stability
- Ability to provide for adequate capital through retained earnings
- Quality/sources of earnings
- Level of expenses in relation to operations

## Liquidity

- Level/prospective sources of liquidity compared to funding needs
- Adequacy of funds management practices relative to Bank's size, complexity and risk profile
- Adequacy of liquidity sources compared to present/future needs and ability of Bank to meet liquidity needs without adversely affecting its operations/condition

## Liquidity (cont.)

- Availability of assets readily convertible to cash without undue loss
- Access to money markets and other sources of funding
- Level of diversification of funding sources
- Degree of reliance on short-term, volatile sources of funds, including borrowing and brokered deposits, to fund longer term assets

## Liquidity (cont.)

- Trend and stability of deposits
- Ability to securitize/sell certain pools of assets
- Capability of management to properly identify, measure, monitor and control Bank's liquidity position, including:
  - Effectiveness of funds management strategies
  - Liquidity policies
  - Management information systems
  - Contingency funding plans

## Sensitivity (to interest rates)

Degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect Bank's earnings/capital -

- Sensitivity of Bank's earning or economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices
- Ability to identify, measure, monitor and control exposure to market risk given Bank's size, complexity and risk profile

## Bank Secrecy Act Examination

- Currency Transaction Reports
- Suspicious Activity Reports
- Customer Identification Program
- Customer Due Diligence/Enhanced Due Diligence
- Beneficial Ownership Rule
- Office of Foreign Assets Control
- BSA Pillars

## Compliance Examination

- Lending Issues
  (TILA, ECOA, HMDA, FDPA, etc.)
- Deposit Issues
  (TISA, EFAA, EFTA, etc.)
- Operational Issues
  (Privacy, UDAP, E-SIGN, etc.)

## Compliance Examination (cont.)

Old Approach: Checklists

New Approach: Risk-based examination

Evaluate compliance management system

## Trust Examinations

- Account administration
- Asset management
- Security transactions, processing and administration
- Conflict of interest / self dealing

## Information Technology

- Operations security and risk management
- Information security standards
- Audit / independent review program
- Disaster recovery and business continuity
- Cybersecurity

## Community Reinvestment Act Examination

- Lending
- Investment
- Services
- Fair Lending

## Bank Holding Company Inspections*

**RFI/C(D)**

- **R** isk management
- **F** inancial condition
- **I** mpact of the holding company and its nondeposit subsidiaries on its subsidiary banks
- **C** omposite rating
- **D** epository institution

*Modified for holding companies < $3 billion and ≥ $100 billion.

## Strategies

(Before and During Examination)

- Preparation
- Organization
- Courtesy
- Advocacy

## Strategies (cont.)

(After Examination)

- Exit meeting
- Response letter
- Subsequent meeting
- Appeals/Ombudsman
- Examination responses

# QUESTIONS?

# Thank You

**Joseph E. Silvia**
Member
**Dickinson Wright PLLC**
312.377.7870
jsilvia@dickinsonwright.com

Joe provides guidance on a variety of matters including mergers & acquisitions, strategic transactions, governance, international banking, payments systems, anti-money laundering and sanctions, and private equity and venture capital investments. He advises financial institutions, fintech companies, and corporations regarding risk and compliance, third party vendor management, consumer protection, digital currencies, affiliate transactions, privacy, and retail and commercial banking, including handling significant drafting and negotiation of vendor agreements and bank agreements between financial institutions and their clients.

Joe handles matters for his clients concerning banking and financial services regulation, including state and federal regulation with respect to licensing, retail banking, consumer credit, cannabis, anti-money laundering and OFAC compliance, and more. Having previously served as counsel to the Federal Reserve Bank of Chicago, where he focused on the supervision and regulation of banks, bank holding companies, and savings and loan holding companies as well as consumer finance and compliance matters, Joseph has a unique perspective on all aspects of the banking system.

Joe is an adjunct professor at Chicago-Kent College of Law, where he teaches Consumer Banking Law.

# ENFORCEMENT

Kevin J Handly, Esq.
Principal, bostonbankinglaw.com
Director, Graduate Program in Banking & Financial Law
Boston University School of Law

# Enforcement

- Examinations
- Confidential Supervisory Communications
- Material Supervisory Determinations & Appeals
- Agency
- Administrative Enforcement
  - Informal Enforcement Actions
  - Formal Enforcement Actions
  - Conditional Approvals of Applications
- Judicial Enforcement
- Criminal Referrals

# Enforcement

Banking Agencies --
- Federal Reserve Board (FRB)
- Office of the Comptroller of the Currency (OCC)
- Federal Deposit Insurance Corporation (FDIC)

Other --
- Consumer Financial Protection Bureau (CFPB)
- Financial Crimes Enforcement Network (FINCEN)
- Office of Foreign Assets Control (OFAC)
- State Banking Supervisors (STATE BANKING)
- U.S. Department of Justice (DOJ)
- State Regulatory and Law Enforcement (STATE)

# Enforcement

Objects of Enforcement Actions –
- Banks, Savings Associations
- Edge Act and Agreement Corporations, State and Federal Agencies
- Bank Holding Companies, S&L Holding Companies
- Bank, Bank Holding Company, and S&L Holding Company Affiliates
- Institution Affiliated Parties (IAPs)
  - Former Officers, Directors
- Bank Service Companies

## Enforcement

"Informal" enforcement actions --

- Confidential
- Non-Binding
- Implied Authority/Triggers
- Different Forms
  - Management Commitments
  - Board Resolutions
  - Memoranda of Understanding
  - Compliance Plans
  - Other

## Enforcement

"Formal" Enforcement Actions –

- Legally Binding – Due Process Rights
- Publicly Disclosed -- FIRREA
- Explicit Statutory Authority – Agency Jurisdiction
- Triggers – "Law" vs. "Guidance"

## Enforcement

"Due Process" Rights – APA Sections 5, 7 & 8 -- "proceedings required to be held on the record after opportunity for hearing"

- Notice
- Hearing
- Decision
- Judicial Review

7th Amendment right to jury trial, prohibition of excessive fines(?)

5th Amendment privileges against self-incrimination, double jeopardy(?)

Contract impairment prohibited(?) (art. I, §10, cl. 1)

## Enforcement

Agency Rules of Practice

- Uniform Rules
- Local Rules
- Special Procedural Rules

Admission to Agency Practice

- Attorneys
- Non-attorneys
- Rules of Conduct
- Sanctions

# Enforcement

Notice of Charges and of Hearing, Then Answer

- Facts Alleged
- Legal Authority
- Remedies Sought
  - Time allowed to answer
  - Venue

Alternative Procedure – Notice of Action, Then Request for Hearing

- Change in Bank Control Act
- Assessment of Civil Money Penalties
- Emergency C&Ds, Removals

# Enforcement

Waiver and Consent --

Stipulation and Consent

- Explicit Waiver of Rights
- Disclaimers
  - Findings or Adjudication
  - Admission or Denial
- Collateral Effects
- In Force Until Terminated

Implied Waiver -- Default

- Fail to Answer or Request Hearing

# Enforcement

Settlement Proposals -- Uniform Rule ___.15

- Any respondent may at any time submit a settlement proposal
  - Submitted to Enforcement Counsel
  - Without prejudice
  - Not admissible
  - No stay of proceedings

# Enforcement

Pre-Hearing Practice

- Appearance
- Motions
- Discovery
  - Parties
  - Non-Party Witnesses
  - Subpoenas
  - Depositions
- Pre-Hearing Conference & Order

# Enforcement

Opportunity for Hearing

- No Dispute of Fact, No Hearing
- Motions
- Objections
- Evidence
  - Witnesses
  - Depositions
  - Exhibits
  - Chalks
- Privilege

# Enforcement

Post-Hearing --

- Hearing Transcript
- Proposed Findings of Fact, Conclusions of Law, Briefs, Argument
- Recommended Decision
- Exceptions

## Enforcement

Agency Decision

- Certification of Record
- Preservation of Issues, Waiver
- Briefing, Oral Argument
- Decision
- Appeal

## Enforcement

Cease & Desist Orders

"Cease and Desist" from --

- Unsafe and Unsound Practices, Conditions, Investments
- Violations of Law/Regulation
- Breaches of Fiduciary Duty
- Unfair and Deceptive Acts/Practices

## Enforcement

Cease & Desist Orders

Affirmative remedial requirements --

- Draft remedial plans to agency for review and approval
  - Address all agency comments and recommendations
  - Adopt and comply with agency-approved plans
- Quarterly compliance reports to Agency
- Effective until terminated by Agency

## Enforcement

Cease & Desist Orders -- Collateral Consequences

- Regulatory
- Securities Disclosure
- Civil Liability
- Industry Disqualification
- Criminal Referrals

# Enforcement

Civil Money Penalties –

- Statutory Authority
- Procedure
  - Notice of Assessment
  - Request for Hearing
- Three Tiers of Severity

# Enforcement

Civil Money Penalties

Amount of Penalty – Factors Considered

- OCC Matrix
  - "Aggravating" Factors
  - "Mitigating" Factors
  - Other, "As Justice May Require"

Collection of Penalty

# Enforcement

Orders of Prohibition & Removal
- Regulatory Violations – 8(e)
- Criminal Proceedings – 8(g)
- Suspension
- Scope of Debarment
- Reinstatement

# Enforcement

Termination of Deposit Insurance
- Grounds -- "Unsafe or Unsound" Condition
- Authority – FDIC only
- Notice/Disclosure
  - To Bank
  - To Bank Customers
- Timing/Transition

# Enforcement

"Back Door" Means to Regulatory Ends?

- Management Removal & Prohibition
  - C&D "Management Review"
  - Prompt Corrective Action directive
- Civil Money Penalty
  - C&D "Restitution/Disgorgement"
- Written Agreement
  - Application Approval Conditions

# Enforcement

Judicial Review of Agency Enforcement Actions–

- Jurisdiction
  - Statutory -- Court of Appeals
  - APA – District Court
- Standards of Review
  - Findings of Fact
  - Conclusions of Law
  - Remedies
- No Stay Unless Ordered

# Enforcement

Coordinated/Tandem Enforcement

Joint Enforcement Actions

- Federal-State
- Multiple Federal Agency
- Federal Agency-DOJ
- Multiple Federal-State Agency & DOJ

- Referrals
- Whistleblower Awards

# Enforcement

What of the Successful Defense?

- Equal Access to Justice Act
  - Recovery
  - Procedure
- Agency/Examiner Retaliation
  - Prohibition
  - Remedies

# Enforcement

Concluding Thoughts --

- Awesome power
- Purpose/Effects
- Prosecutorial Discretion

# Enforcement

- **ATTACHMENTS**

A. Revised Guidelines for Appeals of Material Supervisory Determinations, FIL-04-2021 (FDIC Jan. 19, 2021), with attached Federal Register Notice of Guidelines, 86 FR 6880 (Jan. 25, 2021)

B. Decision and Order On Request for a Private Hearing, In the Matter of Edward Towe, Dkt No. AA-EC-93-42 (OCC 1993)

C. Order Denying Enforcement Counsels' Motion for Interlocutory Review, In the Matter of Richard Usher, Dkt No. AA-EC-2017-3 (OCC 2021)

D. Decision on Entry of Default, In the Matter of Nyema'sha Taylor, Dkt No. AA-ENF-2021-23 (OCC 2023)

E. OCC Assesses $15 Million Penalty Against U.S. Bank for Unfair Practices, News Release 2023-141 (OCC Dec. 19, 2023), with attached Consent Order, In the Matter of U.S. Bank National Association, Dkt No. AA-ENF-2023-64

F. Per Curiam Opinion, Calcutt v. Federal Deposit Insurance Corporation, 598 U.S. 623 (2023)

G. Order Staying Equal Access to Justice Act Application During Ninth Circuit Appeal, In the Matter of Laura Akahoshi, Dkt No. AA-EC-2018-20 (OCC 2023)

Internal Agency Review Procedure

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION



Financial Institution Letter

# Revised Guidelines for Appeals of Material Supervisory Determinations

January 19, 2021 | FIL-04-2021

## Summary:

On January 19, 2021, the FDIC's Board of Directors adopted revised *Guidelines for Appeals of Material Supervisory Determinations*. The revised guidelines are intended to enhance the independence of appeals decisions and to clarify the procedures and timeframes that apply to appeals when the FDIC is taking a formal enforcement action. The revised guidelines generally replace the existing Supervision Appeals Review Committee (SARC) with an independent, standalone office within the FDIC, known as the Office of Supervisory Appeals (Office). The revised guidelines will take effect when the Office is fully operational; current guidelines will remain in effect until that time. The FDIC will publish a notice to inform institutions when this occurs.

**Statement of Applicability to Institutions with Total Assets under $1 Billion:** This Financial Institution Letter (FIL) applies to all FDIC-supervised institutions.

## Highlights:

- The revised guidelines replace the SARC with an independent, standalone office within the FDIC, known as the Office of Supervisory Appeals.
- The Office will be independent of the Divisions that have authority to issue material supervisory determinations, while still operating within the FDIC.
- Appeals submitted to the Office will be decided by a panel of reviewing officials.
- To promote the independence of the Office, the FDIC will recruit externally. Reviewing officials will have bank supervisory or examination experience and serve on term appointments.
- The revised guidelines also:
    - Change the standard of review for appeals to the Division Director so that the Division Director

makes an independent supervisory determination without deferring to the judgments of either party;

- Require that communications between the Office and either supervisory staff or the appealing institution, including materials submitted to the Office for review, also be shared with the other party to the appeal;
- Allow an institution to request expedited review in its appeal to the Office; and
- Modify the procedures and timeframes for when determinations underlying formal enforcement-related actions may be appealed.

## Attachment:

Revisions to the FDIC's Guidelines for Appeals of Material Supervisory Determinations

## Distribution:

FDIC-Supervised Institutions

## Suggested Routing:

Chief Executive Officer
Compliance Officer
Chief Lending Officer

Dated at Washington, DC, on January 19, 2021.

**James P. Sheesley,**

*Assistant Executive Secretary.*

[FR Doc. 2021–01543 Filed 1–22–21; 8:45 am]

BILLING CODE 6714–01–P

## FEDERAL DEPOSIT INSURANCE CORPORATION

RIN 3064–ZA20

### Guidelines for Appeals of Material Supervisory Determinations

**AGENCY:** Federal Deposit Insurance Corporation.

**ACTION:** Notice of guidelines.

**SUMMARY:** The Federal Deposit Insurance Corporation has adopted revised Guidelines for Appeals of Material Supervisory Determinations to establish an independent office that would replace the existing Supervision Appeals Review Committee and to modify the procedures and timeframes for considering formal enforcement-related decisions through the supervisory appeals process.

**DATES:** The new Guidelines for Appeals of Material Supervisory Determinations will become effective once the Office of Supervisory Appeals is fully operational.

**FOR FURTHER INFORMATION CONTACT:** Sheikha Kapoor, Senior Counsel, Legal Division, (202) 898–3960, *skapoor@fdic.gov*; James Watts, Counsel, Legal Division, (202) 898–6678, *jwatts@fdic.gov*.

**SUPPLEMENTARY INFORMATION:**

On September 1, 2020, the Federal Deposit Insurance Corporation (FDIC) published in the **Federal Register** for notice and comment proposed amendments to its Guidelines for Appeals of Material Supervisory Determinations (Guidelines), which provide the process by which insured depository institutions (IDIs) may appeal material supervisory determinations made by the FDIC.[1] The FDIC proposed to establish an independent office that would replace the existing Supervision Appeals Review Committee (SARC) and to modify the procedures and timeframes for considering formal enforcement-related decisions through the supervisory appeals process. The comment period ended October 20, 2020, and the FDIC received fifteen comment letters. These comments and the FDIC's responses are summarized below.

### I. Background

Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (Riegle Act) required the FDIC (as well as the other Federal banking agencies and the National Credit Union Administration) to establish an "independent intra-agency appellate process" to review material supervisory determinations.[2] The Riegle Act defines the term "independent appellate process" to mean "a review by an agency official who does not directly or indirectly report to the agency official who made the material supervisory determination under review." [3] In the appeals process, the FDIC is required to ensure that: (1) An IDI's appeal of a material supervisory determination is heard and decided expeditiously; and (2) appropriate safeguards exist for protecting appellants from retaliation by agency examiners.[4]

The Riegle Act defines "material supervisory determinations" to include determinations relating to: (1) Examination ratings; (2) the adequacy of loan loss reserve provisions; and (3) classifications on loans that are significant to an institution.[5] Expressly excluded from this definition are decisions to appoint a conservator or receiver for an IDI or to take prompt corrective action pursuant to Section 38 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1831o.[6] Finally, Section 309(g) of the Riegle Act expressly provides that the requirement to establish an appeals process shall not affect the authority of the Federal banking agencies to take enforcement or supervisory actions against an IDI.[7]

#### *A. Structure of the Supervisory Appeals Review Committee*

On March 21, 1995, the FDIC's Board of Directors (Board) adopted the Guidelines to implement Section 309(a). The Board, at that time, established the SARC to consider and decide appeals of material supervisory determinations.[8] The SARC was initially comprised of five members: The FDIC's Vice Chairperson (as Chairperson of the SARC), the Director of the Division of Supervision (DOS) (the predecessor to the Division of Risk Management Supervision (RMS)), the Director of the Division of Compliance and Consumer Affairs (DCA) (the predecessor to the Division of Depositor and Consumer Protection (DCP)), the FDIC Ombudsman, and the General Counsel.[9] Consistent with the Riegle Act's mandate to create an intra-agency appeals process, membership in the SARC was limited to FDIC officials.[10] In order to "establish[] a fair and credible review process," the SARC was comprised of senior officials at the FDIC, including the Directors of DOS and DCA, who were expected to "bring to the Committee the necessary experience and judgment to make well-informed decisions concerning determinations under review." [11] The Guidelines were subsequently amended to add the Director of the Division of Insurance as a voting member of the SARC, and to provide formally that the Directors of DOS and DCA would not vote on cases brought before the SARC involving their respective divisions.[12]

In July 2004, the FDIC revised the Guidelines to change the structure and composition of the SARC to its current form. Specifically, the voting members of the SARC are now comprised of: One of the FDIC's three inside directors (who serves as the SARC Chairperson), and one deputy or special assistant to each of the other two inside directors.[13] The FDIC's General Counsel also serves as a non-voting member of the SARC. In the event of a vacancy, the Guidelines authorize the FDIC Chairperson to designate alternate member(s) to the SARC, so long as the alternate member was not directly or indirectly involved in making or affirming the material supervisory determination under review. These changes were intended to avoid the potential conflicts then faced by the Ombudsman and Division Directors,[14] and to "further underscore the perception of the SARC as a fair and independent high-level body for review of material supervisory determinations within the FDIC." [15]

In July 2017, the FDIC further revised the Guidelines to provide an opportunity for IDIs to appeal certain material supervisory determinations

---

[1] 85 FR 54377 (Sep. 1, 2020).

[2] 12 U.S.C. 4806(a).

[3] 12 U.S.C. 4806(f)(2).

[4] 12 U.S.C. 4806(b).

[5] 12 U.S.C. 4806(f)(1)(A).

[6] 12 U.S.C. 4806(f)(1)(B).

[7] 12 U.S.C. 4806(g).

[8] 60 FR 15923 (Mar. 28, 1995).

[9] 60 FR 15923, 15930. Committee members could also designate another person to serve on their behalf.

[10] 60 FR 15923, 15924.

[11] 60 FR 15923, 15924.

[12] 69 FR 41479, 41480 (July 9, 2004).

[13] 69 FR 41479, 41480.

[14] 69 FR 41479, 41480–81. For example, the Ombudsman was excluded from the SARC in order to avoid any possible conflict between the Ombudsman's statutory role as a liaison between the agency and financial institutions on the one hand, and as a decision maker on the SARC on the other hand.

[15] 69 FR 41479, 41480.

underlying formal enforcement actions through the supervisory appeals process.[16] The Guidelines currently provide that if the FDIC does not commence a formal enforcement action within certain time frames after giving written notice to an IDI of a recommended or proposed formal enforcement action, the IDI may appeal the facts and circumstances underlying the formal enforcement action to the SARC.[17]

*B. 2019 Listening Sessions on Supervisory Appeals and Dispute Resolution Process*

In 2019, the FDIC decided to explore potential improvements to the supervisory appeals process. As part of this process, the FDIC's Office of the Ombudsman hosted a webinar and in-person listening sessions in each FDIC Region regarding the agency's supervisory appeals and dispute resolution processes. The sessions offered bankers and other interested persons an opportunity to provide individual input and recommendations regarding the supervisory appeals process.[18] Participants were encouraged to comment on various topics, including: Perceived barriers to, or concerns about, resolving disagreements; timeframes and procedures for pursuing reviews and appeals; and information publicly available on appeals and examination disagreements.

Among other topics, session participants offered suggestions on the composition of the SARC. In particular, participants focused on the composition of the SARC and opportunities to further enhance the independence of the appeals process. Relatedly, participants emphasized the importance of ensuring that SARC members have the subject matter expertise needed to decide supervisory appeals. Participants offered a range of suggestions on this topic, including adding an individual who is not otherwise affiliated with the FDIC to the SARC, such as a retired banking attorney or a former Federal or State bank regulator. Certain challenges were also discussed with respect to adding an individual who is not affiliated with the FDIC, such as ensuring the confidentiality of information and the avoidance of conflicts of interest.

Questions related to the timeframes for appeals and the types of matters that may be appealed if the FDIC pursues a formal enforcement action were also raised at a number of the listening sessions. Through these discussions, it appears that the procedures that apply when the FDIC has provided notice of a recommended or proposed formal enforcement action may be a source of confusion to bankers.

Participants also raised concerns about bankers' fear of retaliation by FDIC examiners, notwithstanding existing provisions in the Guidelines prohibiting such retaliation. This concern was cited as a basis for causing bankers to be reluctant to fully engage with the FDIC on material areas of disagreement. FDIC policy prohibits any retaliation, abuse, or retribution by an agency examiner or any FDIC personnel against an institution, and the FDIC continues to explore options to reaffirm its commitment to ensure compliance with this policy. In addition, while not specifically related to the supervisory appeals process, participants provided a variety of comments and recommendations on the examination process. Participants also shared views regarding the publicly available information on SARC decisions and ideas for improving the transparency of SARC decisions, such as publishing aggregate data on the outcomes of supervisory appeals.

*C. Notice and Request for Comment*

In August 2020, the FDIC published for comment a proposal to replace the SARC with an independent, standalone office within the FDIC, known as the Office of Supervisory Appeals (Office).[19] The Office would have delegated authority to consider and resolve appeals of material supervisory determinations. The Office would be fully independent of those FDIC Divisions with authority to issue material supervisory determinations and would be staffed by reviewing officials with bank supervisory or examination experience. Reviewing officials, as employees of the FDIC, would be cleared for conflicts of interest and subject to the FDIC's usual requirements for confidentiality.

Under the proposed Guidelines, an IDI would be encouraged to make a good-faith effort to resolve disagreements with its examiners and/or the appropriate Regional Office. If these efforts were not successful, the IDI would submit a request for review to the appropriate Division Director, who would have the option of issuing a written decision or sending the appeal directly to the Office. An IDI that disagrees with the decision made by the Division Director could submit an appeal to the Office.

If a material supervisory determination was appealed to the Office, a three-member panel of the Office would consider the appeal and issue a written decision. The Division Director and the Ombudsman would be permitted to submit views on the appeal to the panel. The Legal Division would provide counsel to the Office. Oral presentation to the panel would be permitted if a request was made by the institution or by FDIC staff.

The proposal provided that the panel would review an appeal for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced, consistent with the existing standard of review for the SARC. The scope of the panel's review would be limited to the facts and circumstances as they existed prior to or at the time the material supervisory determination was made, even if later discovered, and no consideration would be given to any facts or circumstances that occur or corrective action taken after the determination was made. The Office's role would not be to set policy, and the Office would not consider aspects of an appeal that sought to change or modify FDIC policy or rules.

Consistent with the existing Guidelines and the Riegle Act, the Office would not review decisions to appoint a conservator or receiver for an IDI. The FDIC proposed to further clarify that decisions made in furtherance of the resolution or receivership process or planning also would not be considered material supervisory determinations.

The FDIC also proposed amending the procedures for considering formal enforcement-related decisions through the supervisory appeals process. Specifically, the proposal clarified that, for purposes of the supervisory appeals process, a formal enforcement-related action commences—and appeal rights become unavailable—when the FDIC initiates a formal investigation, issues a notice of charges (or notice of assessment, as applicable), provides the IDI with a draft consent order, or otherwise provides written notice to the IDI that the FDIC is reviewing the relevant facts and circumstances to determine whether a formal enforcement action is merited. The FDIC would then have 120 days from the date

[16] 82 FR 34522, 34524 (July 25, 2017). The FDIC also noted that it provides an informal process through which institutions can obtain review by the relevant Division Director of matters that are not covered by the SARC process or another existing FDIC appeals or administrative process. *See* FIL–51–2016 (July 29, 2016).

[17] 82 FR 34522, 34526.

[18] *See* FIL–52–2019 (Sep. 24, 2019), *available at https://www.fdic.gov/news/financial-institution-letters/2019/fil19052.pdf.*

[19] 85 FR 54377 (Sep. 1, 2020).

on which notice was given to provide the IDI with a draft consent order. If the FDIC failed to provide a draft consent order within this 120-day period, the IDI's supervisory appeal rights would be made available.

Once the FDIC provides an IDI with a draft consent order, the parties would have an opportunity to negotiate the details of a potential settlement. The proposal did not include a fixed time limit on such negotiations. At any time, the IDI could notify the Division in writing that it believes further negotiation would not be productive, and the Division would then have 90 days to issue a notice of charges (or assessment) or to open an order of investigation. If the Division failed to issue such a notice or open an order of investigation within that time, the IDI would have 60 days to file an appeal of the material supervisory determination, consistent with the standard timeline following a material supervisory determination. If the IDI agrees to the consent order, then the matter would be resolved, and the need for an appeal would be obviated.

## II. Final Guidelines and Discussion of Comments

The FDIC received fifteen comments from a variety of interested parties, including banks, trade associations, law firms, and a consultant. Commenters generally supported the proposal, with most asserting that the changes would enhance the supervisory appeals process. In particular, commenters supported the steps taken to promote the independence of the Office, suggesting that this would bolster the industry's confidence in the supervisory appeals process.

The FDIC's proposal solicited feedback on particular aspects of the supervisory appeals process. Comments on these matters and the FDIC's responses are summarized below.

### Review of Office Decisions

The FDIC asked whether commenters believed that the Chairperson or the Board should have an opportunity to review Office decisions before issuance. While a few commenters asserted that the FDIC's senior management should review Office decisions, most commenters believed that review by the Chairperson or the Board would undermine the independence of the Office. In particular, two commenters suggested that review by the Chairperson or Board could deter banks from availing themselves of the process. A trade association also noted that if an appeal relates to an enforcement action, review of the appeal by the Board members could compromise the spirit of the Board's review of the administrative law judge's recommended decision.

Consistent with the proposal, the final Guidelines provide for review of material supervisory determinations by the Division Director and then by the Office. The FDIC proposed to establish the Office with authority to consider and resolve appeals of material supervisory determinations in order to promote independence. Additional levels of review also could delay the resolution of appeals, and the FDIC is mindful of the need to decide appeals expeditiously. For these reasons, the final Guidelines do not provide for additional levels of review beyond the Office.

### Qualifications To Serve in the Office

The FDIC proposed staffing the Office with reviewing officials who have bank supervisory or examination experience, such as retired bank examiners. The FDIC asked whether bank supervisory or examination experience would constitute appropriate qualifications and experience for these positions. Commenters expressed a range of views on this topic. Some commenters supported staffing the Office with individuals with bank supervisory or examination experience. On the other hand, several trade associations, a bank, and a law firm stated that the Office should not be limited to staff with supervisory experience, and should also include retired bank officers, bank board members, consultants, or banking law attorneys. Some of these commenters suggested that each review panel include one or more members with industry experience.

The FDIC appreciates the perspective and expertise that bankers and other industry professionals could bring to the process. At the same time, the FDIC acknowledges that, because of the Office's role in making final decisions on appeals of material supervisory determinations on behalf of the agency, supervisory experience and training provides a firm foundation for exercising that responsibility and helps ensure a thorough understanding of the supervisory process. With this in mind, the FDIC will, as proposed, deem bank supervisory or examination experience as required background for panelists. However, the FDIC appreciates that industry perspective can be valuable and accordingly will generally view relevant industry experience favorably.

### Staffing

A number of commenters made suggestions with respect to the staffing of the Office. A trade association recommended that reviewing officials serve staggered terms, with no official serving more than five years. Another trade association suggested that terms should not be renewable. Two commenters recommended that reviewing officials selected for the Office should not have been employed by the FDIC for at least the two years prior, thereby promoting separation between the Office and existing staff. The FDIC believes some of these recommendations will be beneficial to promoting the Office's independence, and will consider others carefully as it prepares to hire reviewing officials. Reviewing officials will be hired for terms, and only former, rather than current, government officials will be eligible to serve as reviewing officials.

### Role of the Ombudsman

A few commenters recommended changes with respect to the Ombudsman's role in the process to promote the Office's independence. In particular, a bank encouraged the FDIC to include the Ombudsman as a non-voting member on the panel. The Ombudsman serves as a neutral liaison between the FDIC and institutions, as provided by section 309 of the Riegle Act.[20] The FDIC believes including the Ombudsman as a member of the panel could undermine this role, because as a member of the panel, the Ombudsman would be expected to serve in a decision-making capacity. In addition, institutions that might feel free to share confidential information with the Ombudsman in its role as liaison may be reluctant to do so if the Ombudsman would later be deciding a supervisory appeal.[21] In light of these concerns, and because the FDIC sees value in the Ombudsman's perspective, the final Guidelines allow the Ombudsman to submit views to the panel.

### Administrative and Legal Support for the Office

Two commenters recommended resourcing the Office with independent administrative and legal support. The Office will share administrative support with the Legal Division, which also will provide counsel to the Office. To promote independence, legal staff that were involved in making the material

[20] *See* 12 U.S.C. 4806(d).

[21] The tension between the Ombudsman's statutory role and acting as a decision maker with respect to material supervisory determinations was among the reasons the FDIC removed the Ombudsman from the SARC when it was reconstituted in 2004. The FDIC also considered making the Ombudsman a non-voting member of the SARC, but concluded that also would not resolve this tension. *See* 69 FR 41479, 41481 (July 9, 2004).

supervisory determination that has been appealed will not advise the Office.

To provide further clarity, the Guidelines state that the Legal Division will provide counsel to the Office and generally advise on FDIC policies and rules. If an appeal seeks to change or modify FDIC policies or rules, or raises a policy matter of first impression, the Office will, with the Legal Division's concurrence, refer the matter to the Chairperson's Office. In addition, the Legal Division will review decisions of the Office for consistency with applicable laws, regulations, and policies of the FDIC prior to their issuance. If the Legal Division determines that an Office decision is contrary to a law, regulation, or FDIC policy, the Office will be required to revise the decision to conform with relevant laws, regulations, or policies. The Legal Division will not exercise supervisory judgment or opine on the merits of an appeal.

Retaliation Concerns

A trade association stated that the FDIC should take measures to ensure that reviewing officials are not retaliated against for their decisions. The FDIC has structured the Office to minimize the risk that a fear of retaliation could impact decisions by reviewing officials. Reviewing officials will be hired for terms, and only former, rather than current, government officials will be eligible to serve as reviewing officials. Additionally, all decisions related to which reviewing officials will serve on which panels will be decided by the Office, and not by any FDIC officials outside of the Office.

The FDIC also received comments reiterating that some IDIs may not appeal decisions due to a fear of retaliation from examiners. As noted in the proposal, FDIC policy currently prohibits any retaliation, abuse, or retribution by an agency examiner or any FDIC personnel against an institution, and the FDIC continues to explore options to reaffirm its commitment to and ensure compliance with this policy.

Standard of Review

Like the current standard of review, under the proposed Guidelines, the Division Director and the Office would review appeals for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced. Two trade associations encouraged the FDIC to adopt a *de novo* standard of review, and align the standard with the approach recently taken by the Federal Reserve Board (FRB).

The FDIC agrees that a change in the standard of review for appeals to the Division Director would be appropriate. The final Guidelines therefore provide that the Division Director will make his or her own supervisory determination, which is substantially similar to the standard adopted by the initial review panel under the FRB's approach.[22] Under this standard, the Division Director would have discretion to consider examination workpapers and other materials developed by staff during an examination, but would make an independent supervisory determination, without deferring to the judgments of either party. The final guidelines do not, however, alter the standard of review when the appeal is reviewed by the Office. Consistent with the proposal, the Office would review appeals for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced.

Ex Parte Communications

A law firm and two trade associations recommended that the FDIC prohibit *ex parte* communications between supervisory staff and the Office during an appeal, asserting that this is a due process and fairness concern. The FDIC understands this concern and is addressing it in the final Guidelines by requiring that communications between the Office and either supervisory staff or the appealing institution, including materials submitted to the Office for review, are also shared with the other party to the appeal, subject to limitations on disclosure.

Review Panel Size

The FDIC proposed that each appeal would be heard by a panel of three reviewing officials, and asked whether three reviewers per panel would be an appropriate number, or whether there were some situations where more or fewer panelists might be appropriate. A number of commenters suggested panels comprised of five reviewing officials. In particular, a trade association asserted that this number is common across governmental bodies, affords increased diversity in perspectives and expertise, and decreases the likelihood of deference to the strong opinions of one panel member. Other commenters suggested expanding the size of panels to five members in order to accommodate the addition of staff with industry experience. Two commenters, including a trade association and a consultant, suggested expanding the size of review panels in case a review official becomes ill or must be recused. A law firm suggested that relatively minor matters (*e.g.*, examination ratings, loan loss reserve provisions, loan classifications) should be handled by a panel of three members, while more serious matters (*e.g.*, violations of law or regulation, applications, decisions to initiate informal enforcement actions, matters requiring Board attention) should be handled by five-member panels.

The FDIC agrees that five-member panels could be beneficial in some situations. To provide the Office with flexibility, the final Guidelines provide that panels may be comprised of either three or five reviewing officials. When an appeal is submitted to the Office, a panel of either three or five reviewing officials will be assigned to consider the matter. The FDIC believes that initial experiences administering this new process may help to determine the most appropriate size for panels going forward.

Other Levels of Review

The FDIC proposed that an IDI would be able to appeal the Division Director's decision to the Office, and that no appeal of the Office's decision would be permissible. The FDIC asked commenters whether the appellate process should have any additional level(s) of review before or after the Office.

Commenters generally stated that the process should not include an additional level of review before an appeal to the Office. In particular, a trade association asserted that the FDIC should remove barriers for institutions wishing to appeal material supervisory determinations, including layers of review. However, a few commenters recommended an additional level of review following a decision by the Office. A law firm suggested allowing Office decisions to be appealed to the individuals that currently serve on the SARC, and a trade association suggested that either the Board or the institution could request reconsideration of Office decisions within 30 days of issuance. A bank holding company also recommended that institutions have the option to bring matters to an administrative law judge as an alternative to review by the Office.

The final Guidelines do not include any additional levels of review. It is not clear that review by the individuals currently comprising the current SARC would be beneficial because replacing the SARC with the Office was intended

[22] *See* 85 FR 15175, 15180 (Mar. 17, 2020).

to promote independence, and commenters generally supported that aspect of the proposal. The final Guidelines balance the statutory objectives of independent review and timely resolution of appeals by allowing the Office's decision to serve as the final review.[23] Proceedings before an administrative law judge serve a different purpose and are governed by different procedural standards, and therefore may not be well-suited for appeals of material supervisory determinations. For example, proceedings before administrative law judges typically involve motion practice, discovery, and oral hearings. The supervisory appeals process, by contrast, is intended to resolve disagreements in a more informal and expeditious manner. For these reasons, the FDIC concludes that the appeals process should not provide for review by an administrative law judge as an alternative to review by the Office.

Timelines for Appeals

The FDIC asked whether the proposed timelines properly balance the goals of resolving appeals as expeditiously as possible and providing adequate time for preparation and review. Under the Guidelines, an institution would have 60 calendar days in which to file a request for review with the Division Director. Within 45 calendar days after receiving that request, the Division Director would either review the appeal and issue a written determination or refer the request for review to the Office for consideration. Upon receiving the Division Director's decision, an IDI would have 30 calendar days to file an appeal with the Office. Within 90 calendar days after receiving the appeal (including 30 days for the Ombudsman and the Division Director to submit views), the Office would meet to adjudicate the appeal, and would notify the institution of its decision within 45 calendar days after that meeting.

While several commenters stated that these timeframes were reasonable, others encouraged the FDIC to consider changes to expedite the process. A law firm asserted that unless a particularly serious matter is involved, the appeals process should be completed within 180 days of the examination exit meeting, rather than within 270 days as the proposal would allow. A bank holding company stated that the Office should issue decisions within 60 days of receiving appeals. A few commenters recommended allowing institutions to petition the Office for expedited review of supervisory determinations in certain circumstances. In addition, two trade associations suggested allowing extensions of the time frames in the appeals process. Another commenter suggested that the FDIC clarify that whenever a deadline falls on a weekend or federal holiday, the deadline should move to the next business day.

The FDIC believes that, in general, the proposed timeframes appropriately balance the interest in resolving appeals expeditiously with the need for adequate preparation and review. The FDIC expects that the process will move more quickly in straightforward cases that do not involve complex issues or review of extensive documents. Additionally, certain circumstances may warrant expedited consideration of an appeal, and the FDIC agrees that the process should permit institutions to petition for expedited review. Under section G.2 of the final Guidelines, an institution may request expedited review in its appeal to the Office.

The FDIC expects that extensions will generally be unnecessary, but believes that it is reasonable to permit institutions to request extensions under appropriate circumstances. This is consistent with both the spirit of the process and current FDIC practice. Accordingly, the final Guidelines provide that an institution may request an extension of the time period to submit an appeal. Such requests may be directed to the appropriate Division Director with respect to the first stage of the appeal, and to the Office with respect to the second stage. Finally, the FDIC agrees that the suggested clarification with respect to deadlines that fall on a weekend or federal holiday would be helpful, and has adopted it in the final Guidelines.

Publicly Available Information on the Process

The FDIC proposed publishing decisions of the Office as soon as practicable and with redactions to avoid disclosure of the name of the appealing institution and other information exempt from disclosure under the Freedom of Information Act. For cases in which redaction is deemed insufficient to prevent improper disclosure, the FDIC proposed publishing decision summaries. The FDIC also proposed that published Office decisions could be cited as precedent in Office appeals. Finally, the FDIC proposed publishing annual reports on decisions issued by Division Directors. These proposals are consistent with the FDIC's current policies regarding decisions issued by Division Directors and the SARC. The FDIC asked commenters what other information should be published about the appeals process or specific decisions while still maintaining confidentiality.

Several commenters agreed that the information published about the supervisory appeals process was sufficient, and agreed that the FDIC should continue to ensure that confidentiality is preserved. One commenter encouraged the FDIC to publish a chart online listing the outcome of appeals along with a short summary of the case. The FDIC agrees that the transparency of the appeals process could be enhanced by providing summary statistics on the outcomes of appeals. The final Guidelines therefore provide for the publication of such information.

Authorization To Submit an Appeal

Two trade associations requested that an institution's senior management should be permitted to authorize supervisory appeals. The FDIC has adopted this suggestion in the final Guidelines. If an institution's senior management files an appeal, it must inform the board of directors of the substance of the appeal before filing and keep the board of directors informed of the appeal's status.

Formal Enforcement-Related Changes

The FDIC proposed a timeline that would apply to supervisory appeals in instances in which the FDIC is also evaluating whether a formal enforcement action is merited. In any case where the FDIC has provided notice to an IDI that it is determining whether a formal enforcement action is merited based on an examination, the FDIC would have 120 days to issue an order of investigation, a notice of charges (or notice of assessment, as applicable), or provide the institution with a draft consent order. If the FDIC fails to do so within the 120-day timeframe, the IDI's supervisory appeal rights would be made available. However, if the FDIC provides an IDI with a draft consent order, the parties would have an opportunity to negotiate the details of a potential settlement without a fixed time limit. At any time, if the IDI believes that further negotiations would not be productive, it could notify the Division of its decision in writing, at which point the Division would have 90 days to issue a notice of charges (or assessment) or to open an order of investigation. If the Division failed to produce a notice of charges (or

[23] Two commenters, including a bank and a trade association, requested that the FDIC make clear that Office decisions are subject to further review by the federal courts. The FDIC has noted in the past that because supervisory decisions are entrusted to agency discretion, they cannot be appealed to the courts.

assessment) or to open an order of investigation within those 90 days, the IDI's supervisory appeal rights to the Office would be made available. The IDI would have 60 days to file an appeal, consistent with the standard timeline following a material supervisory determination.

The FDIC proposed that these time periods could be extended with the approval of the Chairperson's Office, or with the mutual agreement of both parties. The FDIC asked commenters whether this timeline would be too restrictive for some cases, and whether commenters expect to invoke the provision(s) allowing for an extension. Several commenters stated that the proposed timeframe was appropriate. A bank suggested that instead of the proposed extension provisions, the process should permit both the FDIC and the institution to request a one-time extension of a deadline for 30 days. The FDIC believes that limiting the parties to a one-time 30-day extension could hinder the parties' efforts to settle an enforcement action, and is therefore finalizing these provisions as proposed.

Transition Period

The FDIC expects that a period of time will be necessary to establish and staff the Office. The current Guidelines, which permit appeals of Division Directors' decisions to the SARC, will apply until the Office is fully operational. The FDIC will publish a notice to inform institutions when this occurs.

For the reasons set out in the preamble, the Federal Deposit Insurance Corporation's Board of Directors adopts the Guidelines for Appeals of Material Supervisory Determinations as set forth below.

Guidelines for Appeals of Material Supervisory Determinations

A. Introduction

Section 309(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103–325, 108 Stat. 2160) (Riegle Act) required the Federal Deposit Insurance Corporation (FDIC) to establish an independent intra-agency appellate process to review material supervisory determinations made at insured depository institutions that it supervises. The Guidelines for Appeals of Material Supervisory Determinations (Guidelines) describe the types of determinations that are eligible for review and the process by which appeals will be considered and decided. The procedures set forth in these Guidelines establish an appeals process for the review of material supervisory determinations by the Office of Supervisory Appeals (Office).

B. Reviewing Officials

The Office will be staffed with reviewing officials who have bank supervisory or examination experience. Reviewing officials will be hired for terms, and only former, rather than current, government officials will be eligible to serve as reviewing officials. Reviewing officials will consider and decide appeals submitted to the Office. Each appeal will be reviewed and decided by a panel of either three or five reviewing officials who have no conflicts of interest with respect to the appeal or the parties to the appeal. All decisions related to which reviewing officials will serve on which panels will be decided by the Office.

C. Institutions Eligible To Appeal

The Guidelines apply to the insured depository institutions that the FDIC supervises (*i.e.*, insured State nonmember banks, insured branches of foreign banks, and state savings associations), and to other insured depository institutions for which the FDIC makes material supervisory determinations.

D. Determinations Subject to Appeal

An institution may appeal any material supervisory determination pursuant to the procedures set forth in these Guidelines.

(1) Material supervisory determinations include:

(a) CAMELS ratings under the Uniform Financial Institutions Rating System;

(b) IT ratings under the Uniform Rating System for Information Technology;

(c) Trust ratings under the Uniform Interagency Trust Rating System;

(d) CRA ratings under the Revised Uniform Interagency Community Reinvestment Act Assessment Rating System;

(e) Consumer compliance ratings under the Uniform Interagency Consumer Compliance Rating System;

(f) Registered transfer agent examination ratings;

(g) Government securities dealer examination ratings;

(h) Municipal securities dealer examination ratings;

(i) Determinations relating to the appropriateness of loan loss reserve provisions;

(j) Classifications of loans and other assets in dispute the amount of which, individually or in the aggregate, exceeds 10 percent of an institution's total capital;

(k) Determinations relating to violations of a statute or regulation that may affect the capital, earnings, or operating flexibility of an institution, or otherwise affect the nature and level of supervisory oversight accorded an institution;

(l) Truth in Lending Act (Regulation Z) restitution;

(m) Filings made pursuant to 12 CFR 303.11(f), for which a request for reconsideration has been granted, other than denials of a change in bank control, change in senior executive officer or board of directors, or denial of an application pursuant to section 19 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1829 (which are contained in 12 CFR 308, subparts D, L, and M, respectively), if the filing was originally denied by the Director, Deputy Director, or Associate Director of the Division of Depositor and Consumer Protection (DCP) or the Division of Risk Management Supervision (RMS);

(n) Decisions to initiate informal enforcement actions (such as memoranda of understanding);

(o) Determinations regarding the institution's level of compliance with a formal enforcement action; however, if the FDIC determines that the lack of compliance with an existing formal enforcement action requires an additional formal enforcement action, the proposed new enforcement action is not appealable;

(p) Matters requiring board attention; and

(q) Any other supervisory determination (unless otherwise not eligible for appeal) that may affect the capital, earnings, operating flexibility, or capital category for prompt corrective action purposes of an institution, or that otherwise affects the nature and level of supervisory oversight accorded an institution.

(2) Material supervisory determinations do not include:

(a) Decisions to appoint a conservator or receiver for an insured depository institution, and other decisions made in furtherance of the resolution or receivership process, including but not limited to determinations pursuant to parts 370, 371, and 381, and § 360.10 of the FDIC's rules and regulations;

(b) Decisions to take prompt corrective action pursuant to section 38 of the FDI Act, 12 U.S.C. 1831*o*;

(c) Determinations for which other appeals procedures exist (such as determinations of deposit insurance assessment risk classifications and payment calculations); and

(d) Formal enforcement-related actions and decisions, including determinations and the underlying facts and circumstances that form the basis of a recommended or pending formal enforcement action.

(3) A formal enforcement-related action or decision commences, and becomes unappealable, when the FDIC initiates a formal investigation under 12 U.S.C. 1820(c) (Order of Investigation), issues a notice of charges or a notice of assessment under 12 U.S.C. 1818 or other applicable laws (Notice of Charges), provides the institution with a draft consent order, or otherwise provides written notice to the institution that the FDIC is reviewing the facts and circumstances presented to determine if a formal enforcement action is merited under applicable statutes or published enforcement-related policies of the FDIC, including written notice of a referral to the Attorney General pursuant to the Equal Credit Opportunity Act (ECOA) or a notice to the Secretary of Housing and Urban Development (HUD) for violations of ECOA or the Fair Housing Act (FHA). Such notice may be provided in the transmittal letter accompanying a Report of Examination. For the purposes of these Guidelines, remarks in a Report of Examination do not constitute written notice that the FDIC is reviewing the facts and circumstances presented to determine if a proposed enforcement action is merited. Commencement of a formal enforcement-related action or decision will not suspend or otherwise affect a pending request for review or appeal that was submitted before the commencement of the formal enforcement-related action or decision.

(4) Additional Appeal Rights:

(a) In the case of any written notice from the FDIC to the institution that the FDIC is determining whether a formal enforcement action is merited, the FDIC must issue an Order of Investigation, issue a Notice of Charges, or provide the institution with a draft consent order within 120 days of such a notice, or appeal rights will be made available pursuant to these Guidelines. If the FDIC timely provides the institution with a draft consent order and the institution rejects the draft consent order in writing, the FDIC must issue an Order of Investigation or a Notice of Charges within 90 days from the date on which the institution rejects the draft consent order in writing or appeal rights will be made available pursuant to these Guidelines. The FDIC may extend these periods, with the approval of the Chairperson's Office, after the FDIC notifies the institution that the relevant Division Director is seeking formal authority to take an enforcement action.

(b) In the case of a referral to the Attorney General for violations of the ECOA, beginning on the date the referral is returned to the FDIC, the FDIC must proceed in accordance within paragraph (a), including within the specified timeframes, or appeal rights will be made available pursuant to these Guidelines.

(c) In the case of providing notice to HUD for violations of the ECOA or the FHA, beginning on the date the notice is provided, the FDIC must proceed in accordance within paragraph (a), including within the specified timeframes, or appeal rights will be made available pursuant to these Guidelines.

(d) Written notification will be provided to the institution within 10 days of a determination that appeal rights have been made available under this section.

(e) The relevant FDIC Division and the institution may mutually agree to extend the timeframes in paragraphs (a), (b), and (c) if the parties deem it appropriate.

E. Good-Faith Resolution

An institution should make a good-faith effort to resolve any dispute concerning a material supervisory determination with the on-site examiner and/or the appropriate Regional Office. The on-site examiner and the Regional Office will promptly respond to any concerns raised by an institution regarding a material supervisory determination. Informal resolution of disputes with the on-site examiner and the appropriate Regional Office is encouraged, but seeking such a resolution is not a condition to filing a request for review with the appropriate Division, either DCP, RMS, or the Division of Complex Institution Supervision and Resolution (CISR), or to filing a subsequent appeal with the Office under these Guidelines.

F. Filing a Request for Review with the Appropriate Division

(1) An institution may file a request for review of a material supervisory determination with the Division that made the determination, either the Director, DCP, the Director, RMS, or the Director, CISR (Director or Division Director), 550 17th Street, NW, Room F–4076, Washington, DC 20429, within 60 calendar days following the institution's receipt of a report of examination containing a material supervisory determination or other written communication of a material supervisory determination. A request for review must be in writing and must include:

(a) A detailed description of the issues in dispute, the surrounding circumstances, the institution's position regarding the dispute and any arguments to support that position (including citation of any relevant statute, regulation, policy statement, or other authority), how resolution of the dispute would materially affect the institution, and whether a good-faith effort was made to resolve the dispute with the on-site examiner and the Regional Office; and

(b) A statement that the institution's board of directors or senior management has considered the merits of the request and has authorized that it be filed. Senior management is defined as the core group of individuals directly accountable to the board of directors for the sound and prudent day-to-day management of the institution. If an institution's senior management files an appeal, it must inform the board of directors of the substance of the appeal before filing and keep the board of directors informed of the appeal's status.

(2) Within 45 calendar days after receiving a request for review described in paragraph (1), the Division Director will:

(a) Review the appeal, considering whether the material supervisory determination is consistent with applicable laws, regulations, and policy, make his or her own supervisory determination without deferring to the judgments of either party, and issue a written determination on the request for review, setting forth the grounds for that determination; or

(b) refer the request for review to the Office for consideration as an appeal under Section G and provide written notice to the institution that the request for review has been referred to the Office.

(3) No appeal to the Office will be allowed unless an institution has first filed a timely request for review with the appropriate Division Director.

(4) In any decision issued pursuant to paragraph (2)(a) of this section, the Director will inform the institution of the 30-day time period for filing with the Office and will provide the mailing address for any appeal the institution may wish to file.

(5) The Division Director may request guidance from the Office or the Legal Division as to procedural or other questions relating to any request for review.

G. Appeal to the Office

An institution that does not agree with the written determination rendered by the Division Director may appeal that determination to the Office within 30 calendar days after the date of receipt of that determination. Failure to file within the 30-day time limit may result in denial of the appeal by the Office.

1. Filing with the Office

An appeal to the Office will be considered filed if the written appeal is received by the FDIC within 30 calendar days after the date of receipt of the Division Director's written determination or if the written appeal is placed in the U.S. mail within that 30-day period. The appeal should be sent to the address indicated on the Division Director's determination being appealed, or sent via email to *ESS_Appeals@fdic.gov*. Upon receiving the appeal, the Office will send an acknowledgment to the institution, and will send copies of the institution's appeal to the Office of the Ombudsman and the appropriate Division Director.

2. Contents of Appeal

The appeal should be labeled to indicate that it is an appeal to the Office and should contain the name, address, and telephone number of the institution and any representative, as well as a copy of the Division Director's determination being appealed. If oral presentation is sought, that request should be included in the appeal. If expedited review is requested, the appeal should state the reason for the request. Only matters submitted to the appropriate Division Director in a request for review may be appealed to the Office. Evidence not presented for review to the Division Director is generally not permitted; such evidence may be submitted to the Office only if approved by the reviewing panel and with a reasonable time for the Division Director to review and respond. The institution should set forth all of the reasons, legal and factual, why it disagrees with the Division Director's determination. Nothing in the Office administrative process shall create any discovery or other such rights.

3. Burden of Proof

The burden of proof as to all matters at issue in the appeal, including timeliness of the appeal if timeliness is at issue, rests with the institution.

4. Submissions from the Ombudsman and the Division Director

The Ombudsman and the Division Director each may submit views regarding the appeal to the Office within 30 calendar days of the date on which the appeal is received by the Office.

5. Oral Presentation

The Office will, if a request is made by the institution or by FDIC staff, allow an oral presentation. The Office may hear oral presentations in person, telephonically, electronically, or through other means agreed upon by the parties. If an oral presentation is held, the institution and FDIC staff will be allowed to present their positions on the issues raised in the appeal and to respond to any questions from the Office.

6. Consolidation, Dismissal, and Rejection

Appeals based upon similar facts and circumstances may be consolidated for expediency. An appeal may be dismissed by the Office if it is not timely filed, if the basis for the appeal is not discernable from the appeal, or if the institution moves to withdraw the appeal. The Office will decline to consider an appeal if the institution's right to appeal is not yet available under Section D(4), above.

7. Scope of Review and Decision

The Office will be an appellate body and will make independent supervisory determinations. The Office will review the appeal for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced. The Office's review will be limited to the facts and circumstances as they existed prior to, or at the time the material supervisory determination was made, even if later discovered, and no consideration will be given to any facts or circumstances that occur or corrective action taken after the determination was made. The Office will not consider any aspect of an appeal that seeks to change or modify existing FDIC rules or policy. The Office will notify the institution, in writing, of its decision concerning the disputed material supervisory determination(s) within 45 days after the date the Office meets to consider the appeal, which meeting will be held within 90 days after either the date of the filing of the appeal or the date that the Division Director refers the appeal to the Office.

8. Role of the Legal Division

The Legal Division will provide counsel to the Office and generally advise the Office on FDIC policies and rules. If an appeal seeks to change or modify FDIC policies or rules, or raises a policy matter of first impression, the Office will, with the Legal Division's concurrence, refer the matter to the Chairperson's Office.

The Legal Division also will review decisions of the Office for consistency with applicable laws, regulations, and policies of the FDIC prior to their issuance. If the Legal Division determines that a decision is contrary to a law, regulation, or policy of the FDIC, the Office will revise the decision to conform with relevant laws, regulations, or policies.

9. Other Communications

Any communications between the Office and either supervisory staff or the appealing institution will be shared with the other party to the appeal, subject to limitations on disclosure.

H. Publication of Decisions

Decisions of the Office will be published as soon as practicable, and the published decisions will be redacted to avoid disclosure of the name of the appealing institution and any information exempt from disclosure under the Freedom of Information Act and the FDIC's document disclosure regulations found in 12 CFR 309. In cases in which redaction is deemed insufficient to prevent improper disclosure, published decisions may be presented in summary form. Published Office decisions may be cited as precedent in appeals to the Office. Annual reports on the Office's decisions and Division Directors' decisions with respect to institutions' requests for review of material supervisory determinations also will be published.

I. Appeal Guidelines Generally

Appeals to the Office will be governed by these Guidelines. The Office, with the concurrence of the Legal Division, will retain discretion to waive any provision of the Guidelines for good cause. Supplemental rules governing the Office's operations may be adopted.

Institutions may request extensions of the time period for submitting appeals under these Guidelines from either the appropriate Division Director or the Office, as appropriate. If a filing under these Guidelines is due on a Saturday, Sunday, or a Federal holiday, the filing may be made on the next business day.

J. Limitation on Agency Ombudsman

The subject matter of a material supervisory determination for which either an appeal to the Office has been filed, or a final Office decision issued, is not eligible for consideration by the Ombudsman. However, pursuant to Section (G)(4) of these Guidelines, the Ombudsman may submit views to the Office for its consideration in connection with any pending appeal.

K. Coordination with State Regulatory Authorities

In the event that a material supervisory determination subject to a request for review is the joint product of the FDIC and a State regulatory authority, the Director, DCP, the Director, RMS, or the Director, CISR, as appropriate, will promptly notify the appropriate State regulatory authority of the request, provide the regulatory authority with a copy of the institution's request for review and any other related materials, and solicit the regulatory authority's views regarding the merits of the request before making a determination. In the event that an appeal is subsequently filed with the Office, the Office will notify the institution and the State regulatory authority of its decision. Once the Office has issued its determination, any other issues that may remain between the institution and the State authority will be left to those parties to resolve.

L. Effect on Supervisory or Enforcement Actions

The use of the procedures set forth in these Guidelines by any institution will not affect, delay, or impede any formal or informal supervisory or enforcement action in progress during the appeal or affect the FDIC's authority to take any supervisory or enforcement action against that institution.

M. Effect on Applications or Requests for Approval

Any application or request for approval made to the FDIC by an institution that has appealed a material supervisory determination that relates to, or could affect the approval of, the application or request will not be considered until a final decision concerning the appeal is made unless otherwise requested by the institution.

N. Prohibition on Examiner Retaliation

The FDIC has an experienced examination workforce and is proud of its professionalism and dedication. FDIC policy prohibits any retaliation, abuse, or retribution by an agency examiner or any FDIC personnel against an institution. Such behavior against an institution that appeals a material supervisory determination constitutes unprofessional conduct and will subject the examiner or other personnel to appropriate disciplinary or remedial action. Institutions that believe they have been retaliated against are encouraged to contact the Regional Director for the appropriate FDIC region. Any institution that believes or has any evidence that it has been subject to retaliation may file a complaint with the Director, Office of the Ombudsman, Federal Deposit Insurance Corporation, 3501 Fairfax Drive, Suite E–2022, Arlington, Virginia, 22226, explaining the circumstances and the basis for such belief or evidence and requesting that the complaint be investigated and appropriate disciplinary or remedial action taken. The Office of the Ombudsman will work with the appropriate Division Director to resolve the allegation of retaliation.

Federal Deposit Insurance Corporation.

By order of the Board of Directors.

Dated at Washington, DC, on January 19, 2021.

**James P. Sheesley,**

*Assistant Executive Secretary.*

[FR Doc. 2021–01547 Filed 1–22–21; 8:45 am]

BILLING CODE 6714–01–P

## FEDERAL ELECTION COMMISSION

### Sunshine Act Meeting

**TIME AND DATE:** Thursday, January 28, 2021 at 10:00 a.m.

**PLACE:** Virtual meeting. Note: Because of the covid–19 pandemic, we will conduct the open meeting virtually. If you would like to access the meeting, see the instructions below.

**STATUS:** This meeting will be open to the public. to access the virtual meeting, go to the commission's website *www.fec.gov* and click on the banner to be taken to the meeting page.

**MATTERS TO BE CONSIDERED:**

Draft Advisory Opinion 2020–06: Escobar

Audit Division Recommendation Memorandum on the Mississippi Republican Party (A17–15)

Management and Administrative Matters

**CONTACT PERSON FOR MORE INFORMATION:** Judith Ingram, Press Officer; Telephone: (202) 694–1220.

**Authority:** Government in the Sunshine Act, 5 U.S.C. 552b.

**Laura E. Sinram,**

*Acting Secretary and Clerk of the Commission.*

[FR Doc. 2021–01594 Filed 1–21–21; 11:15 am]

BILLING CODE 6715–01–P

## FEDERAL TRADE COMMISSION

**[File No. 192 3172]**

### Everalbum, Inc.; Analysis of Proposed Consent Order To Aid Public Comment

**AGENCY:** Federal Trade Commission.

**ACTION:** Proposed consent agreement; request for comment.

**SUMMARY:** The consent agreement in this matter settles alleged violations of federal law prohibiting unfair or deceptive acts or practices. The attached Analysis of Proposed Consent Order to Aid Public Comment describes both the allegations in the draft complaint and the terms of the consent order—embodied in the consent agreement—that would settle these allegations.

**DATES:** Comments must be received on or before February 24, 2021.

**ADDRESSES:** Interested parties may file comments online or on paper by following the instructions in the Request for Comment part of the **SUPPLEMENTARY INFORMATION** section below. Please write "Everalbum, Inc.; File No. 192 3172" on your comment, and file your comment online at *https://www.regulations.gov* by following the instructions on the web-based form. If you prefer to file your comment on paper, mail your comment to the following address: Federal Trade Commission, Office of the Secretary, 600 Pennsylvania Avenue NW, Suite CC–5610 (Annex D), Washington, DC 20580, or deliver your comment to the following address: Federal Trade Commission, Office of the Secretary, Constitution Center, 400 7th Street SW, 5th Floor, Suite 5610 (Annex D), Washington, DC 20024.

**FOR FURTHER INFORMATION CONTACT:** James Trilling (202–326–3497), Bureau of Consumer Protection, Federal Trade Commission, 600 Pennsylvania Avenue NW, Washington, DC 20580.

**SUPPLEMENTARY INFORMATION:** Pursuant to Section 6(f) of the Federal Trade Commission Act, 15 U.S.C. 46(f), and FTC Rule 2.34, 16 CFR 2.34, notice is hereby given that the above-captioned consent agreement containing a consent order to cease and desist, having been filed with and accepted, subject to final approval, by the Commission, has been placed on the public record for a period of thirty (30) days. The following Analysis to Aid Public Comment describes the terms of the consent agreement and the allegations in the complaint. An electronic copy of the full text of the consent agreement package can be obtained at *https://www.ftc.gov/news-events/commission-actions.*

You can file a comment online or on paper. For the Commission to consider your comment, we must receive it on or before February 24, 2021. Write "Everalbum, Inc.; File No. 192 3172" on your comment. Your comment—including your name and your state—

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

| | |
|---|---|
| IN THE MATTER OF<br>EDWARD TOWE,<br>FORMER PRESIDENT AND DIRECTOR,<br>and<br>THOMAS TOWE,<br>FORMER DIRECTOR AND CHAIRMAN<br>OF THE BOARD OF DIRECTORS<br>FIRST NATIONAL BANK & TRUST<br>WIBAUX, MONTANA | AA-EC-93-42<br>AA-EC-93-43 |

DECISION AND ORDER ON
REQUEST FOR A PRIVATE HEARING

Respondents Edward Towe, former President and Director, and Thomas Towe, former Director and Chairman of the Board of Directors of the First National Bank and Trust, Wibaux, Montana ("Bank"), have requested a private hearing in the above-captioned administrative proceeding. The Enforcement and Compliance Division (E&C) of the Office of the Comptroller of the Currency ("OCC") opposes the request.

After considering the applicable law and arguments of the parties, the Comptroller has determined that the Respondents' request for a private hearing must be denied.

I. APPLICABLE LAW

Until 1990, OCC administrative hearings were required by statute to be private unless the Comptroller determined that a public hearing was in the public interest. See 12 U.S.C. § 1818(h)(1) (1989). However, section 2547 of the Crime Control Act of 1990, Public Law No. 101-647, enacted on November 29, 1990, repealed the private hearing presumption in section

1818(h)(1) and amended section 8(u)(2) of the Federal Deposit Insurance Act to establish a presumption in favor of open hearings:

> All hearings on the record with respect to any notice of charges issued by a Federal banking agency shall be open to the public, unless the agency, in its discretion, determines that holding an open hearing would be contrary to the public interest.

12 U.S.C. § 1818(u)(2).

In apparent recognition of the need to protect confidential information in an open hearing, Congress also provided:

> The appropriate Federal banking agency may file any document or part of a document under seal in any administrative enforcement hearing commenced by the agency if disclosure of the document would be contrary to the public interest.

12 U.S.C. § 1818(u)(6).

On August 9, 1991, the OCC promulgated at 12 C.F.R. Part 19 new Rules of Practice and Procedure applicable to all actions commenced on or after that date. The Rules reiterate the statutory presumption in favor of a public hearing:

> (a) General Rule. All hearings shall be open to the public, unless the Comptroller, in his or her discretion, determines that holding an open hearing would be contrary to the public interest.

12 C.F.R. § 19.33(a).

With respect to preserving confidentiality where necessary, the Rules state in part:

> (b) Filing document under seal. Enforcement Counsel, in his or her discretion, may file any document or part of a document under seal if disclosure of the document would be contrary to the public interest. The administrative law judge shall take all appropriate steps to preserve the confidentiality of such documents or parts thereof, including closing portions of the

hearing to the public.

12 C.F.R. § 19.33(b).

## II. PROCEDURAL BACKGROUND

The OCC initiated proceedings against the Respondents by service of a Notice of Assessment of Civil Money Penalty and a Notice of Intention to Prohibit Further Participation, both dated March 29, 1993. In their Answer, the Respondents asked the Comptroller to determine that a public hearing would be contrary to the public interest. Subsequently, the Respondents filed a motion requesting a private hearing and a memorandum in support thereof. Respondents argue that a public hearing would violate the confidential relationship between the Bank and its customers and that some of the evidence would compromise customer financial integrity and privacy. The Respondents further assert that a public hearing would reveal confidential information about financial transactions involving individuals, a partnership, a corporation and a nonprofit organization that are not parties to the proceeding.

On May 26, 1993, E&C filed an opposition. E&C argues that the Respondents have failed to meet their burden of showing that an open hearing would be contrary to the public interest. According to E&C, the Respondents' claim that a public hearing would violate confidential relationships and compromise customers' financial privacy is without merit because 12 U.S.C. § 1818(u)(6) and 12 C.F.R. § 19.33(b) provide procedures to protect confidentiality where warranted. E&C indicates its willingness to file documents under seal and to agree to close portions of the hearing to the public when necessary to protect customer confidentiality. E&C further argues that, with possible exceptions, most of the customer information will be presented through documentary evidence rather than through testimony.

With regard to the Respondents' objections that a public hearing would permit disclosure of financial information about a consultant who provided services to the Bank, E&C argues that the information in question has already been made public in another case, U.S. v. Edward Towe and Cora Florence Towe, No. 91/00011 (Bankr. D. Mont.).

In response to the Respondents' contention that a public hearing would disclose confidential information concerning the partnership, the corporation and the nonprofit organization, E&C argues that the Right to Privacy Act, 12 U.S.C. § 3401 et seq., does not cover partnerships of more than five individuals, or corporations, or nonprofit organizations. Accordingly, E&C maintains that the Respondents have no reasonable expectation of privacy with respect to these entities.

On June 21, 1993, the Respondents filed a reply contending that an open hearing would be so confusing and disjointed as to be unworkable, since many documents pertaining to individual loans would have to be redacted or sealed and portions of the hearings closed to the public. A private hearing, in the Respondents' view, "would be a less cumbersome proceeding and could be conducted in a more workable and orderly fashion."

## III. DISCUSSION

Section 1818(u)(2) establishes a presumption favoring an open hearing, unless the Comptroller determines that an open hearing is contrary to the public interest. In the Comptroller's opinion, the Respondents' argument that an open hearing would not be in the public interest is without merit. The Civil Money Penalty and Prohibition Notices allege that the Respondents engaged in serious violations of law. An open hearing would serve the public interest by apprising the public of actions that adversely affect the safety and soundness of the Bank. A public hearing would also demonstrate that the OCC will take strong enforcement action against directors and officers alleged to have engaged in such practices.

Even when a hearing is public, safeguards are available to protect the confidentiality of persons who are not parties to the proceeding. As noted earlier, the OCC's Rules of Practice and Procedure authorize the filing of any document or part of any document under seal. E&C has indicated it is prepared to take measures authorized by the Rules to preserve confidentiality where necessary. In addition, the administrative law judge has broad authority to address any remaining concerns regarding confidential information by ordering that documents be produced, and portions of the hearing be held, in private. 12 C.F.R. § 19.33(b) (1993). While the redaction of documents and the possibility of closing portions of the hearing may make the proceeding more cumbersome than otherwise, the Comptroller believes that the previous experience of the administrative law judges with this format will assure an orderly and meaningful hearing for both parties.

V. ORDER

The Comptroller is unable to find that an open hearing would be contrary to the public interest, and therefore it is ordered that the Respondents' request for a private hearing is denied.

So ordered this 13th day of September, 1993.

Eugene Ludwig
Comptroller of the Currency

**UNITED STATES OF AMERICA**
**DEPARTMENT OF THE TREASURY**
**COMPTROLLER OF THE CURRENCY**

| | |
|---|---|
| **In the Matter of:**<br><br>RICHARD USHER<br>Former Head of EMEA FX Spot Trading<br><br>JP Morgan Chase Bank, N.A.<br>Columbus Ohio | AA-EC-2017-3 |

## ORDER DENYING ENFORCEMENT COUNSELS' MOTION FOR INTERLOCUTORY REVIEW

Before the Comptroller of the Currency ("Comptroller") is *OCC's Motion for Interlocutory Review* filed by Enforcement Counsel ("EC"), requesting that the Comptroller review the *Order Regarding Enforcement Counsel's Claim of Privilege* issued by Administrative Judge Jennifer Whang on December 7, 2020 and the subsequent *Order Denying Motion for Reconsideration* issued by ALJ Whang on January 15, 2021. For the reasons discussed below, the Comptroller hereby denies *OCC's Motion for Interlocutory Review*. Although the motion is denied, the Comptroller does note the highly sensitive nature of the Document and orders that it and any discussion of its contents remain under seal throughout all proceedings in this matter.

### I. BACKGROUND

This dispute arises out of the disclosure of a document ("Document") by EC to Respondent during the normal course of discovery in the captioned matter. EC claims that the disclosure was inadvertent, and that the Document contains information protected by the attorney-client privilege. Respondent advised EC of his intention to attach the

Document to the parties' joint October 19, 2020 filing regarding scheduling. EC then asserted attorney-client privilege over the content of the Document and attempted to claw back[1] the Document and substitute a redacted version. Ultimately the parties could not agree regarding the disposition of the Document, which resulted in proceedings before the ALJ.

### A. Respondent's Sealed Submission Regarding Enforcement Counsel's Claim of Privilege.

Respondent filed *Respondent Richard Usher's Sealed Submission Regarding Enforcement Counsel's Claim of Privilege* on November 6, 2020. Respondent argued that the statements at issue within the document were not, on their face, subject to attorney-client privilege as they were neither to nor from an attorney. Respondent further argued that the statements at issue fell into two categories; (1) the author's discussion of his expectations based on his conversation with unnamed individuals not identified as attorneys; and (2) a discussion between two OCC bank examiners in which each expressed their opinion without reference to or participation by an attorney. The Respondent noted that the information from the unknown individual in the first category was so intertwined with statements of the author's opinion as to be indistinguishable as separate statements. Finally, Respondent argued that the documents supported a key element of his defense.

[1] The Comptroller notes that discovery in this case is governed by a Protective Order agreed to by the parties and entered by the ALJ on May 20, 2020. The Protective Order states in relevant part that:

> The production of any document in this proceeding shall not, for the purpose of this or any other proceeding, constitute a waiver of any legal privilege, right, or protection from disclosure applicable to the document produced or any other documents, and the parties do not have to meet the requirements similar to or specified in Federal Rule of Evidence 502(b)(1)-(3), or any other standard, to prevent the waiver of any privilege, right, or protection from disclosure.

The Protective Order also provides for a "claw back" procedure to protect documents that are produced pursuant to the order that are subject to claims of privilege. Questions regarding privilege are to be submitted to the ALJ for resolution.

### B. OCC's Response to Respondent's Sealed Submission

EC filed the *OCC's Response to Respondent's Sealed Submission* on November 20, 2020. EC argued that the statements in the Document were, on their face, attorney-client communications because the author referenced "enforcement" which, EC argued, referred to the Enforcement Group within the OCC's Chief Counsel's Office. EC further argued that the communications within the Document were made for the purpose of obtaining legal advice and were privileged, and that the inclusion of 13 non-attorney participants in the email chain is explained by the fact that these participants were OCC examiners with a need to know the information at issue. EC also disputed the argument that Respondent's claimed need for the Documents in support of his defense overrode the attorney-client privilege, challenging the underlying assumption that the Documents support the defense itself.

### C. Respondent's Reply Brief

On November 25, 2020, Respondent filed *Respondent Richard Usher's [Proposed] Reply Brief in Support of His Sealed Submission Regarding Enforcement Counsel's Claim of Privilege.* Respondent argued that the source of the information at issue is not self-apparent on the face of the Document and, more significantly, the EC had not proffered any evidence in its pleading as to that source. Respondent argued that the claim of privilege should not be upheld because the source remained ambiguous and EC, as the party asserting the privilege, had failed to meet its burden to show that the communication was protected. Respondent further argued that the statements reflecting OCC examiner's own thoughts and opinions regarding OCC policies (to the extent that they were not part of seeking or receiving legal advice) did not fall within the attorney-client privilege. Finally, Respondent argued that the Documents contain no indicia that there was any expectation of privacy, noting, *inter alia,* that one recipient forwarded the communication to others without first seeking permission to do so.

**D. Order Regarding Enforcement Counsel's Claim of Privilege**

On December 7, 2020 ALJ Whang issued her *Order Regarding Enforcement Counsel's Claim of Privilege*, rejecting EC's arguments. ALJ Whang held that EC had failed to meet its burden of proof as to either category of statements within the Documents. ALJ Whang specifically held that EC had failed to demonstrate that the statements in the first category were "accurately reflective of communications that[the author] or someone else had had with an E&C attorney, rather than the impressions of some non-attorney managerial, administrative, or support personnel within E&C...." *Order Regarding Enforcement Counsel's Claim of Privilege*, at 6. ALJ Whang likewise held that there was no evidence that the examiner opinions in the second category were made to or received from an attorney[2] nor was there evidence of an intent to confer with an attorney. *Id* at 8.

**E. OCC's Motion for Reconsideration.**

On December 21, 2020, EC filed a motion seeing reconsideration of the December 7, 2020 Order. EC provided an affidavit from Thomas McQuade, the author of the original statements in the Document, attesting to the fact that he was relaying communications from an attorney in Enforcement and that all recipients of the emails within the Document had a need to know the information conveyed.

**F. Respondent's Opposition to Enforcement Counsel's Motion for Reconsideration**

[2] ALJ Whang found that EC conceded that the statements were neither made to nor received from an attorney. *Order Regarding Enforcement Counsel's Claim of Privilege*, at 8.

On January 7, 2021, Respondent filed an opposition to EC's motion for reconsideration. Respondent argued that EC was attempting to relitigate the initial filing by supplementing prior arguments with information that had been available to EC at the time of the original filing.

### G. Order Denying Motion for Reconsideration

On January 15, 2021 ALJ Whang denied EC's Motion for Reconsideration finding that EC's proffered testimony of Mr. McQuade was not new evidence, EC had not established that the testimony was newly discovered and not available at the time the *OCC's Response to Respondent's Sealed Submission* was filed. ALJ Whang took particular note that appropriate time for filing such an affidavit was in support of the original response, particularly because the attorney named by Mr. McQuade as the source of the information was one of the attorneys of record for the OCC at the time of the filing and he could have supplied[3] the necessary affidavit. *Order Denying Motion for Reconsideration* at 3.

ALJ Whang also explained that her order did not represent a categorical determination that EC attorneys are never protected by the attorney client privilege when they provide advice regarding policy or strategy:

> In the Order, the undersigned did note that she was "not sufficiently persuaded," based on Enforcement Counsel's arguments, "that the work done by E&C attorneys in reviewing draft supervisory letters and providing comments and edits to [the Large Bank Supervision division] resembles that of private lawyers seeking to protect the interests of their clients, which may confer the protection of attorney-client privilege, rather than agency lawyers performing regulatory or policy functions, which may not." Id. at 6-7. In so concluding, however, the undersigned made no determination of whether

[3] The Comptroller notes that it appears in the record that Mr. McQuade had retired from the OCC several years previously, presenting the possibility that his late-appearing affidavit was due to the fact that he was not as readily available to provide an affidavit as a current employee. The Comptroller also recognizes that counsel who is appearing on behalf of a client in litigation is placed in a very difficult position when they are also called upon to provide factual testimony in the matter as well. *See generally, ABA Model Rules of Professional Conduct*, Rule 3.7 (Lawyer as Witness).

> the information relayed in the email exchange indeed constituted legal advice, given Enforcement Counsel's lack of sufficient showing that the Document reflected attorney-client communication in the first instance, and she does not do so now. See id. at 7 (stating that "[t]he undersigned does not hold that such activity on the part of agency attorneys reviewing draft supervisory letters is definitively not protected by attorney-client privilege, only that Enforcement Counsel has not made a persuasive case as to why it should be in this instance").

Id. at 2, fn 2. ALJ Whang further emphasized this point:

> In particular, the undersigned disagrees that there is any reason the Order should have a "significant chilling effect on the OCC and the other federal banking agencies" (Motion for Reconsideration at 14), as Enforcement Counsel fears, given that the Order does not reach the issue of when and whether the work done by agency attorneys in reviewing and commenting on draft supervisory letters constitutes privileged legal advice.

Id. at 4, fn 6.

### H. Motion for Interlocutory Appeal

On January 29, 2021 EC filed a *Motion for Interlocutory Appeal* arguing that subsequent modification of the ruling at the conclusion of the proceedings in this matter would be an inadequate remedy to protect the alleged attorney-client privileged information from public disclosure. EC also argued that permitting Respondent to continue to use the information would result in "manifest injustice" and that immediate review was warranted in light of clear errors of law and fact.

### I. Opposition to Enforcement Counsels Motion for Interlocutory Review

On February 12, 2021, Respondent filed his opposition to the motion for interlocutory review, arguing that EC had failed to meet the standard for interlocutory review.

### J. Order Referring Enforcement Counsel's Motion for Interlocutory Review

On February 16, 2021 ALJ Whang referred the Motion for Interlocutory Review and Opposition to the Comptroller of the Currency pursuant to Rule 28 of the Office of the Comptroller of the Currency's Uniform Rules of Practice and Procedure, 12 C.F.R. § 19.28.

## II. DISCUSSION

The Comptroller may, at his discretion, exercise interlocutory review of an ALJ's ruling if the Comptroller finds that:

(1) The ruling involves a controlling question of law or policy as to which substantial grounds exist for a difference of opinion;
(2) Immediate review of the ruling may materially advance the ultimate termination of the proceeding;
(3) Subsequent modification of the ruling at the conclusion of the proceeding would be an inadequate remedy; or
(4) Subsequent modification of the ruling would cause unusual delay or expense.

12 C.F.R. § 19.28(b). EC invokes the third criteria as grounds for interlocutory review of the *Order Regarding Enforcement Counsel's Claim of Privilege* and *Order Denying Motion for Reconsideration*. EC also argues that manifest injustice will result from a failure to intercede in the dispute on an interlocutory basis, and that the interlocutory review is not only warranted but also required to correct clear errors of law and fact.

As a general matter, an interlocutory appeal of a presiding officer's ruling on a case-management issue will not be granted unless the circumstances justifying the appeal are extraordinary or involve issues that are fundamental to the presentation of the case or affect substantial rights of the parties. *IN THE MATTER OF * * * NATIONAL BANK * * *, * * **, 1985 WL 203012, at *1 (Citing *Beatrice Foods Co.*, 18 Ad. L.2d 305 (FTC 1965); *Montgomery Ward Co. Inc.*, 16 Ad. L.2d 458 (FTC 1964); *James S. Rivers, Inc.*, 14 Ad. L.2d 447 (FCC Rev. Bd. 1963); *School Services Inc.*, 22 Ad. L.2d 323 (FTC 1967).. Discovery issues are rarely the proper subject for interlocutory review. *Id.* In that context, "an agency will not normally accept interlocutory review on matters committed to the ALJ's discretion, such as the admissibility of evidence." *IN THE MATTER OF * * *, FORMER PRESIDENT AND DIRECTOR, * * * NATIONAL BANK,* * * *, * * *, 1987 WL 288108, at *1 (citing *Toledo-Edison Co.*, 38 Ad. L.2d 763 (NRC 1976); *Mellon National Corp.*, 38 Ad. L.2d 50 (FRB 1975);2 Fed. Proc. 136 § 2:167 (1981)). Again, "interlocutory review is proper where the underlying issue is significant, and the interests of the parties are sufficiently great." *Id.* (citing *Kansas Gas and Electric Co.*, 39 Ad. L.2d 11 (NRC 1976).

Questions of privilege may merit consideration on an interlocutory basis, and the Comptroller has granted such review in the past. However, in the one past instance where interlocutory appeal was granted that the Comptroller is aware of, review was granted to delineate a larger, more fundamental issue, such as how to apply a qualified governmental privilege to proceedings before the Comptroller. *See, IN THE MATTER OF * * *, FORMER PRESIDENT AND DIRECTOR, * * * NATIONAL BANK,* * * *, * * *, 1987 WL 288108, at *1. (In this instance, while this motion for interlocutory review arises in a procedural context, the underlying issue involves a substantive rule of law which requires the application of the deliberative process privilege. At issue are the interests of the Respondent in accurate judicial fact finding and of EC in maintaining the integrity of the bank examination process.). That situation is not presented here. In this case there is no dispute that the attorney-client privilege presents an absolute privilege that, if applicable, would bar the disclosure of at least a portion of the document in question in this setting. There is also no fundamental uncertainty regarding the appropriate burden of proof– a preponderance of the evidence – necessary to successfully defend the assertion of the privilege. There is likewise no question that the burden of proving that the attorney-client privilege is applicable rests with EC. *See, e.g. .Judicial Watch, Inc. v. U.S. Dep't of Homeland Security*, 841 F. Supp. 2d 142, 153 (D.D.C. 2012)(" the proponent bears the burden of demonstrating the applicability of any asserted privilege...[t]o do so, the proponent must adduce competent evidence in support of 'each of the essential elements necessary to support a claim of privilege.'" (citations omitted). Likewise, any ambiguity in that presentation of proof is construed against EC. *Scholtisek v. Edlre Corp*, 441 F. Supp. 2d 459, 462 (W.D.N.Y 2006). Moreover, as ALJ Whang's order makes clear, her ruling does not represent a categorical determination that communications by EC attorneys are not covered by the attorney client privilege when they provide policy advice to their clients. ALJ Whang's order found that EC counsel had failed to provide timely evidence to meet its burden that the communication was privileged, not that the communication was unlikely to be privileged.

For the reasons stated below, the Comptroller disagrees with EC that the criteria supporting interlocutory review – specifically that subsequent modification of the ruling at the conclusion of the proceeding would be an inadequate remedy – has been met. The Comptroller therefore denies EC's *Motion for Interlocutory Review* as to both the *Order Regarding Enforcement Counsel's Claim of Privilege* and *Order Denying Motion for Reconsideration*. In denying this motion the Comptroller expressly takes no view regarding the merits of the underlying privilege dispute.

### A. <u>Post-Hearing Review Would Be an Adequate Remedy</u>

With respect to the first criterion raised in support of their motion, EC argues that the "sacred" nature of attorney-client privilege and likelihood of public disclosure of the information if this matter proceeds further require immediate review. Specifically, EC argues that:

> [u]nder the Tribunal's ruling, Respondent will be free to use a highly sensitive, confidential, and plainly privileged Document. In addition, once unsealed, any member of the public could likely obtain the Document under the Freedom of Information Act. Respondent will also likely introduce the Document into the record at hearing, meaning that the privileged information in the Document would likely become known to the public, including any members of the public or press that attend the hearing.

*Motion for Interlocutory Appeal* at 4. EC further cites as support for its position the provisions of the Uniform Rules of Practice and Procedure, 12 C.F.R. Part 19, subpart A ("Uniform Rules"), specifically 12 C.F.R. §19.25(g) governing the ruling on motions related to discovery disputes, which provides:

> ...the administrative law judge may not release, or order a party to produce, documents withheld on grounds of privilege if the party has stated to the administrative law judge its intention to file a timely motion for interlocutory review....

12 C.F.R. §19.25(g). EC's argues that this provision acknowledges the importance of any discovery ruling involving privileged material, and, more significantly, mandates the acceptance of an interlocutory appeal in any matter in which a dispute involves a claim of privilege.

The Comptroller recognizes that maintaining and preserving applicable privileges is important to the maintaining the integrity of the OCC's supervisory functions. However, EC's argument ignores the other protections against unwarranted public disclosure of sensitive information during the course of proceedings as well as the opportunity for post-proceeding review during the course of a review of recommended decision by the Comptroller that are inherent in the Uniform Rules. Specifically, the Document has been filed under seal, and can remain under seal throughout the proceedings, including being shielded from public disclosure by closing to the public portions of any hearing that involve evidentiary discussion, testimony and argument regarding the Document.

EC is correct that proceedings before an ALJ are generally public in nature. *See* 12 C.F.R. §19.33(a). However, EC is incorrect that participation in a public hearing will immediately expose the Documents to public scrutiny. The Uniform Rules provide that parties may file sensitive material under seal, a procedure well known to EC as all pleadings in the instant dispute have been filed under seal. Once filed under seal, the ALJ is required to "take all appropriate steps to preserve the confidentiality of [documents as to which a dispute regarding, *inter* alia, privilege exists] or parts thereof, **including closing portions of the hearing to the public.**" 12 C.F.R. §19.33(b) (emphasis added).

The Uniform Rules likewise provide a mechanism for post-hearing review of the disputed materials and related rulings while the information is still protected from public disclosure. Specifically, the Uniform Rules provide that after a hearing an administrative judge prepares and files with the Comptroller findings of fact, conclusions of law, a proposed decision and order along with the record in every case. 12 C.F.R. §19.38. The Parties may then file exceptions to "the recommended decision, findings, conclusions or proposed order, **to the admission or exclusion of evidence**, or to **the failure of the administrative judge to make a ruling proposed by a party.**" 12 C.F.R. §19.39(a) (emphasis added). Only after review and decision on the exceptions would the Documents become public, and then only if EC were not successful in persuasively arguing in favor of the privilege. Therefore, contrary to its assertions, EC is not without the ability to protect the Documents from public disclosure nor without an adequate remedy even if interlocutory review is denied. Although the Comptroller is denying the Motion for Interlocutory Appeal, the Comptroller does note the highly sensitive nature of the Document. Because of this, the Comptroller will order that the Document and any discussion of its contents remain under seal throughout all proceedings in this matter.

Furthermore, the Comptroller agrees with Respondent that the Supreme Court's decision in *Mohawk Industries Inc. v. Carpenter*, 558 U.S. 100 (2009) supports the finding that interlocutory appeal is not required. In *Mohawk Industries* the petitioner asserted a claim of attorney-client privilege regarding a meeting with counsel. Petitioner argued that "disclosure orders adverse to the attorney-client privilege qualify for immediate appeal," reasoning that such orders render confidentiality "irreparably destroyed." 558 U.S. at 103, 108. The Court disagreed, stating "post judgement appeals generally suffice to protect the rights of litigants and ensure the vitality of the attorney-client privilege." 558 U.S. at 109. The Court further noted "[a]ppellate courts can remedy the improper disclosure of privileged material . . . by vacating an adverse judgment and remanding for a new trial in which the protected material and its fruits are excluded from evidence." *Id.* This is exactly the scenario envisioned by the post-hearing exceptions provisions of the uniform rules. The Document can remain under seal, the hearing can be closed to the public during discussion of the document, EC can brief its objections as part of the exceptions process and, if EC is correct, the Comptroller "can remedy the improper disclosure of privileged material . . . by vacating [the] adverse judgment and remanding for a new trial in which the protected material and its fruits are excluded from evidence."

**B. Manifest Injustice**

The Comptroller is similarly unpersuaded by EC's argument that manifest injustice will result if Judge Whang's rulings stand. EC argues that "[m]anifest injustice would result from allowing Respondent to obtain and use privileged information in an OCC administrative proceeding, particularly when EC has demonstrated that the Document itself, on its face, evidences that it contains attorney-client privileged information." *OCC's Motion for Interlocutory Review* at 6. Every contested ruling in every adverse proceeding necessarily results in one party "winning" and one party "losing." As detailed above, the Uniform Rules contemplate that a party may disagree with one or more rulings of an administrative judge and provide a mechanism for obtaining review prior to issuance of a final decision. See 12 C.F. R. §19.39(a). EC's argument is essentially that the manifest injustice that will result is that it will have to wait to obtain that review, as any party would, until the conclusion of proceedings. The Comptroller is unpersuaded that subjecting EC to application of the Uniform Rules constitutes manifest injustice.

### C. Clear Error of Law and Fact

The Comptroller is not persuaded by EC's third and final argument that interlocutory intervention is required because ALJ Whang's decisions evidence clear errors of fact and law. Inherent in any appeal is an argument that there has been an erroneous ruling of fact, law or both. EC has failed to demonstrate that the error alleged here merits interlocutory review under the provisions of 12 C.F.R. §19.28(b). To the contrary, as detailed above, EC proffered a single reason, inadequacy of a post-hearing remedy, which has been found unpersuasive. The Comptroller is also unpersuaded that by itself EC's assertion of clear error of law and fact somehow renders post-hearing review pursuant to section 19.39(a) to be an inadequate remedy.

## III. CONCLUSION

The Comptroller notes that in declining to grant interlocutory appeal, the parties and the public should not construe this ruling as a broad statement of policy regarding the availability of interlocutory appeal, generally. Further, this order should not be construed as establishing precedent regarding a particular set of facts that are necessary to establish (or overcome) an assertion of the attorney-client privilege. Each case presents a unique circumstance and turns on its own set of facts. Finally, this order should not be construed as a ruling on the correctness of the ALJ's ruling on the underlying issue, whether the Document is properly subject to an assertion of attorney-client privilege. This order finds that EC's claim of privilege did not succeed in this instance because of a perceived weakness in the factual record developed in this case; if the Document is subjected to a future demand for production the agency may seek to supplement the record to bolster its claim.

For the reasons stated above, the Comptroller hereby denies *OCC's Motion for Interlocutory Review*. The Comptroller further orders that the Document and all discussion of its contents remain under seal throughout all proceedings in this matter.

It is so ordered.

Date: April 22, 2021

/s/ Blake J. Paulson, Acting Comptroller of the Currency

[redacted]

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY

| | | |
|---|---|---|
| In the Matter of<br><br>**NYEMA'SHA Taylor,**<br>Former Teller and institution-affiliated party,<br><br>WELLS FARGO BANK, N.A.<br>Sioux Falls, South Dakota<br>Atlanta, Georgia Branch | )<br>)<br>)<br>)<br>)<br>)<br>)<br>) | Docket No.<br>AA-ENF-2021-23 |

## DECISION ON ENTRY OF DEFAULT

This matter is before the Comptroller of the Currency ("Comptroller" or "OCC") on the recommended finding of the Administrative Law Judge ("ALJ") for entry of default and order of prohibition against Nyema'sha Taylor ("Respondent"), a former Teller at Wells Fargo Bank, National Association, Sioux Falls, South Dakota ("Bank"). On June 15, 2023, the OCC issued to Respondent a *Notice of Charges for an Order of Prohibition* ("*Notice of Charges*" or "*Notice*"), pursuant to Section 8(e) of the Federal Deposit Insurance Act ("FDIA"), 12 U.S.C. § 1818(e). On or about June 15, 2023, Respondent was served the *Notice* via United Parcel Service overnight delivery. The *Notice* seeks an order prohibiting Respondent from further participation in the banking industry on the basis of the OCC's allegations that Respondent had violated the law and engaged in unsafe or unsound practices by knowingly processing unauthorized cash withdrawals from a customer account. *See* Notice ¶¶ 8-21.

Respondent failed to respond to the *Notice* within the time limits prescribed under the Uniform Rules of Practice and Procedure set forth in 12 C.F.R. Part 19, Subpart A. *See* 12 C.F.R. § 19.19. Indeed, Respondent failed to provide any response to the *Notice*. Upon consideration of the pleadings, the ALJ's *Order of Default and Recommended Decision to Prohibit Further*

*Participation* ("*Recommended Decision*"), dated September 18, 2023, and of the entire record in this case, the Comptroller concludes that: (1) by failing to respond to the *Notice*, Respondent is in default; and (2) the uncontested allegations in the *Notice* support a finding that Respondent should be prohibited from any further participation in the conduct of the affairs of any institution or entity set forth in Section 8(e) of the FDIA. The Comptroller contemporaneously issues an order of prohibition that is consistent with these conclusions.

## I. INITIATION AND COURSE OF PROCEEDINGS

On June 15, 2023, OCC Deputy Comptroller Mark D. Richardson issued the *Notice of Charges* to Respondent. The *Notice* is based upon violations[1] that arose from Respondent's conduct at the Bank during the period from October 2018 to November 2018 and alleges that Respondent violated 18 U.S.C. § 656 and/or engaged in unsafe or unsound practices,[2] that such violation caused the Bank to suffer a financial loss and/or Respondent to receive financial gain, and that the violation involved personal dishonesty and/or demonstrated a willful disregard for the safety and soundness of the Bank. *See* 12 U.S.C. § 1818(e)(1). Specifically, the *Notice* alleges that Respondent processed five unauthorized in-person cash withdrawals from a customer's account ("Customer A") totaling $11,800. *Notice* at 3-4.

---

[1] The *Notice of Charges* seeks an order of prohibition under 12 U.S.C. § 1818(e) for the violations described therein.

Twelve U.S.C. § 1818(e)(1) authorizes the prohibition of an institution-affiliated party from participating in the conduct of the affairs of any insured depository institution when (1) the party violates a law, regulation, or order; engages or participates in any unsafe or unsound practice in conducting the affairs of the depository institution; or commits or engages in any act, omission, or practice which constitutes a breach of the party's fiduciary duty; (2) the violation, practice, or breach causes the bank to suffer, or probably suffer, financial loss or other damage; prejudices the interests of depositors; or results in financial gain or other benefit to the party; and (3) the violation, practice, or breach involves personal dishonesty; or demonstrates willful or continuing disregard for the safety or soundness of the insured depository institution.

[2] Eighteen U.S.C. § 656 makes it a crime for an employee of a national bank to embezzle, abstract, purloin, or willfully misapply any of the money, funds, or credits of the bank, or which are entrusted to the custody of the bank.

The *Notice* alleges facts that are sufficient to support the claimed violations of law and unsafe or unsound practices and the proposed penalties. At all times relevant to the charges set forth in the *Notice*, the Bank was an "insured depository institution"[3] as defined in 12 U.S.C. § 1813(c)(2). *Notice* ¶ 1. Respondent was an employee of the Bank and was therefore an "institution-affiliated party"[4] of the Bank, as that term is defined in 12 U.S.C. § 1813(u), having served in such capacity within six years of the date of the *Notice*, *see* 12 U.S.C. § 1818(i)(3). *Notice* ¶ 2. The Bank is a national banking association within the meaning of 12 U.S.C. § 1813(q)(1)(A) and is chartered and examined by the OCC. *Notice* ¶ 3. The OCC is the "appropriate Federal banking agency"[5] as that term is defined in 12 U.S.C. § 1813(q) and is therefore authorized to initiate and maintain a prohibition against Respondent pursuant to 12 U.S.C. § 1818(e). *Notice* ¶ 4.

The *Notice* alleges that Respondent was employed by the Bank between April 2018 and November 2018. *Id.* ¶ 6. On or about October 26, 2018, Respondent accessed Customer A's account without a valid purpose. *Id.* ¶ 10. On or about October 29, 2018, Respondent processed two unauthorized cash withdrawals from Customer A's account for $2,400 each, totaling $4,800. *Id.* ¶¶ 11-12. On or about October 31, 2018, Respondent processed two unauthorized cash withdrawals from Customer A's account for $2,400 each, totaling $4,800. *Id.* ¶¶ 13-14. On or about November 7, 2018, Respondent processed one unauthorized cash withdrawal from Customer A's account for $2,200. *Id.* ¶¶ 15-16.

---

[3] An insured depository institution includes "any bank . . . the deposits of which are insured by the [Federal Deposit Insurance] Corporation." 12 U.S.C. § 1813(c)(2).

[4] An institution-affiliated party includes "any director, officer, employee . . . of, or agent for, an insured depository institution." 12 U.S.C. § 1813(u)(1).

[5] The OCC is the appropriate Federal banking agency with respect to national banking associations, Federal branches or agencies of foreign banks, and Federal savings associations. 12 U.S.C. § 1813(q)(1).

On November 19, 2018, Respondent signed a written statement admitting to processing the withdrawals on behalf of a friend. *Id.* ¶ 17.

A. Notification of Respondent's Obligation to Answer

The *Notice* adequately notified Respondent of her obligation to respond to the case against her. The *Notice* directed her to file an answer within 20 days of the date of service of the *Notice* with the Office of Financial Institution Adjudication, the OCC's Hearing Clerk, and Enforcement Counsel. *Notice* at 4-5; *see also* 12 C.F.R. § 19.19(a), (b). The *Notice* lists the physical and email addresses for all parties who should receive service of an answer. *Notice* at 4-5. The *Notice* also specifically states that a failure to file an answer within the 20-day time period "shall constitute a waiver of the right to appear and contest the allegations contained in [the] Notice." *Id.*; *see also* 12 C.F.R. § 19.19(c). Respondent was required to file her answer to the *Notice* by July 5, 2023, which she failed to do.

B. Receipt of Service of *Notice of Charges* and Proof of Service of Process

The record reflects that OCC Enforcement Counsel served a copy of the *Notice*, dated June 15, 2023, on Respondent on or about June 15, 2023 via UPS overnight delivery. *Motion for Entry of Order of Default and Recommended Decision to Prohibit Further Participation and Report on Proof of Service of Process* ("*Default Motion*") at 1. Respondent received service of the *Notice* at her physical address, obtained by Enforcement Counsel via Westlaw CLEAR search, and confirmed with the Housing Authority of Savannah, her landlord. *Id.* at 2-3.

C. Entry of Default and ALJ Recommendation

Following Respondent's failure to file a timely answer to the *Notice*, Enforcement Counsel filed the *Default Motion* on August 23, 2023. It was served upon Respondent the same day. *Certificate of Service* to *Default Motion*. Respondent did not respond to that motion. On

September 18, 2023, ALJ Jennifer Whang entered the *Recommended Decision*. The ALJ determined that Respondent had failed to file an answer to the *Notice* within the time limits under the Uniform Rules of Practice and Procedure and, therefore, that Respondent was in default and had waived her right to appear and contest the allegations in the *Notice*. *Recommended Decision* at 2; *see also* 12 U.S.C. § 19.19(c)(1). Accordingly, the ALJ recommended that the Comptroller issue an order prohibiting Respondent from further participation in the banking industry. *Recommended Decision* at 2. Respondent did not file exceptions or otherwise respond to the *Recommended Decision*, and the record was submitted to the Comptroller for a final decision on October 31, 2023. *Notice of Submission of Proceeding for Final Decision*.

## II. DECISION

The Comptroller affirms the ALJ's finding that Respondent is in default based upon Respondent's failure to submit a timely answer to the *Notice of Charges*. The record of this case supports this conclusion. The record reflects that the *Notice* was served upon Respondent on or about June 15, 2023. The *Notice* informed Respondent that she was required to file an answer within 20 days of being served the *Notice*, or by July 5, 2023. Respondent was also warned that failing to file a timely answer could result in a default judgment. Respondent received the *Notice*, failed to submit a timely response, and has not shown good cause for her failure to do so.

The Uniform Rules of Practice and Procedure state that it is appropriate to deliver papers to a party via "a reliable . . . overnight delivery service." 12 C.F.R. § 19.11(b)(2). If properly served, the "[f]ailure of a respondent to file an answer required by this section within the time provided constitutes a waiver of his or her right to appear and contest the allegations in the notice." *Id.* at § 19.19(c)(1). Further, if a party fails to show "good cause" for her failure to file a timely answer, the ALJ "shall file with the Comptroller a recommended decision containing the findings and the relief sought in the notice." *Id.* After issuance of a recommended decision, a party has 30 days to file exceptions to that decision, and failure to do so waives any "objection thereto." *See id.* at § 19.39. Finally, "[a]ny final order issued by the Comptroller based upon a respondent's failure to answer is deemed to be an order issued upon consent." *See id.* at § 19.19(c)(1).

Based on the record of this proceeding, the Comptroller finds no basis to question the conclusion that Respondent had actual notice of the proceeding or of her obligation to respond. The Comptroller agrees with the ALJ's findings: (1) that Respondent was properly served with the *Notice* in accordance with 12 C.F.R. § 19.11(b)(2); (2) that she failed to file an answer within the time limits prescribed under the Uniform Rules of Practice and Procedure; and (3) that she is in default. Further, Respondent has not filed any exception challenging the ALJ's *Recommended Decision*, and any objection thereto is waived. *See id.* at § 19.39(b)(1). Respondent therefore has waived her right to appear and contest the allegations in the *Notice of Charges*.

The Comptroller also concludes that the uncontested facts as alleged in the *Notice of Charges* and the record herein support the conclusion that Respondent violated 18 U.S.C. § 656 and engaged in unsafe or unsound practices; that such violation caused the Bank to suffer financial loss and Respondent to receive financial gain; and that the violation involved personal dishonesty and demonstrated a willful disregard for the safety and soundness of the Bank. *See* 12 U.S.C. § 1818(e)(1).

The Comptroller finds that Respondent's unauthorized withdrawals from a customer account violated 18 U.S.C. § 656 and constituted an unsafe or unsound practice. Further, such misconduct caused the Bank to suffer a financial loss when it charged off the unauthorized withdrawals and caused Respondent to receive a financial gain when she took the cash from the customer account, regardless of what ultimately happened with the cash. And, finally, the taking of unauthorized withdrawals from a customer account involves personal dishonesty and a willful disregard for the safety and soundness of the Bank.

Accordingly, the Comptroller concludes that the facts as alleged in the *Notice of Charges* and the record herein support entry of the requested order that Respondent be prohibited from any further participation in the conduct of the affairs of any institution or entity enumerated in Section 8(e)(7)(A) of the FDIA.

## III. CONCLUSION

The ALJ's recommended finding that Respondent be found in default based upon her failure to file an answer is affirmed. Upon consideration of the entire record in this proceeding, the Comptroller finds: (1) that Respondent is in default and has waived her right to contest the findings in the *Notice of Charges*; and (2) that Respondent should be prohibited from any further participation in the conduct of the affairs of any institution or entity set forth in Section 8(e) of the FDIA, 12 U.S.C. § 1818(e). Accordingly, the Comptroller issues an Order of Prohibition contemporaneously with this Final Decision.

Michael J. Hsu

Digitally signed by Michael J. Hsu
Date: 2024.01.09 12:54:51 -05'00'

MICHAEL J. HSU
ACTING COMPTROLLER OF THE CURRENCY

News Release 2023-141 | December 19, 2023

# OCC Assesses $15 Million Penalty Against U.S. Bank for Unfair Practices

WASHINGTON—The Office of the Comptroller of the Currency (OCC) today assessed a $15 million civil money penalty against U.S. Bank, National Association, Cincinnati, Ohio, for violations of law relating to the bank's administration of a prepaid card program to distribute public unemployment insurance benefit payments.

The OCC found that the bank engaged in unfair practices in violation of Section 5 of the Federal Trade Commission Act. From August 2020 through at least March 2021, the bank had deficient processes for permitting consumers to regain access to their unemployment benefits in a reasonable timeframe following account freezes. In response to supervisory concerns, the bank committed to remediate harmed consumers.

The OCC's civil money penalty is separate from, but coordinated with, the Consumer Financial Protection Bureau (CFPB), which issued an enforcement order today against the bank. The CFPB ordered the bank to pay a $15 million civil money penalty and redress harmed consumers. The OCC penalty will be paid to the U.S. Treasury.

## Related Link

- Civil Money Penalty (PDF)

### Media Contact

Stephanie Collins
(202) 649-6870

Topic(s): - ENFORCEMENT ACTIONS

Get updates

Enter your email Subscribe

**#2023-046**

**UNITED STATES OF AMERICA**
**DEPARTMENT OF THE TREASURY**
**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

| | | |
|---|---|---|
| **In the Matter of:**<br><br>U.S. Bank National Association<br>Cincinnati, Ohio | )<br>)<br>)<br>)<br>) | AA-ENF-2023-64 |

**CONSENT ORDER**

**WHEREAS**, the Office of the Comptroller of the Currency ("OCC") has supervisory authority over U.S. Bank National Association, Cincinnati, Ohio ("Bank");

**WHEREAS**, the OCC intends to initiate civil money penalty proceedings against the Bank pursuant to 12 U.S.C. § 1818(i), through the issuance of a Notice of Assessment of a Civil Money Penalty, for engaging in unfair practices in violation(s) of Section 5 of the Federal Trade Commission Act ("FTC Act"), 15 U.S.C. § 45(a)(1).

**WHEREAS**, in the interest of cooperation and to avoid additional costs associated with administrative and judicial proceedings with respect to the above matter, the Bank, by and through its duly elected and acting Board of Directors ("Board"), consents to the issuance of this Consent Order ("Order"), by the OCC through the duly authorized representative of the Comptroller of the Currency ("Comptroller"); and

**NOW, THEREFORE**, pursuant to the authority vested in the OCC by Section 8(i) of the Federal Deposit Insurance Act, as amended, 12 U.S.C. § 1818(i), the OCC hereby orders that:

**ARTICLE I**

**JURISDICTION**

(1) The Bank is an "insured depository institution" as that term is defined in 12 U.S.C. § 1813(c)(2).

(2) The Bank is a national banking association within the meaning of 12 U.S.C. § 1813(q)(1)(A), and is chartered and examined by the OCC. *See* 12 U.S.C. § 1 *et seq.*

(3) The OCC is the "appropriate Federal banking agency" as that term is defined in 12 U.S.C. § 1813(q) and is therefore authorized to initiate and maintain this civil money penalty action against the Bank pursuant to 12 U.S.C. § 1818(i).

**ARTICLE II**

**COMPTROLLER'S FINDINGS**

The Comptroller finds, and the Bank neither admits nor denies, the following:

(1) For several years, the Bank issued and administered prepaid debit cards to distribute unemployment insurance benefits to unemployment recipients on behalf of states, hereinafter referred to as the ReliaCard UI Program.

(2) In March 2020, millions became unemployed and Congress enacted the Coronavirus Aid, Relief, and Economic Security Act (CARES ACT), which created the new Pandemic Unemployment Assistance (PUA) benefit. The CARES Act and PUA expanded unemployment benefits eligibility and provided greater benefit amounts than previously available. As a result, the number of participants in the ReliaCard UI Program increased substantially, as did the volume of benefits issued by the states and distributed by the Bank. The Program also experienced an exponential increase in fraud.

(3) In response to rising rates of fraud in the ReliaCard UI Program, the Bank

increased fraud prevention measures in late August 2020, resulting in account freezes, which denied certain legitimate consumers access to the benefits loaded on prepaid cards until those consumers could validate their identities with the Bank.

(4) Deficiencies in the Bank's unfreeze process from August 2020 through at least March 2021 impeded many consumers' ability to authenticate their identity and regain access to their unemployment benefits through their ReliaCard UI accounts in a reasonable timeframe, typically taking weeks and somtimes even months.

(5) The deficiencies included instances where the Bank failed to timely notify consumers of the freezes to their accounts; the Bank's call center representatives provided consumers with unclear, inconsistent, or inaccurate guidance on the unfreeze process; and the Bank's process to unfreeze accounts resulted in errors and long delays.

(6) By reason of the foregoing conduct, the Bank engaged in unfair practices in violation of Section 5 of the FTC Act, 15 U.S.C. § 45(a)(1), which supports an action against the Bank under 12 U.S.C. § 1818(i)(2)(B).

(7) The Bank took steps to enhance its unfreeze process beginning in September 2020 and has subsequently undertaken corrective actions and has committed to remediate harmed consumers.

## ARTICLE III

## ORDER FOR A CIVIL MONEY PENALTY

(1) The Bank shall make payment of a civil money penalty in the total amount of fifteen million ($15 million), which shall be paid upon the execution of this Order.

(2) Such payment shall be made by a wire transfer sent in accordance with instructions provided by the OCC and the docket number of this case (AA-ENF-2023-64) shall

be entered on the wire confirmation. A copy of the wire confirmation shall be sent immediately, by overnight delivery, to the Director of Enforcement, Office of the Comptroller of the Currency, 400 7th Street, S.W., Washington, D.C. 20219 or by email to the address provided by the OCC.

## ARTICLE IV

## WAIVERS

(1) The Bank, by executing and consenting to this Order, waives:

(a) any and all rights to the issuance of a Notice of Charges pursuant to 12 U.S.C. § 1818;

(b) any and all procedural rights available in connection with the issuance of this Order;

(c) any and all rights to a hearing and a final agency decision pursuant to 12 U.S.C. § 1818 and 12 C.F.R. Part 19;

(d) any and all rights to seek any type of administrative or judicial review of this Order;

(e) any and all claims for fees, costs, or expenses against the OCC, or any of its officers, employees, or agents related in any way to this enforcement matter or this Order, whether arising under common law or under the terms of any statute, including, but not limited to, the Equal Access to Justice Act, 5 U.S.C. § 504 and 28 U.S.C. § 2412;

(f) any and all rights to assert these proceedings, the consent to and/or the issuance of this Order, as the basis for a claim of double jeopardy in any pending or future proceedings brought by the United States Department of Justice or any other governmental entity; and

(g) any and all rights to challenge or contest the validity of this Order.

## ARTICLE V

## CLOSING

(1) This Order is a settlement of the civil money penalty proceedings against the Bank contemplated by the OCC, based on the violations of law described in the Comptroller's Findings set forth in Article II of this Order. The OCC releases and discharges the Bank from all potential liability for a civil money penalty order that has been or might have been asserted by the OCC based on the violations described in Article II of this Order, to the extent known to the OCC as of the effective date of this Order. The OCC expressly reserves its right to assess additional civil money penalties or take other enforcement actions if the OCC determines that the Bank has continued, or failed to correct, violations described in Article II of this Order.

(2) Nothing in this Order shall prevent the OCC from:

(a) instituting enforcement actions other than a civil money penalty order against the Bank based on the Comptroller's Findings set forth in Article II of this Order;

(b) instituting enforcement actions against the Bank based on any other findings, including the Bank's continuation of or failure to correct the violations described in Article II of this Order;

(c) instituting enforcement actions against institution-affiliated parties (as defined by 12 U.S.C. § 1813(u)) based on the Comptroller's Findings set forth in Article II of this Order, or any other findings; or

(d) utilizing the Comptroller's Findings set forth in Article II of this Order in future enforcement actions against the Bank or its institution-affiliated parties to establish a pattern or the continuation of a pattern.

(3) Nothing in this Order is a release, discharge, compromise, settlement, dismissal, or resolution of any actions, or in any way affects any actions that may be or have been brought by any other representative of the United States or an agency thereof, including, without limitation, the United States Department of Justice.

(4) This Order is:

(a) an "order issued with the consent of the depository institution" within the meaning of 12 U.S.C. § 1818(h)(2);

(b) an "effective and outstanding . . . order" within the meaning of 12 U.S.C. § 1818(i)(1); and

(c) a "final order" within the meaning of 12 U.S.C. § 1818(i)(2) and (u).

(5) This Order is effective upon its issuance by the OCC, through the Comptroller's duly authorized representative.

(6) This Order is not a contract binding on the United States, the United States Treasury Department, the OCC, or any officer, employee, or agent of the OCC and neither the Bank nor the OCC intends this Order to be a contract.

(7) No separate promise or inducement of any kind has been made by the OCC, or by its officers, employees, or agents, to cause or induce the Bank to consent to the issuance of this Order.

(8) The terms of this Order, including this paragraph, are not subject to amendment or modification by any extraneous expression, prior agreements, or prior arrangements between the parties, whether oral or written.

IN TESTIMONY WHEREOF, the undersigned, authorized by the Comptroller as his duly authorized representative, has hereunto set her signature on behalf of the Comptroller.

//s// Digitally Signed, Dated: 2023.12.19

Michael T. McDonald for Monica A. Freas
Deputy Comptroller
Large Bank Supervision

IN TESTIMONY WHEREOF, the undersigned, as the duly elected and acting Board of Directors of U.S. Bank National Association, Cincinnati, Ohio have hereunto set their signatures on behalf of the Bank.

| | |
|---|---|
| /s/ | December 12, 2023 |
| Andrew Cecere | Date |
| /s/ | December 12, 2023 |
| Warner L. Baxter | Date |
| /s/ | December 12, 2023 |
| Dorothy J. Bridges | Date |
| /s/ | December 12, 2023 |
| Elizabeth L. Buse | Date |
| /s/ | December 12, 2023 |
| James L. Chosy | Date |
| /s/ | December 12, 2023 |
| Alan B. Colberg | Date |
| /s/ | December 12, 2023 |
| Kimberly N. Ellison-Taylor | Date |
| /s/ | December 12, 2023 |
| Kimberly J. Harris | Date |

| | |
|---|---|
| /s/ | December 12, 2023 |
| Ronald A. Hernandez | Date |
| /s/ | December 12, 2023 |
| Richard P. McKenney | Date |
| /s/ | December 12, 2023 |
| Yusuf I. Mehdi | Date |
| /s/ | December 12, 2023 |
| Loretta E. Reynolds | Date |
| /s/ | December 12, 2023 |
| Jodi L. Richard | Date |
| /s/ | December 12, 2023 |
| John P. Wiehoff | Date |
| /s/ | December 12, 2023 |
| Scott W. Wine | Date |

Syllabus

# CALCUTT *v.* FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 22–714. Decided May 22, 2023

The Federal Deposit Insurance Corporation brought an enforcement action against petitioner, the former CEO of a Michigan-based community bank, for mismanaging the bank's loan relationships with a group of family-owned businesses operating in the real estate and oil industries. As relevant here, Congress has granted the FDIC the power to sanction individuals working in the banking sector if it finds three conditions are met: The individual has "engaged or participated in any unsafe or unsound practice," or breached his "fiduciary duty," 12 U. S. C. §§ 1818(e)(1)(A)(ii)–(iii); a bank or its depositors were harmed, or the individual personally benefited, "by reason of" the individual's misconduct, § 1818(e)(1)(B); and the individual's misconduct involved personal dishonesty or disregard for the soundness of the bank, see § 1818(e)(1)(C).

After conducting an investigation and holding an evidentiary hearing, the FDIC concluded that petitioner's conduct with respect to the loan relationship satisfied these standards. It accordingly ordered that petitioner be barred from the banking industry and assessed a $125,000 civil penalty. Petitioner filed a petition for review in the Sixth Circuit, identifying purported errors in the FDIC's decision. The Sixth Circuit agreed that the FDIC had misapplied the "by reason of" requirement in § 1818(e)(1)(B) by concluding that a showing of proximate cause was not needed. The Sixth Circuit also held that petitioner could not be held liable for all of the harms to the bank that the FDIC had identified. The Sixth Circuit nevertheless affirmed the FDIC's decision, concluding substantial evidence supported the sanctions that it ordered.

*Held*: By affirming the FDIC's sanctions against petitioner based on a legal rationale different from the one adopted by the FDIC, the Sixth Circuit violated the "fundamental rule of administrative law" that reviewing courts "must judge the propriety of [agency] action solely by the grounds invoked by the agency." *SEC* v. *Chenery Corp.*, 332 U. S. 194, 196. "[A]n agency's discretionary order [may] be upheld" only "on the same basis articulated in the order by the agency itself." *Burlington Truck Lines, Inc.* v. *United States*, 371 U. S. 156, 169. Thus, after finding that the FDIC had erred in adjudicating petitioner's case, the Sixth Circuit should have remanded the matter back to the agency for further consideration. And although remand may be unwarranted in circumstances where "[t]here is not the slightest uncertainty as to the outcome" on remand, *NLRB* v. *Wyman-Gordon Co.*, 394 U. S. 759, 766, n. 6, that narrow exception does not apply here, where the issue of what, if any, sanctions to impose is a discretionary judgment committed to the agency. Pp. 624, 628–630.

Certiorari granted; 37 F. 4th 293, reversed and remanded.

Per Curiam.

The Federal Deposit Insurance Corporation (FDIC) brought an enforcement action against petitioner, the former CEO of a Michigan-based community bank, for mismanaging one of the bank's loan relationships in the wake of the "Great Recession" of 2007–2009. After proceedings before the agency concluded, the FDIC ordered petitioner removed from office, prohibited him from further banking activities, and assessed $125,000 in civil penalties. Petitioner subsequently filed a petition for review in the Court of Appeals for the Sixth Circuit. That court determined that the FDIC had made two legal errors in adjudicating petitioner's case. But instead of remanding the matter back to the agency, the Sixth Circuit conducted its own review of the record and concluded that substantial evidence supported the agency's decision.

That was error. It is "a simple but fundamental rule of administrative law" that reviewing courts "must judge the propriety of [agency] action solely by the grounds invoked by the agency." *SEC* v. *Chenery Corp.*, 332 U. S. 194, 196 (1947). "[A]n agency's discretionary order [may] be upheld," in other words, only "on the same basis articulated in the order by the agency itself." *Burlington Truck Lines, Inc.* v. *United States*, 371 U. S. 156, 169 (1962). By affirming the FDIC's sanctions against petitioner based on a legal rationale different from the one adopted by the FDIC, the Sixth Circuit violated these commands. We accordingly grant the petition for certiorari limited to the first question presented; reverse the judgment of the Sixth Circuit; and order that court to remand this matter to the FDIC so it may reconsider petitioner's case anew in a manner consistent with this opinion.

I

Under § 8(e) of the Federal Deposit Insurance Act (FDIA), 12 U. S. C. § 1818(e), as amended by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, § 903, 103 Stat. 453, the FDIC may remove and prohibit individuals from working in the banking sector if certain conditions are met. First, the FDIC must determine that an individual committed misconduct. That occurs when, as relevant here, the individual has "engaged or participated in any unsafe or unsound practice," or breached his "fiduciary duty." §§ 1818(e)(1)(A)(ii)–(iii). Second, the FDIC must find that a bank or its depositors were harmed, or that the individual personally benefited, "by reason of" the individual's misconduct. § 1818(e)(1)(B). Finally, the individual's misconduct must "involv[e] personal dishonesty" or "demonstrat[e] willful or continuing disregard . . . for the safety or soundness" of the bank. § 1818(e)(1)(C).

In this case, the FDIC brought an enforcement action under these provisions against petitioner Harry C. Calcutt, III. From 2000 to 2013, Calcutt served as CEO of Northwestern Bank, headquartered in Traverse City, Michigan. During Calcutt's tenure, the Bank developed a lending relationship with the Nielson Entities, a group of 19 family-owned businesses that operate in the real estate and oil industries. In 2009, the lending relationship—by then, the Bank's biggest—began to sour. On September 1 of that year, facing financial difficulties due to the Great Recession, the Entities stopped paying their loans outright. At the time, they owed the Bank $38 million.

A few months later, the parties reached a multistep agreement known as the Bedrock Transaction to bring all of the Entities' loans current. That agreement stabilized the Nielson lending relationship for the following year. But on September 1, 2010, the Entities again stopped making their loan payments. Another short-term agreement was reached, allowing the Entities to continue servicing their debt for the next few months. But in January 2011, the Entities once more stopped making their loan payments. They have remained in default ever since.

On April 13, 2012, the FDIC opened an investigation into the Bank's officers for their role in the Nielson matter. The investigation concluded on August 20, 2013, at which time the agency issued a notice of intention to remove petitioner as well as two other Bank executives from office, and to prohibit them from further participation in the banking industry. The agency also issued a notice of assessment of civil penalties. The bases for the proposed sanctions were the agency's allegations that petitioner had, in violation of § 1818(e), mishandled the Nielson Entities lending relationship in various ways: The Bedrock Transaction failed to comply with the Bank's internal loan policy; the Bank's board of directors was misled or misinformed of the nature of the Transaction; petitioner failed to respond accurately to FDIC inquiries about the Transaction; and the Transaction was misreported on the Bank's financial statements.

On October 29, 2019, an FDIC Administrative Law Judge (ALJ) began a 7-day evidentiary hearing into petitioner's conduct. Petitioner was among one of 12 witnesses who testified. On April 3, 2020, the ALJ issued his written decision, recommending that petitioner be barred from the banking industry and be assessed a $125,000 civil penalty based on his mishandling of the Nielson Loan relationship. Petitioner appealed the ALJ's decision to the FDIC Board.

The FDIC Board began its review by determining, first, whether petitioner had engaged in an unsafe or unsound banking practice. Such a practice, according to the Board, "is one that is 'contrary to generally accepted standards of prudent operation' whose consequences are an 'abnormal risk of loss or harm' to a bank." App. to Pet. for Cert. 150a (quoting *Michael* v. *FDIC*, 687 F. 3d 337, 352 (CA7 2012)).

The Board held that standard satisfied, concluding that "the record in this matter overwhelmingly establishes that [petitioner] engaged in numerous unsafe or unsound practices." App. to Pet. for Cert. 150a.

The Board then addressed the issue of causation. In doing so, the Board concluded that an individual "need not be the proximate cause of the harm to be held liable under section 8(e)." *Id.*, at 160a. With that understanding in mind, the Board found that petitioner had caused the Bank harm in three ways: First, the Bank had to charge off (*i. e.*, forgive) $30,000 of one of the loans made in the Bedrock Transaction; second, the Bank suffered $6.4 million in losses on other Nielson Loans; and third, the Bank incurred investigative, auditing, and legal expenses in managing the Bedrock Transaction and its fallout. *Id.*, at 159a–166a.

Finally, the Board turned to the issue of culpability. It found that the record "well supported" the ALJ's conclusions that petitioner "persistently concealed . . . the true common nature of the Nielson Entities Loan portfolio, [and] problems with that portfolio." *Id.*, at 167a–168a. The Board also found that petitioner "falsely answered questions presented to him during examinations," "concealed documents showing the true condition of the loans," and "falsely testified that Board members had been fully apprised of the nature of the Nielson Loan portfolio." *Ibid.*

Based on these findings, the Board issued a final decision imposing the penalties that the ALJ had recommended. *Id.*, at 184a–185a.

Petitioner then filed a petition for review in the Sixth Circuit, identifying several purported errors in the Board's decision. Two are relevant here.

First, petitioner contended that the Board had misapplied the FDIA's "by reason of" requirement by concluding that a showing of proximate cause was not needed. 12 U. S. C. § 1818(e)(1)(B). The Sixth Circuit agreed. The court "observed that [t]he Supreme Court has repeatedly and explicitly held that when Congress uses the phrase 'by reason of' in a statute, it intends to require a showing of proximate cause." 37 F. 4th 293, 329 (2022) (some internal quotation marks omitted); see also *ibid.* (citing for that proposition *Hemi Group, LLC* v. *City of New York*, 559 U. S. 1, 9 (2010), and *Holmes* v. *Securities Investor Protection Corporation*, 503 U. S. 258, 268 (1992)).

Second, petitioner argued that he had not proximately caused the harms that the Board had identified or, in the alternative, that those harms did not qualify as harmful effects as a matter of law. See § 1818(e)(1)(B). The Sixth Circuit agreed in part. Petitioner had indeed proximately caused the $30,000 charge off on one of the Bedrock Transaction loans, the court held, because he had "participated extensively in negotiating and approving the Bedrock Transaction." 37 F. 4th, at 330. But the $6.4 million in losses on other Nielson Loans were a different matter. Petitioner could be held responsible only for "part" of that harm, the court explained, because "[t]he Bank probably would have incurred *some* loss no matter what Calcutt did." *Id.*, at 331. Finally, none of the investigative, auditing, and legal expenses incurred in dealing with the Nielson Entities could qualify as harms to the Bank, because those expenses occurred as part of the Bank's "normal business." *Ibid.*

Despite identifying these legal errors in the Board's analysis, the Sixth Circuit nevertheless affirmed the Board's decision by a 2-to-1 vote. The court concluded that substantial evidence supported the Board's sanctions determination, even though the Board never applied the proximate cause standard itself or considered whether the sanctions against Calcutt were warranted on the narrower set of harms that the Sixth Circuit identified. See *id.*, at 333–335.

We now reverse.

## II

It is a well-established maxim of administrative law that "[i]f the record before the agency does not support the agency action, [or] if the agency has not considered all relevant factors, . . . the proper course, except in rare circumstances, is to remand to the agency for additional investigation or explanation." *Florida Power & Light Co.* v. *Lorion*, 470 U. S. 729, 744 (1985). A "reviewing court," accordingly, "is not generally empowered to conduct a *de novo* inquiry into the matter being reviewed and to reach its own conclusions based on such an inquiry." *Ibid.* For if the grounds propounded by the agency for its decision "are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis." *Chenery*, 332 U. S., at 196; see also *Smith* v. *Berryhill*, 587 U. S. 471, 488 (2019) ("Fundamental principles of administrative law . . . teach that a federal court generally goes astray if it decides a question that has been delegated to an agency if that agency has not first had a chance to address the question").

As both petitioner and the Solicitor General representing respondent agree, the Sixth Circuit should have followed the ordinary remand rule here. That court concluded the FDIC Board had made two legal errors in its opinion. The proper course for the Sixth Circuit after finding that the Board had erred was to remand the matter back to the FDIC for further consideration of petitioner's case. "[T]he guiding principle, violated here, is that the function of the reviewing court ends when an error of law is laid bare." *FPC* v. *Idaho Power Co.*, 344 U. S. 17, 20 (1952); see also *Gonzales* v. *Thomas*, 547 U. S. 183, 187 (2006) (*per curiam*) (remanding to agency based on failure by Court of Appeals to "appl[y] the ordinary remand rule" (internal quotation marks omitted)); *INS* v. *Orlando Ventura*, 537 U. S. 12, 18 (2002) (*per curiam*).

The Sixth Circuit, for its part, believed that remand was unnecessary because it "would result in yet another agency proceeding that amounts to 'an idle and useless formality.'" 37 F. 4th, at 335 (quoting *NLRB* v. *Wyman-Gordon Co.*, 394 U. S. 759, 766, n. 6 (1969) (plurality opinion)). It is true that remand may be unwarranted in cases where "[t]here is not the slightest uncertainty as to the outcome" of the agency's proceedings on remand. *Id.*, at 767, n. 6. But we have applied that exception only in narrow circumstances. Where the agency "was *required*" to take a particular action, we have observed, "[t]hat it provided a different rationale for the necessary result is no cause for upsetting its ruling." *Morgan Stanley Capital Group Inc.* v. *Public Util. Dist. No. 1 of Snohomish Cty.*, 554 U. S. 527, 544–545 (2008).

That exception does not apply in this case. The FDIC was not *required* to reach the result it did; the question whether to sanction petitioner—as well as the severity and type of any sanction that could be imposed—is a discretionary judgment. And that judgment is highly fact specific and contextual, given the number of factors relevant to petitioner's ultimate culpability. To conclude, then, that any outcome in this case is foreordained is to deny the agency the flexibility in addressing issues in the banking sector as Congress has allowed.

* * *

The petition for writ of certiorari is granted limited to the first question presented. The judgment of the Court of Appeals for the Sixth Circuit is reversed, and the case is remanded for further proceedings consistent with this opinion.

*It is so ordered.*

**UNITED STATES OF AMERICA**
**DEPARTMENT OF THE TREASURY**
**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

| | |
|---|---|
| **In the Matter of:**<br><br>**LAURA AKAHOSHI**, former Chief Compliance Officer<br>Equal Access to Justice Applicant | OCC AA-EC-2018-20 |

**ORDER STAYING EQUAL ACCESS TO JUSTICE ACT APPLICATION DURING NINTH CIRCUIT APPEAL**

On May 5, 2023, pursuant to 5 U.S.C. § 504, Laura Akahoshi filed with the Office of the Comptroller of the Currency an Application for an Award of Attorneys' Fees and Costs Pursuant to the Equal Access to Justice Act ("EAJA Application"). On the same day, Ms. Akahoshi filed in the United States Court of Appeals for the Ninth Circuit a petition for review of the Comptroller's Final Decision Terminating Enforcement Action, which dismissed the charges against Ms. Akahoshi on April 5, 2023. On June 14, 2023, Administrative Law Judge Whang entered an order denying Respondent's EAJA Application.[1]

Because Ms. Akahoshi is currently seeking review of the dismissal order in the Ninth Circuit, this matter has not yet resulted in a "final disposition" or "final judgment" as required by EAJA. 5 U.S.C. § 504(a)(2); 28 U.S.C. § 2412(d)(2)(G) ("'[F]inal judgment' means a judgment that is final and not appealable . . . "); 31 C.F.R. § 6.11(b) ("If review or reconsideration is sought or taken of a decision as to which an applicant believes it has prevailed, proceedings for

[1] After entry of the order, Enforcement Counsel and Ms. Akahoshi filed a Joint Stipulation and Proposed Order seeking to establish July 14, 2023 as the date ALJ Whang's order would become "the final decision of the OCC" unless the Acting Comptroller were to issue a decision before then. For the reasons set forth in this order, the Joint Stipulation is deemed moot for present purposes.

the award of fees shall be stayed pending final disposition of the underlying controversy."); *Scafar Contracting, Inc. v. Sec'y of Labor*, 325 F.3d 422, 423 (3d Cir. 2003) (holding that "final disposition" in 5 U.S.C. § 504 means "final and unappealable").[2] Therefore, the Comptroller hereby stays Ms. Akahoshi's application until 30 days after the appeal results in a final judgment. *See* 31 C.F.R. § 6.15.

SO ORDERED.

Michael J. Hsu
Digitally signed by Michael J. Hsu
Date: 2023.07.13 10:54:43 -04'00'

Michael J. Hsu
Acting Comptroller of the Currency

[2] The Comptroller notes that, because Ms. Akahoshi has appealed the agency action to the Ninth Circuit, her EAJA application may have been filed under the incorrect statute. *See* 5 U.S.C. § 504(c)(1) ("If a court reviews the underlying decision of the adversary adjudication, an award for fees and other expenses may be made only pursuant to section 2412(d)(3) of title 28").

# Building the Banking Organization:
## Structural Choices and Powers of Banks

John A. Buchman
Hugh C. Conroy Jr.

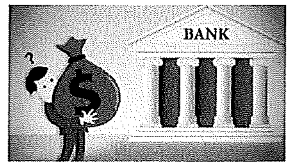
Fundamentals of Banking Law
June 2024

1

A Client and a Lawyer Walk into a Bar . . . .

2

# Do You Need a Bank Charter?




**<u>I want to create a company that does the following:</u>**

1. Mobile app for funds transfers and payments

Cash App

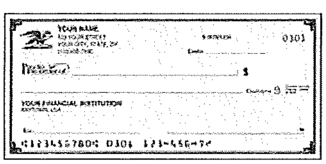
**Answer:** No bank charter required, but will need state money transmitter licenses. State licenses – less rigorous process, but many states.

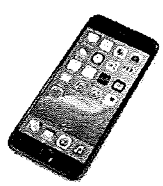
3

# Do You Need a Bank Charter?

**<u>I want to create a company that does the following:</u>**

2. Mobile app now also allows users to take a photo of their checks and then pick up cash from Western Union or other participating stores.




**Answer**: This is a form of online check cashing; no bank charter is necessary, although state check cashing or money transmitter license may be required.

4

## Do You Need a Bank Charter?

**I want to create a company that does the following:**

3. Lend money to customers for mobile app transfers and payments.

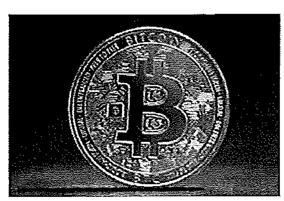

**Answer**: Does not require a bank charter, although state consumer lending licenses may be required.

5

## Do You Need a Bank Charter?

**I want to create a company that does the following:**

4. Helps customers buy/sell Bitcoin, and holds the Bitcoin for customers

**Answer**: Does not require a bank charter, although (1) some states require money transmitter/exchange license, (2) NY would require a NY "BitLicense", and (3) some states may require a trust company license for holding the Bitcoin.

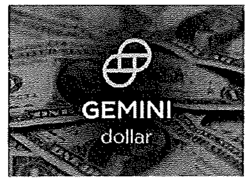
6

# Do You Need a Bank Charter?

**I want to create a company that does the following:**

5. Issues a "stablecoin" backed by cash deposits at another bank, and helps customers use stablecoins to buy goods and send money

tether



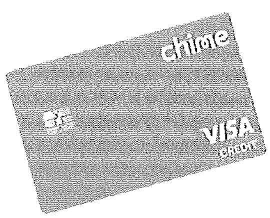

**Answer**: Does not currently require a bank charter, although (1) some states require money transmitter/exchange license, (2) NY would require a NY "BitLicense", (3) several states have issued limited purpose licenses (Wyoming "SPDI", New York LPTC), (4) Federal Reserve GC thinks stablecoins are tokenized deposits, and (5) is it a security?

7

# Do You Need a Bank Charter?

**I want to create a company that does the following:**

6. Helps customers make deposits and get a debit or credit card . . . . *But from another bank* . . . .




wealthfront

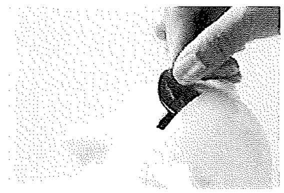
**Answer**: Does not require a bank charter, although some states require money transmitter/exchange or deposit broker license. Depending upon business model may be an investment adviser (see Wealthfront)

8

# Do You Need a Bank Charter?

**I want to create a company that does the following:**

7. Utilize deposits as a funding source to lend money to customers for mobile app transfers and payments.

**Answer**: A bank charter is required to accept insured deposits (but see Wyoming "SPDI").

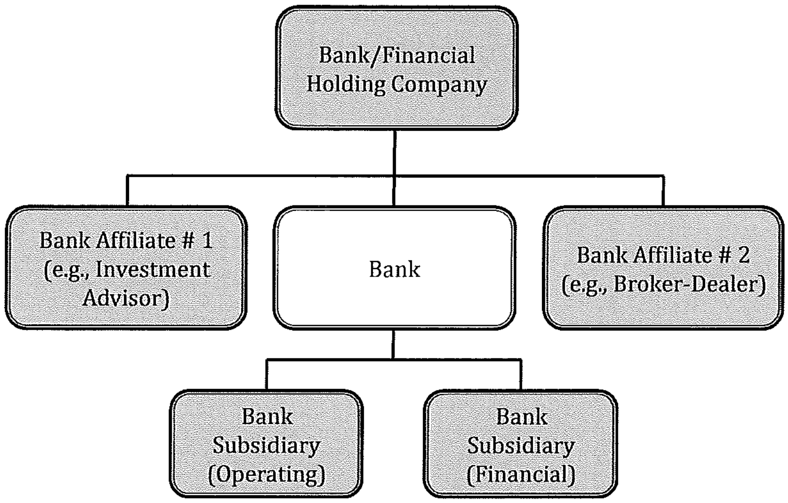
9

# Do You Need a Bank Charter?

- **What is the Role of a "Bank"? Is it Unique?**
  - **Make loans**
    - But other entities make loans – auto dealers, hedge funds, payday lenders, mortgage lenders, Rocket Mortgage, Quicken Loans
  - **Handles payments** (e.g., clearing checks, money transfers)
    - But other entities handle payments – Western Union, PayPal, Venmo, CashApp, check casher
  - **Intermediates financial transactions** – moves money or risk from one party to another
    - But other entities intermediate financial transactions – broker-dealers, mutual funds, swap dealers, Travelex Currency Services
  - **Takes deposits / offers insured deposits**
    - Generally, to take a deposit, and particularly to offer an insured deposit, an entity must have a banking charter (either itself or somewhere in the picture)
    - State "non-encroachment" statutes
    - Some companies may just broker deposits for others, but may not be banks -- IntraFi
  - While making loans, transferring money, intermediating financial transactions may require other licenses or approvals (state lending, check cashing, money transmission licenses; state/federal swap, broker-dealer registrations, etc.), **taking deposits generally requires a banking charter**

10

# Building the Banking Organization




11

# Implications of Having a Bank Charter

## BENEFITS

- Banks' positive reputation – safe and trustworthy
  - Due in part to banks' status as highly regulated entities
- Stable, low-cost source of funding from FDIC-insured deposits
  - Ability to provide transaction accounts (liabilities payable on demand at par and readily transferable to third parties)
- Preemption from many state requirements for National Banks and Federal Savings Associations
- Potential access to Federal Reserve discount window ("lender of last resort")

## BURDENS

- Cumbersome application processes
- Subject to ongoing regulation, supervision, and examination
  - Constant contact with a banking regulator
- Required to file call and other reports with regulator
- Subject to possible enforcement actions by a regulator
- Subject to activity and ownership restrictions at both the bank and holding company levels; need frequent regulatory approvals
- Capital, liquidity, risk management, capital distribution and safety/soundness requirements

12

# Different Types of Bank Charters

- Entities that accept deposits
  - National banks
  - State-chartered banks – Fed-member and non-member
  - Federal savings associations
  - State-chartered savings associations
  - State-chartered savings banks
  - Federal credit unions
  - State-chartered credit unions
  - Industrial loan companies
  - Some trust companies
- Limited purpose entities that do not usually accept deposits
  - Credit card banks
  - Limited purpose trust companies
  - Fintech companies that do not take deposits (but may hold or transmit customer cash)

13

# What Charter is Right for Me?

## SAVINGS & LOAN – FEDERAL / STATE

- Previously regulated by the Office of Thrift Supervision (OTS); July 21, 2011 – OTS merged into the OCC.
- Deposits primarily from individuals; Loans primarily residential mortgages
- Ownership:
  - Mutual ownership model – Owned by its depositors and borrowers, or
  - Share ownership – Shareholders control through issued stock
- Limited commercial lending -- Up to 20% of assets for commercial loans; half of that for small business loans.
- Qualified thrift lender test -- 65% of its assets invested in residential mortgages and other consumer-related assets

## SAVINGS BANKS

- Hybrid of a state commercial bank and a state thrift
- Historically, organized for individuals to encourage thrift by paying interest on savings
- Can have state or federal charter
- Most have some commercial lending authority as commercial banks
- Ability to have holding company treated as SLHC if it satisfies QTL test

## CREDIT UNIONS – FEDERAL / STATE

- Member-owned cooperative – Membership is tied to a "common bond" -- Examples: Military, Teachers, Company, Residency
- No capital stock (has member shares), and builds capital through retained earnings
- May be organized under state or federal law, except for Wyoming, Delaware and South Dakota, which require federal incorporation
- Insured by the National Credit Union Share Insurance Fund (NCUSIF) – backed by the US gov't and administered by the National Credit Union Association (NCUA)
- Non-profit and tax-exempt
- Not required to follow CRA requirements

## INDUSTRIAL LOAN COMPANIES

- May be owned by commercial firms without requiring the parent company to be registered as a bank holding company under the Bank Holding Company Act of 1956, provided one of the following conditions is met
  - May not accept demand deposits that are withdrawn by check,
  - Must have assets less than $100 million, or
  - Must not have been acquired after August 10, 1987
- Only 7 states offer this charter: CA, CO, HI, IN, MN, NV, UT
- Can be controversial because they allow for mixing of banking and commerce – see WalMart, Rakuten

14

# What Charter is Right for Me?
# -- Limited Purpose Charters

**CREDIT CARD BANK**

- Engages only in credit card activities
- Does not accept demand deposits or make commercial loans
- May be owned by commercial firms without requiring the parent company to be registered as a bank holding company under the Bank Holding Company Act of 1956

**TRUST COMPANY**

- OCC- or state-regulated institution that limits operations to activities that are solely in a trust or fiduciary capacity
- Does not accept demand deposits or make commercial loans
- Trust banks can be owned by commercial firms without requiring the parent to register as a BHC

**FINTECH CHARTER**

- Fintech companies, through the use of new technologies, either (i) provide innovative lending and payment products themselves or (ii) improve the offer and delivery of financial products by others
- May be subject to state licensing (e.g., money transmitter) and other banking provisions (e.g., AML), but do not require a bank charter
- July 2018: OCC opened doors for acceptance of special purpose national bank charter for Fintech companies but to date has received no applications; lawsuit against the OCC by CSBS was dismissed on ripeness grounds in Sept. 2019
- Some Fintech companies have obtained traditional bank charters—see Varo Bank, N.A. (opened in Aug. 2020), SoFi Technologies (acquired Golden Pacific Bank, rebranded SoFi Bank, N.A. (Feb. 2022)), but see Square Financial Services (ILC owned by Block)

15

# What Charter is Right for Me?
# -- National or State?

| | |
|---|---|
| ACTIVITIES | ▫ National Bank – more developed set of guidance and precedents from OCC<br>▫ State Banks – limited to powers of national bank, <u>except</u> agency activities or principal activities with approval of FDIC. Some include real estate development, ownership of stock, operating insurance companies and insurance agencies. |
| GEOGRAPHIC SCOPE | ▫ National banks enjoy potential preemption of state laws; OCC has exclusive visitorial rights<br>▫ State banks need to follow laws of each state when branching into other states.<br>▫ State regulators know local communities better |
| ABILITY TO OBTAIN CHARTER | ▫ Minimum capital requirements<br>▫ Director / officer requirements<br>▫ Receptivity of regulator to application |
| REPUTATION OF REGULATOR | ▫ Flexible or enforcement minded?<br>▫ In what regulatory "region" would headquarters be?<br>▫ Size – state bank regulators / FDIC often seen as specializing in local/community banks.<br>▫ Responsiveness |
| COSTS | ▫ Examination fees – states are cheaper than federal<br>▫ Organization fees – states are cheaper than federal<br>▫ State bank can opt out of Federal Reserve membership, avoid costs of FRB stock purchase |

16

# Chartering Process:

## Why Do we Require Banks to Obtain a Charter?

17

## Concept of a Charter

- Ordinary corporations -- File Articles of Incorporation with the Sec'y of State
  - **No approval needed**

- "Banks are Special": Bank chartering requires **positive approval** of the chartering authority
  - **National banks** chartered by the Office of the Comptroller of the Currency ("OCC")
  - **State banks** may be subject to various regimes – charter is typically granted by the state banking department, but may also need to be filed with corporations bureau or secretary of state (e.g., CA) to register as a corporate entity
  - **FDIC** must separately approve grant of deposit insurance (previously embedded in national bank charter approval)
  - **Federal Reserve** must separately approve if forming a holding company or new bank will be subsidiary of existing holding company

- Most banks do **<u>not</u>** have the residual power of a corporation to engage in all lawful activities; in fact, the principal concept is the opposite – an activity is not permitted unless authorized by statute, regulation or regulator

18

## Reasons for Regulatory Approval Requirement

- Banks play a critical role in the economy
  - Back-up sources of liquidity and credit
  - Transmission of funds, fluidity
  - Safekeeping of wealth
- Gatekeeping function of regulators
  - Vet bank organizers, management, investors
  - Ensure sufficient resources available
  - Reasonable prospect of success
- Protection of the FDIC deposit insurance fund (the DIF), and ultimately the taxpayer
- Regulate competition
- Banks infused with a "public purpose"

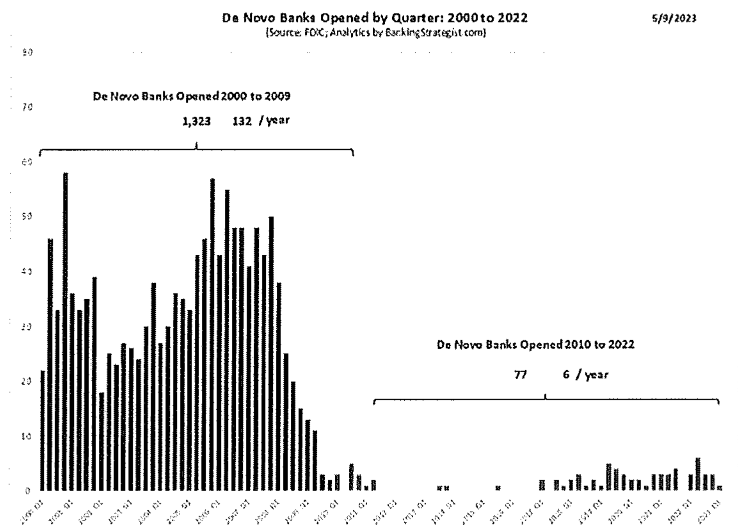
19

## Chartering Process – Substance

- Factors typically considered by chartering authority and FDIC:
  - Integrity, experience and competence of **management and directors**, as well as **investors**
  - **Financial resources**, including the amount of **capital** available to the bank and ability to raise additional capital if need be; including financial resources of organizers
  - **Competitive situation** in the market– does the market have too many banks? What is the target market/niche? Reasonable opportunity to obtain market share?
  - **Soundness of business plan** – range of products offered, pricing of such products, anticipated level of earnings; description of management, compliance, risk management, IT, etc.
  - Multi-year pro forma **financial statement projections**, i.e., future earnings prospects
  - **Convenience to and needs of community** to be served by the bank – is the primary service area reasonably drawn?
  - Commitment to **compliance** (with banking laws, but also consumer laws, anti-money laundering, etc.)
  - New ("de novo") banks often subject to **more rigorous standards**
    - OCC Operating Agreement requiring approval for new directors or senior managers or new lines of business for a period of 5 to 7 years.
    - Requirement not to deviate from business plan without approval for at least 3 years
    - FDIC requirement for leverage ratio of 8% or higher for 3 years

20

# The Burden of Regulation

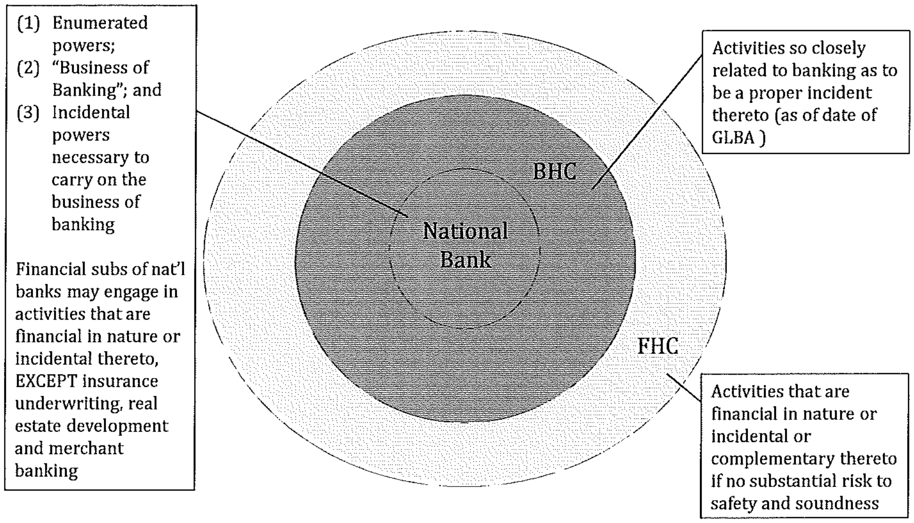



21

# Powers of Banks

22

# A Very Rough Picture of Bank Powers




23

# Why Restrict the Powers of Banks?

- **Banks are "special"**

  "Banks are **indispensable agencies** through which the industry, trade and commerce of all civilized countries and communities are now carried on. . . . [B]anking has ceased to be, if it ever was, a matter of private concern only, like the business of the merchant, and for all purposes of legislative regulation and control it may be said to be **'affected with a public interest'.** The public patronage which the banker invites and receives is of such a character that he becomes in a just sense **a trustee of the fiscal affairs of the people and of the state.** . . . If a bank is unable to meet a check drawn upon it, the refusal to pay is an act of insolvency. Its doors are closed, its business is arrested. . . . Confidence is destroyed. Enterprises are stopped. Business is brought to a standstill. . . . Property is sacrificed and disaster spreads from locality to locality. All these incidents of the banking business are matters of common knowledge and experience. They clearly **distinguish banking from the ordinary private business, illustrate its public nature and show that it is properly subject to the police power of the state, vested in its legislature.**"

  Schaake v. Dolley, 85 Kan. 598, 118 P. 80 (1911) (emphasis added)

  See also E. Gerald Corrigan, "Are Banks Special?", Fed. Res. Bank of Minneapolis, Annual Report 1982.

24

# Limited Powers / Separation of Banking and Commerce

- **Bank powers/activities are limited** to those described in the applicable chartering law
  - Compare to corporations, which may generally engage in any legal activity
  - Activity restrictions are a main component of US banking regulation
  - "Unless it is permitted to a bank, it is prohibited"
- Historically U.S. law has sought to:
  - **(1) separate banking from commercial activities,** and
  - (2) to varying degrees, **separate banking from investment banking and other nonbank financial services**
- Why?
  - Concerns about the concentration of economic power
  - Potential conflicts of interest, particularly with respect to bank credit decisions
  - Limitations on scope of risks banks may take given importance to functioning of economy, access to federal safety net and the "special trusteeship" falling on institutions that lend depositor money
  - Special concerns (and special interests) regarding securities, insurance and real estate

25

# Separation of Commercial / Investment Banking

- Ongoing debate in U.S. about the **separation of commercial and investment banking**
  - Concerns with
    - Risks inherent in trading and avoiding taxpayer subsidy of such risks, and
    - Concentration of financial power and risk in a few large institutions (e.g., TBTF)
  - Counterarguments – diversity of business may reduce risk; increased competition from nonbanks requires banks to evolve to compete with new entrants and with substitutes for traditional bank products; competition from non-U.S. "universal banks"
- Prevailing views have varied – the pendulum swings . . .
  - **Glass-Steagall Act** (provisions of the Banking Act of 1933)
    - Limited ability of banks to engage in securities activities or to affiliate with securities firms
  - **Gramm-Leach-Bliley Act** ("GLBA") (1999)
    - "Repeal of Glass-Steagall" – repealed restrictions on affiliation b/t banks and securities firms, permits "financial holding companies" to engage in broader "financial-in-nature" activities
  - **Volcker Rule** (part of the Dodd-Frank Act of 2010)
    - Bans banks/affiliates from engaging in proprietary trading, or investing in or sponsoring private equity or hedge funds – but more flexibility provided in "Volcker 2.0" (Aug. 2019)
    - France/Germany (and EU?) – segregation (not prohibition) of trading, incl. prop trading
    - UK "ring-fencing" – separate retail from institutional, wholesale and international businesses
    - "21st Century Glass-Steagall"?

26

# Separation of Commercial / Investment Banking

- The **Glass-Steagall Act**'s Statutory Framework:
  - **Section 16, 12 U.S.C. § 24 (Seventh):** National banks may purchase and sell securities "without recourse, solely upon the order . . . of customers", and purchase "investment securities". May only underwrite limited types of securities; may not purchase equities.
  - **Section 20, 12 U.S.C. § 377:** Barred member banks from being affiliated with companies that are "engaged principally in the issue, flotation, underwriting, public sale or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities. . . ."
  - **Section 21, 12 U.S.C. § 378:** No person or organization engaged in the business of "issuing, underwriting, selling or distributing" securities (except as permitted under Section 16) may engage "at the same time to any extent whatever" in deposit taking. (Same approach as Section 16, but from the investment banking side)
  - **Section 32, 12 U.S.C. § 78:** Barred personnel interlocks b/w member banks and entities "primarily engaged" in the issuance, underwriting, public sale or distribution of securities.
- The **"affiliation" provisions** of Sections 20/32 were **repealed by GLBA.**
- **But**, the **"activities/powers" restrictions** of Section 16 (prohibiting commercial banks from conducting securities activities in the bank) and Section 21 (prohibiting investment banks from taking deposits) **were retained.**

27

# Bank Powers – National Banks

- **National bank** – chartered and supervised by the **Office of the Comptroller of the Currency ("OCC")** within the US Treasury Department.
- Legal authority: **National Bank Act of 1864**, 12 U.S.C. § 21 et seq.
- Supervisor: **OCC**
- Grant of "corporate powers" in the National Bank Act at **12 U.S.C. § 24**
  - **First** – To adopt a corporate seal
  - **Second** – To have succession or continuing existence until dissolved
  - **Third** – To make contracts
  - **Fourth** – To sue and be sued
  - **Fifth** – To elect or appoint directors and officers
  - **Sixth** -- To prescribe bylaws on transfer of stock and election of directors and sale of property not inconsistent with the rules of the OCC
  - **Eighth** – To contribute to charitable organizations
  - **Ninth** – To issue and sell its own securities
  - **Tenth** – To invest in personal property
  - **Eleventh** – To engage in community reinvestment activities

28

# Section 24(Seventh)

*"**Seventh.*** To exercise by its board of directors or duly authorized officers or agents, subject to law, all such **incidental powers** as shall be **necessary** to carry on the **business of banking**; by **discounting and negotiating promissory notes**, drafts, bills of exchange, and other evidences of debt; by **receiving deposits**; by **buying and selling exchange**, coin, and bullion; by **loaning money on personal security**; and by **obtaining, issuing, and circulating notes** according to the provisions of title 62 of the Revised Statutes."
(Emphasis added.)

- Indicates that there may be **3 types of "banking" powers** in addition to corporate powers:
  - Enumerated powers;
  - General "business of banking";
  - Incidental powers

29

# Section 24(Seventh): Enumerated Powers

- **Specifically enumerated powers**
  - Discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt
  - Receiving deposits
  - Buying and selling exchange, coin and bullion
  - Loaning money on personal security
  - Obtaining, issuing and circulating notes
  - Glass-Steagall modified § 24(Seventh) in 1933:
    - Power to buy and sell securities and stock as agent for customers, but not as principal for its own account
    - Underwriting and dealing of government/municipal securities permitted, but underwriting of many debt securities and stock not permitted
    - Permitted purchase of "investment securities" (IG debt securities) for the bank's own account
- Examples of **other statutory grants of power**:
  - 12 U.S.C. § 92: Insurance agency/brokerage if bank (or one of its branch offices) is located in a "place" of less than 5000 inhabitants
  - 12 U.S.C. § 92a: Trust/fiduciary powers for national banks

380

## Section 24(Seventh): Business of Banking

- Examples of other activities deemed to be **part of the "business of banking"**, generally through OCC regulations or OCC interpretations, include:
  - Investment advisory, financial consulting, private banking and asset management services
  - Broad authority with respect to derivative products ("payment intermediary" concept)
  - Agency securities lending services
  - Personal property leasing
  - Issuance of letters of credit and certain types of guarantees
  - Payment processing, including payment-related information processing
  - "Finder" activities / other intermediary activities
  - Employee benefits and payroll servicing
  - Electronic imaging services, check printing for banks
  - Appraisal services

31

## Section 24(Seventh): Incidental Powers

- No clear line between the broader interpretations of the "business of banking" and "incidental" powers
- What might be deemed **"incidental" to the business of banking**?
  - **Facilitate the operations of a bank** (e.g., advertising, borrowing money, hiring employees, owning/operating bank premises)
  - **Enhance quality and efficiency of banking products and services**
    - Offering nonbanking services to banking customers, such as payment of state tax on accounts and prosecution of lawsuits on behalf of customers
    - Financial advice
    - Sale of computer hardware in connection with sale of banking software
    - Join a clearing house to facilitate extensions of credit that settle securities and derivatives transactions
  - **Optimize value and avoid economic waste**
    - Management and disposition of property received in satisfaction of "debt previously contracted" (DPC)
    - Management of businesses to reduce losses on loans
    - Sale/lease of excess electronic capacity; leasing space in lobby
    - Statement stuffers in credit card mailings; coupons at ATMs

32

## What is the Business of Banking?

- **Arnold Tours, Inc. v. Camp**, 472 F.2d 427 (1st Cir. 1972)
  - Overturning 1963 OCC ruling that national banks could engage in travel agency business
  - Reasoned that "incidental powers . . . *necessary* to carry on the business of banking" should be given an expansive reading to include powers that are "convenient or useful" to carrying on a bank's activities, so long as the incidental power was "directly related" to one of the national bank's expressly enumerated powers
- **M&M Leasing Corp. v. Seattle First National Bank**, 563 F.2d 1377 (9th Cir. 1977)
  - The business of banking includes leases of personal property "when, in the light of all relevant circumstances, the transactions constitute the loan of money secured by the properties leased"
  - Leases with certain characteristics functionally interchangeable with secured loans
  - "[T]he National Bank Act did not freeze the practices of national banks in their nineteenth century forms. . . . [T]he powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking"

33

## What is the Business of Banking?

- **Nations Bank of North Carolina v. Variable Annuity Life Insurance Co. [("VALIC")]**, 513 U.S. 251 (1995)
  - Banks are permitted to act as agent in the sale of annuities
  - OCC decisions regarding scope of national bank powers and scope of meaning of insurance receive Chevron deference
  - By offering annuities, "banks are essentially offering financial investment instruments of the kind congressional authorization permits them to broker"
  - "We expressly hold that the 'business of banking' is not limited to the enumerated powers in § 24 Seventh and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated."
  - BUT the Court remembers Arnold Tours: "The exercise of the Comptroller's discretion, however, must be kept within reasonable bounds. Ventures distant from dealing in financial investment instruments—for example, operating a general travel agency—may exceed those bounds."

34

# What is the Business of Banking?

- VALIC affirms the OCC view of the **"business of banking" as an evolving concept**
  - See, e.g., Williams and Jacobsen, *The Business of Banking*, 50 Bus. Law. 783 (1995)
    - Principles for evaluating the scope of the business of banking, "both today and as it evolves":
      - Is the activity a contemporary functional equivalent or logical outgrowth of a recognized banking function?
      - Are the risks of the activity similar to the type of risks already assumed by banks?
      - Does the activity benefit customers and/or strengthen the bank?
- For more information on permissible activities, please refer to the OCC publication, Activities Permissible for National Banks and Federal Savings Associations, Cumulative (Oct. 2017).
- Section 620 of the Dodd-Frank Act – Study released on Sept. 8, 2016

35

# What is not the Business of Banking?

National banks are **largely or wholly excluded from certain types of activity** (subject to exceptions):

- **Commercial activities** – e.g., travel agency, manufacturing
- **Ownership of equity** – see 12 U.S.C. § 24(Seventh) which states: "...except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation."
  - Exceptions? – Hedging, subsidiaries, DPC, fiduciary
- **Insurance – Underwriting** activities generally impermissible; **insurance agency** only permissible (for national banks) if conducted in a town of 5000 or fewer inhabitants (12 U.S.C. § 92).
- **Real estate activities** generally – **Real property ownership** prohibited, except in foreclosure (debts previously contracted, or "DPC") and to conduct the business of the bank, 12 U.S.C. § 29.
- **Guarantees** historically prohibited by case law, but exceptions for (i) letters of credit, (ii) transactions in which bank has substantial interest and (iii) financial obligations that are ascertainable (12 C.F.R. §§ 7.1016 and 7.1017)
- **Lotteries**, 12 U.S.C. § 25a; for member banks, 12 U.S.C. § 339.
- Loans by bank **secured by its own stock**, 12 U.S.C. § 83; for member banks, 12 U.S.C. § 324.
- Transfers in contemplation of **insolvency**, 12 U.S.C. § 91.
- **Recent developments** also impinge on activities of banks:
  - **Broker-Dealer**: GLBA "push out" of broker-dealer activities, notwithstanding broker activities permitted under § 24(Seventh)
  - **Proprietary trading**: Volcker Rule (Dodd-Frank Act § 619)
  - **Swaps "push out"**: Mostly repealed, except for structured finance swaps (Dodd-Frank Act § 716)

36

# Bank Powers – State Banks

- A **state bank** receives its charter from state government authorities.
- Supervisors: **State regulators <u>and</u> the Federal Deposit Insurance Corporation ("FDIC") (for non-member banks) or Federal Reserve Board ("FRB") (for member banks)**
- **Powers are defined in the first instance under state law** – vary by state
  - Even if permitted by state law, **Federal law limits state bank powers to activities permitted for national banks,** unless approved by the FDIC with the explicit finding that the new activity would pose no threat to the insurance fund and the bank meets its capital requirements (§ 24 of the 1991 Federal Deposit Insurance Corporation Improvement Act ("FDICIA"), 12 U.S.C. 1831a; § 9(13) of the Federal Reserve Act, 12 U.S.C. 330)
    - Limit principal activities (as opposed to agency activities)
    - Insurance underwriting impermissible, unless permitted to national banks
    - Equity investments restricted, other than investing in majority owned subsidiaries
    - Powers of subsidiaries restricted to those permissible for national bank subsidiary
  - **"Wild Card" / parity statutes** – allow banks to engage in any activity that would be permissible for a national bank, with or without approval from the state regulator (e.g., NY)
  - **"Super Wild Card" statutes** – engage in activity permissible for any other U.S. state bank (e.g., IL, MO)

37

## Are Digital Asset Activities Part of the Business of Banking? An Area of Uncertainty . . .

**National Bank / Federal Savings Association Precedents**

| | |
|---|---|
| **OCC Interpretive Letter # 1170 (July 22, 2020)** | **Cryptocurrency custody services** on behalf of customers, including by holding unique cryptographic keys; permissible in both fiduciary and non-fiduciary capacities as "a modern form of . . . traditional bank activities" |
| **OCC Interpretive Letter # 1172 (Sept. 21, 2020)** | **Hold stablecoin "reserves"** for stablecoin issuer customers; but did not address (i) authority to support stablecoin transactions involving unhosted wallets, or (ii) stablecoins other than those backed on a 1:1 basis by a single fiat currency; bank must verify at least daily that 1:1 reserve account balances are maintained |
| **OCC Interpretive Letter # 1174 (Jan. 4, 2021)** | Use **independent node verification networks (INVNs) and stablecoins (including by issuing a stablecoin)** to engage in and facilitate payment activities; need to be able to (i) verify the identity of all transacting parties, including for unhosted wallets, (ii) safeguard reserve assets, (iii) meet liquidity needs, and (iv) manage risks, including heightened operational, AML, fraud and cyber risks |
| **OCC Interpretive Letter # 1179 (Nov. 18, 2021)** | Interps 1170, 1172 and 1174 are still appropriate interpretations after review by new administration, "provided the bank can demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner. . . . **a proposed activity cannot be part of the 'business of banking' if the bank lacks the capacity to conduct the activity in a safe and sound manner**" |

38

## Are Digital Asset Activities Part of the Business of Banking? An Area of Uncertainty . . .

**Recent Federal Reserve views in relation to State Banks:** Policy Statement on Section 9(13) of the Federal Reserve Act, 88 Fed. Reg. 7848 (Feb. 7, 2023)

| | |
|---|---|
| REBUTTABLE PRESUMPTION | **Rebuttable presumption** that Federal Reserve will limit state member banks to engaging as principal in only those activities that are permissible for national banks, unless those activities are permissible for state banks by federal statute or under FDIC regulations. |
| LEGAL PERMISSIBILITY VS. SAFETY/SOUNDNESS OVERRIDE | **Legal permissibility is a necessary, but not sufficient,** condition to establish that a state member bank may engage in a particular activity; a state member bank must at all times conduct its business and exercise its powers with due regard to safety and soundness. |
| CUSTODY / SAFEKEEPING | "Nothing in the policy statement would prohibit a state member bank . . . from providing safekeeping services for crypto-assets in a custodial capacity if such activities are conducted in a safe and sound manner and in compliance with consumer, anti-money-laundering, and anti-terrorist-financing laws." |
| HOLDING CRYPTO ASSETS AS PRINCIPAL | "The Board has not identified any authority permitting national banks to hold most crypto-assets, including bitcoin and ether, as principal in any amount. . . . Therefore, the Board would **presumptively prohibit state member banks** from engaging in such activity." Also Interagency Statement on Crypto-Asset Risks to Banking Organizations, Jan. 3, 2023 ("issuing or holding as principal crypto-assets . . . highly **unlikely to be consistent with safe and sound** banking"). |
| ISSUING STABLECOINS | "The permissibility of the issuance of dollar tokens to facilitate payments for national banks is subject to OCC Interpretive Letters 1174 and 1179, including the conditions set out therein . . ., including demonstrating, to the satisfaction of Federal Reserve supervisors, that the bank has controls in place to conduct the activity in a safe and sound manner, and receiving a supervisory nonobjection before commencing such activity." However, "[t]he Board generally believes that issuing tokens on open, public, and/or decentralized networks, or similar systems is highly likely to be inconsistent with safe and sound banking practices." |

# Subsidiaries of Banks

- Domestic subsidiaries of national banks are generally either "**operating subsidiaries**" or "**financial subsidiaries**"
  - Under 12 U.S.C. § 24(Seventh), national banks are prevented from owning "stock of any corporation" and this precluded ownership of subsidiaries until the 1960s.
  - Owning a subsidiary is also not in the list of corporate powers in 12 U.S.C. § 24.
  - No Preemption - After Dodd Frank, subsidiaries are not entitled to preemption
- **Operating subsidiaries** are like departments of the bank and can engage only in bank-permissible activities. Permission found in OCC Regs, **12 CFR 5.34**
  - Originally required to be 80% owned; now 50% requirement, but banks can also make minority investments in less-than-50% joint venture with restrictions – see 12 CFR 5.36 for permission for minority investments
  - Operating subsidiaries are part of the bank and not "affiliates" for purposes of bank safety and soundness rules (e.g., Section 23A of the Federal Reserve Act)
- **Financial subsidiaries** created by GLBA can engage in "financial in nature activities", except insurance underwriting, real estate development/investment activities, or merchant banking. Permission found in OCC Regs, **12 CFR 5.39**
  - Financial subs are affiliates and not subsidiaries for Section 23A purposes.
  - Bank must be well capitalized and well managed, and large banks must be well rated

40

# Preemption

41

## Constitutional Concept of Preemption

- **National Banks** are chartered and created by the OCC under the federal National Bank Act.
  - As such they are instrumentalities of the federal government entitled to exercise the powers granted to them by Congress in the National Bank Act without interference by the states.
  - **State banks**, on the other hand, **do not benefit from preemption.**

- Supremacy Clause of the Constitution provides states may not enact laws that intrude on areas where Congress has acted or is authorized to act
  - This is the view historically after **McCulloch v. Maryland** – attempt by Maryland to tax the First Bank of the United States was held unconstitutional.
  - **Davis v. Elmira Savings Bank**, 161 U.S. 275, 283 (1896): "... an attempt by a state to define [a national bank's] duties or control the conduct of [a national bank's] affairs is absolutely void wherever ... [it] expressly conflicts with the laws of the United States and either frustrates the purpose of the national legislation or impairs the efficiency of [the bank] to discharge the duties for the performance of which they were created."

42

## Standards for Preemption

- Three traditional standards of federal preemption were listed in the case of **Barnett Bank of Marion County, N.A. v. Nelson**, 517 U.S. 25 (1996). Barnett involved insurance agency in a town of 5000 permitted in 12 U.S.C. 92 and Florida's attempt to preclude this if the bank was a BHC sub.
  - **Explicit preemption**—Congress states the existence and scope of preemption
  - **Field preemption** — Congress adopts a framework for federal regulation that "occupies the field" and leaves no room for states to adopt supplemental laws.
    - While once the primary interpretation of HOLA, now national banks and federal savings banks are treated primarily under conflict preemption principles for consumer financial law.
  - **Conflict preemption** — There exists conflict between the state action and federal regulations, such that compliance with both is a "physical impossibility", or state law is an "obstacle to the accomplishment" of the full purposes and objectives of Congress.
- **Barnett** then articulated a conflict standard that applies preemption to a state law that "prevents or significantly interferes with exercise by a national bank of its powers".

43

## Standards for Preemption after Dodd-Frank

- **Dodd Frank Act** sections 1044-1047, 12 U.S.C. 25b, made significant changes
  - With regard to state consumer financial laws, preemption holds only if:
    - (1) Discriminates against national banks
    - (2) Preempted under the **Barnett** standard of **conflict preemption**—"prevents or significantly interferes with" the exercise by a national bank of its powers, based on "substantial evidence"
      - In contrast to 2004 OCC standard that preemption should preclude any state law that would "**obstruct, impair or condition**"
      - Also eliminates "charter" or ""field" preemption.
    - (3) Preempted directly by a federal statute.
  - **Eliminated judicial deference** to OCC in preemption of state consumer financial laws – case-by-case review requirement
  - Federal thrifts and national banks have **same** preemption standards (see also 12 C.F.R. § 7.4010)
  - No preemption for the **operating subsidiaries** of national banks, overturning **Watters v. Wachovia Bank**, 550 U.S. 1 (2007)
  - OCC does have exclusive visitation powers (see 12 C.F.R. § 7.4000), but a state AG has the right to enforce applicable state laws by court action as in **Cuomo v. Clearing House Association**, 557 U.S. 519 (2009)

44

## Standards for Preemption after Dodd-Frank

- Post-Dodd Frank Act, OCC statement of its preemption authority:
  - **12 C.F.R. § 7.4008(d): The following state law limitations are preempted** in relation to non-real-estate lending:
    - Licensing, registration (except for purposes of service of process), filings, or reports by creditors;
    - The ability of a creditor to require or obtain insurance for collateral or other credit enhancements;
    - Loan-to-value ratios;
    - The terms of credit, including the schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan;
    - Escrow accounts, impound accounts, and similar accounts;
    - Security property, including leaseholds;
    - Access to, and use of, credit reports;
    - Disclosure and advertising, including laws requiring specific statements, information, or other content to be included in application forms, solicitations, billing statements, credit contracts, or other documents;
    - Disbursements and repayments; and
    - Rates of interest on loans.

45

## Standards for Preemption after Dodd-Frank

- Post-Dodd Frank Act, OCC statement of its preemption authority:
  - **12 C.F.R. § 7.4008(e): State laws that are not preempted.**

    State laws on the following subjects are not inconsistent with the non-real estate lending powers of national banks and apply to national banks to the extent consistent with the decision of the Supreme Court in Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al., 517 U.S. 25 (1996):
    - Contracts;
    - Torts;
    - Criminal law
    - Rights to collect debts;
    - Acquisition and transfer of property;
    - Taxation;
    - Zoning; and
    - Any other law that the OCC determines to be applicable to national banks in accordance with the decision of the Supreme Court in Barnett Bank or that is made applicable by Federal law.

46

# Standards for Preemption after Dodd-Frank

- Post-Dodd Frank Act, Recent Case Law
  - **Lusnak v. Bank of America** (Mar. 2, 2018) and **Flagstar Bank, FSB v. Kivett** (May 17, 2022): 9th Circuit upholds CA state law requiring interest payments on loan escrow accounts
  - **Cantero v. Bank of America** (Sept. 15, 2022): 2nd Circuit holds that NY law on escrow interest is pre-empted
  - BUT → **Cantero v. Bank of America**, 602 U. S. ___ (May 24, 2024) (Kavanaugh for a unanimous S.Ct.)
    - "Dodd-Frank provided, as relevant here, that the National Bank Act preempts a state law **'only if'** the state law (i) discriminates against national banks as compared to state banks; or (ii) **'prevents or significantly interferes with the exercise by the national bank of its powers,'** as determined 'in accordance with the legal standard for preemption in [Barnett Bank].'"
    - "Barnett Bank did not purport to establish a clear line to demarcate when a state law 'significantly interfere[s]'"
    - "A court applying that Barnett Bank standard **must make a practical assessment of the nature and degree of the interference** caused by a state law. . . . In assessing the significance of a state law's interference, courts may consider the interference caused by the state laws in [Supreme Court cases] on which Barnett Bank relied. If the state law's interference with national bank powers is more akin to the interference in cases [where preemption was found], then the state law is preempted. If the state law's interference with national bank powers is more akin to the interference in cases [where preemption was not found], then the state law is not preempted."
    - "In analyzing the New York interest-on-escrow law at issue here, the [2nd Circuit] **did not conduct that kind of nuanced comparative analysis.** Instead, the [2nd Circuit] . . . distilled a categorical test that would preempt virtually all state laws that regulate national banks"
    - "**We appreciate the desire by both parties for a clearer preemption line one way or the other.** But Congress expressly incorporated Barnett Bank into the U. S. Code. And in determining whether the Florida law at issue there was preempted, Barnett Bank **did not draw a bright line.** Instead, Barnett Bank sought to **carefully account for and navigate this Court's prior bank preemption cases.**"

47

Banking Law Fundamentals

# BANK HOLDING COMPANIES AND THE CONCEPT OF CONTROL

SCOTT G. ALVAREZ
FORMER GENERAL COUNSEL,
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 24, 2024

## Who can own a bank and take advantage of its special characteristics?

Individuals

Companies

- A company that wants to own a bank has choices:
  - It can control the bank and take full advantage of the powers and privileges of owning a bank by becoming a bank holding company—or BHC—regulated by the Federal Reserve (or control a savings association, with similar regulatory consequences);
  - It can own some of the shares of a bank, but not enough to control the bank. This limits the supervisory oversight of the company and gives it more freedom to conduct nonbanking activities, but also limits its ability to benefit from the funding and other advantages of controlling a bank; or
  - It can own and control a type of bank that would not subject the company to regulation by the Federal Reserve, such as an industrial loan company, credit-card bank or limited-purpose trust company. Ownership of each of these types of banks has a different set of advantages and disadvantages.

# What is a BHC?

A bank holding company (BHC) is any company that controls a bank for purposes of the Bank Holding Company Act.

- A "company" under the BHC Act is any corporation, partnership, LLC, association or other corporate type vehicle, whether chartered by a state or by another chartering authority (including a foreign authority).

Most banks in the US are owned through a BHC; a BHC will typically own and control 100 percent of the shares of one or more banks, either directly or through one or more intermediate companies (all of which are typically also BHCs).

- As of year-end 2022, there were approximately 3,600 top-tier BHCs in the US controlling over 3700 US banks
- BHCs control approximately 94% of the assets held by banks in the US
- Bank holding companies control the largest banks in the United States
  - Citigroup, JP Morgan, Bank of America, Goldman Sachs, Morgan Stanley, Wells Fargo
  - All banks with assets of $100 billion or more are controlled by BHCs



# Why be a BHC?

Becoming a BHC allows a corporate owner to take full advantage of the powers and features of a bank in conducting its operations. For example:

- BHCs can offer a full suite of financial products, including loans, deposits, insurance, securities brokerage services, investment advisory and wealth management services, and investment products.
- BHCs facilitate mixing banking and nonbanking activities, including allowing banks to affiliate with securities firms and other companies engaged in financial activities not permitted for the bank
- BHCs facilitated multi-state operations
- By owning multiple banks, BHCs may offer depositors increased deposit insurance benefits
- BHCs facilitate better risk management and corporate organization: e.g., managers could separate the retail bank from credit card operations or wholesale bank operations, or higher risk lending from lower risk lending
- BHCs facilitate the operation of US banks by foreign banks and the operation of foreign banks by US banks

# What are the consequences of becoming a bank holding company?

The BHC and all its non-IDI subsidiaries are subject to supervision and regulation by the Federal Reserve. **(12 USC 1841 et seq; 12 CFR 225 et seq.)**

- Examination
- Reporting
- Minimum capital requirements at the BHC on a consolidated basis
- Requirement to serve as a source of financial and managerial strength to banks controlled by the BHC
- Need permission to acquire other IDIs or BHCs
- Limits on the activities of affiliates
- Enhanced prudential standards for large BHCs (by statute, BHCs with assets over $250 billion; the Fed may apply to BHCs with assets between $100 billion and $250 billion). **Section 165 of the DFA (12 USC 5365)**
  - Stress tests and enhanced capital requirements
  - Liquidity requirements
  - Single counterparty credit limits and other regulation designed to limit risk to the financial system

Some things are unavoidable: Limits on transactions between a bank and its affiliates **do not** depend on the BHC structure



# Activities Permissible for a BHC and its affiliates

**Permissible Nonbanking Activities**. A BHC may engage in a limited set of nonbanking activities. The primary activities include any activity that has been determined by the Federal Reserve Board by regulation or order as of November 11, 1999, to be so closely related to banking as to be a proper incident thereto. **12 USC 1843(c)(8); 12 CFR 225.28**

These activities include:

- All types of lending,
- Investment advisory activities,
- Securities brokerage activities and a limited amount of securities underwriting activities,
- Leasing that is functionally equivalent to lending,
- Certain derivatives activities, and
- Financial data processing activities
- But **not** insurance sales or underwriting activities or merchant banking activities.

# What is a Financial Holding Company (FHC)?

A Financial Holding Company (FHC) is a type of bank holding company. To become a FHC:

- **Provide Notice**: A BHC must elect to be treated as a FHC by providing 30-days written notice to the Federal Reserve for verification that all pre-conditions are met**.**
- **Statutory pre-conditions**:
  - All of the depository institutions controlled by the BHC must be well capitalized;
  - All of the depository institutions controlled by the BHC must be well managed;
  - The BHC itself must be well capitalized and well managed; and
  - All IDIs controlled by the BHC must have achieved at least a satisfactory rating in the most recent examination under the Community Reinvestment Act of 1977. **12 USC 1843(l).**

These are on-going requirements. An FHC that fails to meet these requirements on an ongoing basis has 180 days to correct its failure before it must terminate all activities that are financial in nature, unless the Federal Reserve allows the company a longer period to conform or comply. **12 USC 1843(m).**



# Activities Permissible for an FHC and its affiliates

**ACTIVITIES DETERMINED BY STATUTE TO BE PERMISSIBLE FINANCIAL ACTIVITIES**

- Traditional Banking Activities: Lending, exchanging, transferring, investing for others, or safeguarding money or securities;
- Insurance Underwriting and Brokerage Activities: Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State;
- Investment Advisory Activities: Providing financial, investment, or economic advisory services, including advising a company that is an investment company under the Investment Company Act of 1940;
- Asset-backed Securities Underwriting Activities: Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
- Securities Underwriting and Dealing Activities: Underwriting, dealing in, or making a market in securities;
- Foreign Banking Activities in the US: Engaging, in the United States, in any activity that a BHC may engage in outside of the United States that the Federal Reserve had determined before November 12, 1999, to be usual in connection with the transaction of banking or other financial operations abroad; and
- Merchant Banking Investment Activities. **12 USC 1843(k)(4); 12 CFR 225.86.**

# Chance for More Activities to be Permissible for an FHC and its affiliates

**ACTIVITIES DETERMINED BY THE FED AND THE TREASURY TO BE PERMISSIBLE.**

In addition to activities determined by statute to be permissible for an FHC, an FHC may engage in, and may acquire and retain the shares of any company engaged in—

- Any activity that the Federal Reserve and Treasury agree is financial in nature **or** incidental to a financial activity; and
- Any activity that the Federal Reserve determines is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of DIs or the financial system generally. **12 USC 1843(k)(1).**



# Merchant Banking Investments

Broad but small. Any **BHC** may own up to 5% of the voting shares of any company. **(12 USC 1843(c)(5) and (6))**

More narrow but potentially large. An **FHC** may own any amount or type of ownership interest in any type of company (*other than an IDI*), without regulatory approval or review, if—

- The ownership interest is not acquired or held by an IDI or subsidiary of an IDI;
- The ownership interest is acquired and held—
  - By a securities affiliate or an affiliate of a securities affiliate as part of a bona fide underwriting or merchant or investment banking activity, including investment activities conducted for the purpose of appreciation and ultimate disposition of the investment;
- The ownership interests are held for a period of time to enable their sale or disposition on a reasonable basis consistent with the financial viability of the activities;
  - The Federal Reserve generally permits merchant banking investment to be held for up to 10 years; if the investment is held through a qualifying private equity fund (PEF), it may be held for up to 15 years. See 12 CFR 225.172 and 173; (**Note**, The Volcker Rule limits short-term proprietary trading activities and investments in certain types of funds, but **not** long-term merchant banking investments); and,
- During the period the ownership interests are held, the BHC does not routinely manage or operate the company except as may be necessary or required to obtain a reasonable return on the investment on resale or disposition. **12 USC 1843(k)(4)(H); see 12 CFR 225.171**
  - Generally, an FHC may not integrate a merchant banking investment with its banking operations; e.g., no cross-marketing of FHC products with products offered by merchant banking entities.

# Not everyone wants to be a BHC

Private investors, including individuals, investment firms, hedge funds, mutual funds, pension funds, others, often see opportunities to make returns by investing in banks or BHCs

- However, investors that are corporate entities (such as private equity funds) may not be able to comply with the restrictions on nonbanking activities and investments that are contained in the BHC Act, or may not want to be subject to the ongoing financial, source of strength, managerial and supervisory requirements of the BHC Act;
- Similarly, a BHC may want to make a limited investment in another bank or BHC without becoming responsible for serving as a source of financial strength for the second bank or BHC
  - For example, the BHC may want to stake-out a bank in a new geographic area for expansion at a later date.



# Avenues for a company to invest in a bank

It is possible for a company to gain some of the advantages of owning an FDIC-insured bank or a BHC without the responsibilities and obligations that are attendant to becoming a BHC

- A company may seek to acquire shares of a bank or BHC as an investment, without all of the attendant regulatory limitations and supervisory responsibilities, if the company does <u>not</u> trigger the definitions of "<u>control</u>" under the relevant banking laws.

# What is "control" under the BHC Act?

For purposes of the BHC Act, a company "controls" a bank or other entity if—

- The company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or entity;
- The company controls in any manner the election of a majority of the directors or trustees of the bank or entity; **or**
- The Federal Reserve Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or entity. 12 USC 1841(a)(2).

Presumption of non-control: The BHC Act establishes a presumption that any company that directly or indirectly owns, controls, or has power to vote less than 5 percent of any class of voting securities of a given bank or entity does not have control over that bank or entity. 12 USC 1841(a)(3).



# What is a "controlling influence"?

The BHC Act definition of "control" does not require "absolute," "actual," or "effective" control.

- The test rests on the ability to exercise a "controlling influence" over the management or policies" of the bank.
- Note that ownership of 25% of the voting shares of a bank--the statutory threshold for "control"-- would not provide the owner absolute control over the bank.

**What is a "controlling influence"?**

- The SEC and the courts (in reviewing a parallel statute, the Public Utilities Holding Company Act) have found that "controlling influence" is the ability to ensure that ideas are heard and considered; something less than control that embraces those pressures and influences, at times delicate, by which an investing company can exercise a dominating persuasiveness in the affairs of the portfolio company. See The Chicago Corporation, 28 S.E.C. 463, 468 (1948)
- A controlling influence does not mean that an investor must be able to carry their point. A controlling influence may be effective without accomplishing its purpose fully. Nor is it necessary that there be an actual exercise of the "controlling influence." It is sufficient if the power exists in a latent form. Id.
- A controlling influence embraces pressures and influences, at times subtle, by which a company may be capable of influencing or controlling the affairs of another company. North Platte Corporation, 66 Federal Reserve Bulletin 782, 784 (1980); Patagonia Corporation, 63 Federal Reserve Bulletin 288, 291 (1977).

**Fact intensive**. Determining whether a "controlling influence" may exist requires an appraisal of the past and prospective relationships and circumstances. North Platte Corporation, 66 Federal Reserve Bulletin 782, 784 (1980)

# What factors lead the Federal Reserve to find a "controlling influence"?

**Important Factors**. In determining whether a company has the power to exercise a "controlling influence" over a bank or BHC, the Federal Reserve considers a variety of factors. The most important are:

- The size and type of investment made by the company in the bank and/or BHC,
- Whether, as part of the investment, the company may restrict the business decisions of the bank and/or BHC,
- Any management connections between the company and the bank and/or BHC that might allow the company to influence business decisions of the bank or BHC, and
- The level of business relationships between the company and the bank and/or BHC.

**Other Factors**. The Federal Reserve may also look at other factors, unique to the investment relationship, that would indicate the presence of a "controlling influence," such as a history of control of the bank and/or BHC by the company and special profit-sharing arrangements.



# Presumptions at 5% ownership level

**General approach**: The Federal Reserve has established a series of regulatory "presumptions of control" based on the level of ownership by an investing company in the equity of the bank and/or BHC. (see 12 CFR 225.31-34; Federal Reserve policy statements at 12 CFR 225.143 and 225.144, and numerous private letters.)

- These presumptions are rebuttable—in other words, an investing company may exceed these levels if unique facts indicate that the investing company does not in fact have a controlling influence over the bank and/or BHC.

**Presumption at 5% ownership level**. The Fed rules presume an investing company to have a controlling influence over a bank and/or BHC if the investing company controls 5% or more of any class of voting securities of the bank and/or BHC **AND** (pick one):

- Agents of the investing company represent more than 25% of the board of directors of the second company;
- Agents of the investing company may make or veto major operational or policy decisions of the second company;
- More than one employee or director of the investing company is a senior management official of the second company;
- An employee or director of the first company serves as CEO of the second company;
- Business relationships between the two companies generate 10% or more of the annual revenue or expenses of either company; **OR**
- The investing company has a forbidden covenant.

# What is a Forbidden Covenant?

A **forbidden covenant** is any contractual right to restrict or exert significant influence over operational or management decisions of the second company, such as decisions regarding:

- The activities, lines of business or counterparties of the company;
- Use of proceeds from investors;
- Hiring/firing/compensation of employees;
- Mergers or acquisitions;
- Payment of dividends, or setting financial goals/capital-levels/debt levels/liquidity or other financial benchmarks;
- Issuance of junior equity or public offerings of securities;
- Changes to articles of incorporation or by-laws, removal or selection of an independent accountant, auditor, or advisor, and
- Regulatory matters.

Exceptions:

- An investing company may, by contract, require:
  - Access to financial reports;
  - That the second company consult with the investing company on a periodic basis and provide notice of material events;
  - Limitations on the issuance of securities senior to those owned by the investor; and
  - Certain anti-dilution protections, a right of first refusal to purchase shares of other investors, and, if the investing company has an agreement to merge with the second company within 1 year, that the second company take action to complete the merger.



# Presumptions at 10% and 15% ownership levels

**Presumption at 10% ownership level**. An investing company is presumed to have a controlling influence over a bank and/or BHC if the investing company controls 10% or more of any class of voting securities of the bank and/or BHC **AND** (pick one):

- Triggers any of the presumptions of the 5% level;
- Proposes directors in opposition to those proposed by management of the bank or BHC that (when added to the number of director representatives of the company) would exceed 25% of total directors;
- Director representatives comprise more than 25% of any committee of the board of the bank or BHC that can bind the bank or BHC; **OR**
- Business relationships generate more than 5% of annual revenues or expenses of the bank or BHC **or** are not on market terms.

**Presumption at 15% ownership level**. An investing company is presumed to have a controlling influence over a bank and/or BHC if the investing company controls 15% or more of any class of voting securities of the bank and/or BHC **AND** (pick one):

- Triggers any of the presumptions at the 5% or 10% level;
- Has a director representative that serves as Chair of the board of the bank or BHC;
- Has any employee or director that becomes a senior management official of the bank or BHC; **OR**
- Business relationships with the company generate more than 2% of annual revenues or expenses of the bank or BHC.

# Presumption of control in Special Circumstances

The Fed rules presume that a company can exercise a controlling influence over bank or BHC if the investing company:

- Has a management contract (including, for example, serving as a managing member, general partner or trustee of the bank or BHC, but not as an investment advisory agreement) with the bank or BHC;
- Controls (i.e. owns, holds or has the power to either vote or sell other than in a bona fide fiduciary capacity) **one-third or more of the total equity** (see next slide) of the bank or BHC;
- Consolidates the financial statements of the bank and/or BHC with the company's balance sheet for GAAP reporting;
- Controls at least 5% of the voting shares of the BHC and/or bank AND the investing company, together with its management/directors (and immediate family), control in the aggregate 25% or more of the voting shares of the bank and/or BHC EXCEPT if investing company controls less than 15% of the bank and/or BHC and management of the bank and/or BHC controls more than 50% of the voting shares of the bank and/or BHC as individuals.

19

# Total Equity and Voting Shares Defined

Definition of Total Equity: Total equity includes:

- All issued and outstanding common shares (or the equivalent for non-stock companies);
- All issued and outstanding shares of all classes of preferred stock (or the equivalent for non-stock companies); and
- Outstanding debt instruments that have equity-like features, such as long-dated maturities, qualification as regulatory capital, subordination to other debt instruments, qualification as equity under GAAP or tax laws, and/or issuance on non-market terms.

Definition of voting securities:

- Any interest that allows the holder to vote on selection of the board of directors/trustees/partners of a company and/or decisions regarding operations or significant policies of a company.
- Non-voting shares that are convertible into voting shares are considered to be voting shares.
  - EXCEPT if the shares are not convertible in the hands of the holder AND are transferable by the holder only in a widespread public or private distribution or to a person that already has more than 50 percent of the voting shares of the company.

20

# Determinations of Control

Informal process for findings of non-control:

- The Federal Reserve has traditionally been willing to issue informal letters passing on proposed investments (sometimes from the Board in connection with approvals under the CIBC Act or upon special request, most often from staff as a no-recommendation letter);

Formal Process for findings of control:

- Under its formal process, the Federal Reserve provides an investing company with notice of a preliminary finding of control and allows the company a period (typically 30 days) to respond and to request a hearing—formal or informal at the choice of the Federal Reserve—after which the Federal Reserve makes a formal finding whether or not control exists.
- In the case of a finding of control, the Federal Reserve typically allows the investing company to either divest control or seek approval under applicable law to maintain control.
- A finding of control is not retro-active **unless** the investor owned at least 5% of any class of voting shares at the time of the alleged violation.

The Change in Bank Control Act:

- As explained below, an investor that has successfully avoided being deemed to control a bank or BHC under the BHC Act may still be required to obtain regulatory approval under the Change in Bank Control Act prior to acquiring voting shares of an IDI or IDI holding company.
- However, the approval requirement under the CIBC Act is a one-time approval requirement without ongoing regulatory or supervisory requirements.



# What if a company wants to control an IDI but not become a BHC?

A company may want to control a bank and not thread through the limitations that accompany the definition of “control” under the BHC Act. For example--

- A retailer may want to own a bank that offers a private label credit card or installment credit to the customers of the retailer
  - Nordstrom’s; John Deere; Macy’s; Home Depot
- A company may want to receive its payments from customers more quickly or sell its customers payment services like gift cards
  - Walmart
- A financial services company may want to offer its customers full-service banking in addition to its financial services but also avoid regulation and supervision by the Federal Reserve as a BHC
  - Pre-2008, Goldman Sachs; Morgan Stanley
  - USAA; AIG; Countrywide
- A commercial company that provides financing to customers to purchase items that the company manufactures and sells may want to collect deposits to fund loans to customers of the manufacturer
  - Toyota; BMW

# What is a "bank" under the BHC Act?

The BHC Act has its own definition of "bank." A "bank" for purposes of the BHC Act means:

- A national banking association;
- An entity incorporated under State law that collects deposits insured by the FDIC; and
- An institution organized under the laws of the United States, any State, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands that **both**—
  - accepts demand deposits **or** deposits that the depositor may withdraw by check or similar means for payment to third parties or others; **and**
  - is engaged in the business of making commercial loans. **12 USC 1841(c)(1).**

This definition covers nearly all types of IDIs that operate in the United States

23

# What is not a "bank" under the BHC Act?

**Key exceptions to the definition of "bank" under the BHC Act (12 USC 1841(c)(2):**

- A foreign bank that conducts banking operations in the US only through a US branch;
- A savings association;
- A credit union**;**
- A trust company (even if chartered as a national bank or a state bank) provided that—
  - It functions solely in a trust or fiduciary capacity;
  - All or substantially all of the deposits of the trust company are in trust funds and are received in a bona fide fiduciary capacity;
  - No deposits of the company that are insured by the FDIC are offered or marketed by or through an affiliate of the trust company;
  - The trust company does not accept demand deposits **or** deposits that the depositor may withdraw by check or similar means for payment to third parties or others **or** make commercial loans; and
  - The trust company does not obtain payment or payment related services from the Federal Reserve or exercise discount or borrowing privileges at the Federal Reserve. **12 USC 1841(c)(2)(D)**

24

# Also <u>not</u> a "bank" under the BHC Act

A <u>credit card bank</u> (even if chartered as a national bank or a state bank) so long as it--

- Engages only in credit card operations;
- Does not accept demand deposits **<u>or</u>** deposits that the depositor may withdraw by check or similar means for payment to third parties or others;
- Does not accept any savings or time deposit of less than $100,000 (though it may accept deposits under $100,000 as collateral for extensions of credit);
- Maintains only one office that accepts deposits; and
- Does not engage in the business of making commercial loans, other than credit card loans that are made to businesses that meet the criteria for a small business concern under regulations established by the Small Business Administration. **12 USC 1841(c)(2)(F).**

A number of retailers own credit card banks that offer private label credit cards and provide the retailer access to the Federal Reserve, VISA and MasterCard payments networks.

A credit card bank is still a bank for purposes of the CIBC Act. **12 USC 1817(j).**

Transactions between a credit card bank and its affiliates (including its owner) are also restricted by sections 23A and 23B of the Federal Reserve Act (an important provision that will be covered in another class). **12 USC 371c and 371c-1.**



# The ILC exception

A "bank" under the BHC Act does not include an entity that is organized as an industrial loan company, industrial bank or similar company (ILC) ***if*** the ILC <u>either</u>--

- <u>Grandfathered State laws</u>. Is organized as an ILC under the laws of a State which, on March 5, 1987, had in effect or had under consideration in such State's legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act <u>*and either*</u>--
  - Does not accept demand deposits **<u>that</u>** the depositor may withdraw by check or similar means for payment to third parties; or
  - Has total assets of less than $100,000,000; or
  - The control of which is not acquired by any company after August 10, 1987; ***<u>or</u>***
- <u>Grandfathered ILCs</u>. Does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987.
  - An ILC loses its grandfathered status if it permits or incurs any overdraft (including any intraday overdraft) in the institution's account at a Federal Reserve Bank, on behalf of an affiliate other than an overdraft that is the result of an inadvertent computer or accounting error that is beyond the control of both the institution and the affiliate. **12 USC 1841(c)(2)(H).**

Currently, seven states (most notably Utah and Nevada) are grandfathered to charter ILCs and grant ILCs some or all of the powers of a state chartered commercial bank.

# Change in Bank Control Act

- While a company does not become a BHC by virtue of acquiring an ILC or any other type of exempt insured depository institution (IDI), any potential acquiror (including any company) must nonetheless obtain the approval of a Federal banking agency prior to acquiring an ILC or other exempt IDI.
  - Any person that is not already a BHC or SLHC must give notice under the Change in Bank Control Act to a Federal banking agency (typically to the FDIC) at least 60 days before acquiring "control" of an ILC or other exempt IDI. **12 USC 1817(j).**
  - A company that is already a BHC or SLHC may also acquire an ILC or other exempt IDI, but must obtain the prior approval of the Federal Reserve under the BHC Act (if a BHC) **(12 USC 1843(j))** or the SLHC Act (if an SLHC) **(12 USC 1467a(e)(1).**



# "Control" of an IDI under the CIBC Act

Definition of "control" under the CIBC Act

- the power, directly or indirectly, to direct the management or policies of an IDI **or**
- the power to vote 25 per cent or more of any class of voting securities of an IDI. **12 USC 1817(j)(8)(B).**

Regulatory presumptions of control (i.e., presumption that the owner has the power to direct the management of policies of the IDI)

- the power to vote 10 percent or more of any class of voting securities of an IDI if—
  - the shareholder is the largest shareholder of the IDI, or
  - the IDI has issued securities registered under the Federal Securities laws. **(See, e.g., 12 CFR 225.41(c)).**

"Control" does not mean "absolute control;" indeed, the acquiror may not have anything approaching managerial control.

# Consequences of acquiring control of an IDI under the CIBC Act

- The statutory and regulatory definition of "control" is set at a low threshold because the consequences for the acquiror of Federal review of ownership are small, while the potential consequences of a bad actor being involved in an IDI with a taxpayer backing are potentially high for the taxpayer
- CIBC Act requires only an initial review and approval in a relatively constrained process
  - The appropriate Federal regulator must act within statutory periods (initially 60 days, with possibility for extensions of up to 120 days)
- There are no ongoing regulatory, reporting or activities restrictions tied to the CIBC Act

29

# The savings association exception

**SAVINGS ASSOCIATIONS**

- Savings associations and certain savings banks, and, consequently, companies that control them, are excluded from the definition of "bank" under the BHC Act because savings associations, certain savings banks and companies that control them are regulated under a parallel statutory framework:
  - The Home Owners Loan Act and the Savings and Loan Holding Company Act. **12 USC 1464 and 1467a**.
- A savings association may be either Federally chartered or State chartered, and its deposits are insured by the FDIC up to the same limits as afforded to banks.
- Qualified Thrift Lender (QTL) test. A savings association has essentially the same powers as a commercial bank, except a savings association must maintain at least 65 percent of its assets in residential mortgage loans, credit card loans, education loans and/or small business loans, while a bank has no similar restriction.
  - A savings association that fails the QTL test must restore its asset mix to meet the QTL test within 3 years or become subject to enforcement actions and fines, limitations on its activities and dividends, and regulation and supervision of its holding company as if it were a BHC under the BHC Act.

30

# Savings and Loan Holding Companies

Any company that controls a savings association is a savings and loan holding company (SLHC)

- Similar statutory definition of control as under the BHC Act; slightly different regulatory definition

Being an SLHC (now) has similar consequences to being a BHC

- Examination and supervision by the Federal Reserve
- Capital requirements set by the Federal Reserve
- Limitations on activities of the SLHC and its subsidiaries
- However, some statutory provisions that apply to BHCs do not apply to SLHCs (E.g., enhanced prudential supervisory requirements, Federal Reserve stress testing requirements and resolution planning requirements)

A limited set of Grandfathered SLHCs are exempt from the activity restrictions applicable to SLHCs

- The SLHC must own only 1 savings association (but may acquire additional S&Ls in distress) and it must meet the QTL test;
- The SLHC may not acquire an additional savings association (except a savings association in distress);
- The SLHC may not engage in any activity (other than a financial activity) that the company did not conduct on March 5, 1987; and
- The savings association controlled by the SLHC may not increase the number of locations it conducts business and may not incur overdrafts on behalf of an affiliate at the Federal Reserve.

# Mutuals & Conversions

Kevin J Handly, Esq.
Principal, bostonbankinglaw.com
Director, Graduate Program in Banking & Financial Law
Boston University School of Law

## Mutuals

Defining Mutuality --

- Thrifts -- focused on local savings deposits and residential mortgage lending
- No transferable ownership rights
- Depositors (also Borrowers in some states) are “members”
  - In cooperative banks, they may be called “shareholders”
- In lieu of members, State-chartered savings banks have boards of ”corporators” serving lengthy terms, and electing their own successors
- Members, shareholders, or corporators of thrifts elect the governing board of trustees (or ”directors”)
- Under applicable state and federal law, depositors have residual ownership rights if a mutual thrift is liquidated

# Mutuals

Mutuals Come In State or Federal Flavors Under Multiple Labels

- Savings & Loans
- Building & Loans
- Savings Banks
- Savings Associations
- Mutual Holding Companies

# Mutuals

Original Advantages –

- Best defense against hostile take-overs
- Access to low-cost deposit funding
- Insulated from commercial bank competition
- Depositors are [were] their borrowers
- Prior to 1952, mutuals were Federal income tax exempt
- Taxed after 1951, but afforded very generous bad debt deduction (phased out after Tax Reform Act of 1986)

## Mutuals

Mutuality -- The Best Anti-Takeover Defense

- Mutuals can acquire stock-form thrifts, banks, and non-depository companies
  - Stock purchases
  - Merge stock form banks or thrifts into mutual
- Ordinarily, mutuals cannot be acquired by, or merged into, a stock form bank, thrift, or company (even if they want to be)
- Even after converting to stock, converted mutuals are protected from sale or merger for three-year period

## Mutuals

Disadvantages –

- No access to equity capital markets
- No ability to offer equity compensation to management
- [Formerly] Caps on interest paid on savings accounts
- Dependent on customer savings deposits for liquidity
- Income dependent on long-term, fixed-rate residential mortgages
- Geographically concentrated and dependent on local economy

## Thrifts – A Digression on Deposit Insurance

- FSLIC deposit insurance was required for all Federal thrifts but optional for most State-chartered thrifts until the early to mid-1980s
- Following the first thrift crisis of 1978-1982 and the failure of several private and State-sponsored insurers, State-chartered thrifts were required (often by State law, always by competitive necessity) to obtain Federal deposit insurance
- But by 1982, the FSLIC was insolvent, and not accepting new members
- So well-capitalized State-chartered thrifts were admitted to FDIC membership as savings banks, insured and regulated by FDIC

## Mutuals

Disaster Strikes Thrifts

- Late 1970s interest rate increases, MMMF competition drive disintermediation
- FSLIC goes insolvent, takes on no more thrifts
- 1986 Tax Reform Act phases out generous bad debt deductions, limits tax benefits of passive real estate investment
- 1987-1990 New England real estate recession

## Mutuals

- Dwindling in Number & Significance
  - Repeated thrift crises – mass failures
  - Convergence of activities and investment powers
  - Mutual-to-Stock Conversions
  - Banking Industry Consolidation
- Regulatory Convergence
  - Separate thrift regulator eliminated
  - Separate deposit insurance funds combined
  - Convergence of bank and thrift regulatory standards, requirements
  - Convergence also at holding company level

## Conversions

- Commencing in 1974, following State models, FHLBB permitted Federally-chartered and FSLIC-insured mutuals to convert to stock
- Initially limited to distressed mutuals in need of capital, soon even healthy mutuals were permitted to convert
- Mutual bank directors and executives (and their professional advisers) profited handsomely from the conversion transaction and from equity incentive compensation plans thereafter
- By the mid-1980s, dozens of healthy mutual thrifts had converted to stockholder ownership, raising hundreds of millions in new equity capital [contributing to the New England real estate recession of 1988-1992]

## Conversions

**Q: How Does A Mutual to Stock Conversion Enrich the Thrift's Insiders?**

1. The subscription price in a conversion offering is always below, often substantially below, the post-conversion book value of the stock
2. Recognizing this, a thrift's directors and officers seek to maximize their purchases of stock in the conversion offering
3. Following conversion, the insiders initiate equity incentive compensation plans, awarding ample free stock, stock options, stock appreciation rights, etc., to themselves as directors and officers
4. These awards typically "vest" in 3 to 5 years, approximately the same period the converted thrift is protected by statute from takeover
5. Following expiration of the takeover protection period, the directors and officers sell the converted thrift to a larger acquirer and receive 1.5 to 2.0 X book value for their stock

## Conversion Mechanics

- In a conversion of a mutual thrift, the thrift's depositors enjoy priority subscription rights to purchase conversion shares
  - On average, despite the IPO discount, fewer than 5% of a converting thrift's depositors actually exercise their subscription rights to purchase shares
- In a conversion of a mutual thrift, the pre-conversion net worth of the thrift is quantified and recorded as a "liquidation account"
- In the event of a solvent liquidation of the converted thrift (or MHC), the thrift's depositors would have priority rights to receive the balance of the liquidation account, before stockholders receive anything
  - However, the balance of the liquidation account ratchets down with every withdrawal of deposits post-conversion.
  - The liquidation account never increases, despite additions to the depositors' accounts post-conversion
  - In the 50+ years since mutual to stock conversions were initiated, there apparently has never been a priority distribution of liquidation account balances to a converted thrift's depositors

## Mutual Holding Companies

- Commencing in 1987, a mutual was permitted to form a mutual holding company (MHC) by organizing a stock savings bank subsidiary and then transferring to it all of the deposits and virtually all of the assets of the reorganizing mutual in a P&A transaction
- Bridgeport Savings Bank of Connecticut formed the first MHC, followed by Eastern Bank of Massachusetts in 1988
- Although permitted by statute to sell up to 50% of the stock of their thrift subsidiaries, these early MHCs were formed without issuance or sale of any stock

## Non-Stock MHCs

The ”non-stock” MHC was seen as a helpful structure for –

- Raising capital as needed without losing ownership control, e.g., through issuance of trust preferred stock or sale of minority shares of subsidiary thrift
- Acquiring and combining multiple mutual banks under common management
- Acquiring and keeping separate stock form State and national banks
- Expanding into nonbank lines of business activity, de novo or by acquisition
- Creating additional Board seats to resolve/address social and governance challenges in M&A transactions

## MHCs – State or Federal

**Two Parallel Frameworks for MHC reorganizations:**

**State**: Authorized by State Law for State-chartered Savings Banks
- MHC has a State-chartered savings bank charter
- Middle Tier can be a State-chartered business corporation
- Subsidiary thrift has a State-chartered savings bank charter

**Federal**: Authorized by Federal law for Federally chartered thrifts
- MHC has a Fed-issued Federal MHC charter
- Middle Tier has a Fed-issued Middle Tier charter
- Subsidiary thrift has a Federal thrift charter

## MHC Conversions

- Like mutual thrifts, MHCs are permitted to convert from mutual to stock through subscription offerings of stock at a price discounted as much as 35% from pro forma book value
  - The same dynamic that enriches insiders in a thrift conversion works in the same way to enrich insiders in an MHC conversion
- An MHC is also permitted to sell up to 50% of the stock of its subsidiary thrift

## MHC "Partial Conversions"

- Because many thrifts are prohibited from repurchasing their own stock, MHCs desiring to sell minority interests in their thrift subsidiaries do it through newly formed "middle tier" stock holding companies
  - The MHC transfers to the middle tier 100% of the stock of the subsidiary thrift
  - The MHC then sells up to 50% of the stock of the middle tier to subscribers and investors, retaining majority stock ownership of the middle tier in the MHC
  - As in a direct thrift conversion and for the same reasons, insiders strive to maximize their purchases of middle tier stock
  - The middle tier can repurchase stock to fund equity incentive compensation plans for the thrift's directors and officers

## "2$^{nd}$ Step" MHC Conversions

- Typically, the directors/trustees of a "partially converted" MHC waive receipt of any dividends declared by the middle tier
  - Professional conversion advisers assert that such a waiver is in the interest of the MHC because it avoids taxes and facilitates the sale of minority shares to investors
- In a subsequent "second step" conversion of the MHC, the minority shareholders of the middle tier receive shares of the converted holding company in exchange for their shares in the middle tier
- Regulators assert that the exchange ratio for middle tier shares should be adjusted downward to recoup for the MHC the amount of dividends it would have received, but for the waiver
  - Alternatively, regulators argue that directors and officers of the MHC should be prohibited from purchasing minority shares of the middle tier, to avoid the conflict of interests between the MHC and minority investors in the middle tier's stock

# Mutuals & Conversions

Some Questions for Regulatory Policy Makers --

- Why are mutual thrift institutions disappearing?
- Who wins and who loses from the disappearance of mutual thrifts?
- How and to whom should stock in a converted thrift be allocated?
- Should insiders be prohibited from purchasing stock in a mutual thrift or MHC conversion?
- Should MHCs be permitted to waive receipt of dividends from their majority-owned middle tier subsidiaries?
- Should the exchange ratio for minority shares in a 2nd step MHC conversion be adjusted to recoup dividends waived by the MHC?
- Are credit unions next in line?

# Mutuals & Conversions

**Attachments:**

A. Treasury Department Report of June 1960 on the Taxation of Mutual Savings Banks and Savings and Loan Associations, with attachments

B. Federal Deposit Insurance Corporation, “Mutual-to-Stock Conversions of State Nonmember Savings Banks,” Notice and request for comments, 59 FR 30357 (June 13, 1994)

C. Federal Reserve Board, Mutual Holding Companies, Regulation MM §239.8 – Operating restrictions

D. Federal Reserve Board, Mutual Holding Companies, Regulation MM §239.24 – Issuances of stock by subsidiary holding companies of mutual holding companies

E. Federal Reserve Board, Mutual Holding Companies, Regulation MM §239.25 – Contents of Stock Issuance Plans

*F.* *Gut v. MacDonough*, Massachusetts Superior Court, Worcester, Aug. 14, 2007

G. Meeting Between Federal Reserve Board Staff and Representatives of Luse Gorman Pomerennk & Schick, P.C., Northfield Bank, Stifel, Nicolaus & Company, Inc., and RP Financial, LC, Nov. 22, 2011

5/23/61

TREASURY DEPARTMENT REPORT OF JUNE 1960
ON THE TAXATION OF MUTUAL SAVINGS BANKS
AND SAVINGS AND LOAN ASSOCIATIONS

## I. INTRODUCTION

In his tax message, the President observed that some "of the most important types of private savings and lending institutions in the country are accorded tax deductible reserve provisions which substantially reduce or eliminate their Federal income tax liability." The President stated that these "provisions should be reviewed with the aim of assuring nondiscriminatory treatment."

During recent months, the Treasury Department in cooperation with representatives of financial institutions, supervisory authorities, and other interested Federal agencies, has given intensive review to the tax provisions applicable to mutual savings banks and savings and loan associations. Under section 593 of the Internal Revenue Code, these institutions are permitted to make tax-free transfers of retained earnings to a bad debt reserve in any amount determined reasonable by the taxpayer, if the surplus, undivided profits, and reserves of the institution do not exceed 12 percent of its deposits. This special bad debt reserve provision has kept these institutions virtually tax-exempt because they may accumulate $12 of earnings tax-free for each $100 of new deposits. During 1960, these institutions had assets of about $110 billion and they retained, tax-free, current earnings of over $700 million. For 1958, the latest year for which accurate statistics are available, these institutions paid total Federal income taxes of $8.8 million.

Two major conclusions have developed from the recent Treasury review.

First: Differences between the mutual thrift institutions and other financial intermediaries which have been advanced in the past to justify special tax treatment for the mutuals, such as encouragement of thrift, mutuality, lack of access to capital markets, and supervisory requirements, are no longer persuasive in justifying a special tax treatment amounting to tax exemption. Thus, from the viewpoint of a logical and equitable application of the Federal income tax, the mutual thrift institutions should no longer be permitted to retain earnings tax free except in accordance with established concepts for computing bad debt reserves.

Second: The mutual thrift institutions invest a large percentage of their funds in residential mortgages. The continuation of proper housing programs requires an adequate supply of funds for home mortgages. Consequently, from the viewpoint of our housing programs, any change in the current tax treatment of mutual thrift institutions must be weighed in the light of its possible adverse effect on those programs.

Further, should it be decided to subject these organizations to regular corporate income taxation, the risk of the possible adverse impact upon the supply of funds for home mortgages may justify consideration of alternative methods of taxation over a transitional period.

II. BACKGROUND

(a) Mutual savings banks

Mutual savings banks are nonstock organizations which perform two basic functions: The encouragement of thrift and the provision of safe and convenient facilities to care for savings. They were originally organized for the principal purpose of serving factory workers and other wage earners of moderate means, who at the time these banks were started, had no other place where they could put their savings. Most mutual savings banks were organized by groups of civic-minded citizens who put up guaranty funds which were repaid out of later earnings. The organizers appointed boards of trustees, generally self-perpetuating, to direct the policies of the banks, subject to the limitations imposed on them by the laws of the several States in which they operate. The depositors themselves have no voice either in the choice of trustees or in the management of the banks' affairs. Today, there are 515 mutual savings banks located in 17 States, although the great bulk of their operations are located in Connecticut, Massachusetts, and New York.

At the end of 1960, the mutual savings banks had assets of $40.6 billion and surplus, reserves, and undivided profits of $3.6 billion. During the year 1960, the savings banks had net operating income of $1.45 billion, made payments to depositors of $1.25 billion, and retained corporate earnings of $144 million. Approximately 66% of their assets were invested in real estate mortgages. For 1958, the mutual savings banks paid total Federal income taxes of $1.5 million.

(b) Savings and loan associations

Savings and loan associations are financial institutions which were organized to encourage thrift and promote home ownership. These organizations, which also go under the name of building and loan associations, secure their funds through the sale of "shares". Although these associations typically are not stock corporations, a growing number of "stock" associations have been organized.

In the early days of these institutions, the transactions of the associations were confined to members, and no one could participate in the benefits afforded without becoming a shareowner. Individuals became investing members of these organizations in the expectation of ultimately becoming borrowing members as well. Membership implied not only regular payments to the association for a considerable period of time, but also risk of losses. Members could not cancel their memberships or withdraw their shares before maturity without incurring heavy penalties. The fact that the members were both the borrowers and the lenders was the essence of the "mutuality" of these institutions.

Today, the 6,200 savings and loan associations have for the most part lost the characteristics of their earlier mutuality. More and more, investing members are becoming simply depositors who in practice can withdraw their shares on demand. The borrowing members find dealing with a savings and loan association not very different from dealing with other mortgage lending institutions in which the lending group is distinct from the borrowing group. Since the character of these organizations has been modified by the practice of paying more or less fixed rates of return on shares, and of building up substantial surplus accounts to protect shareholders against risk of losses, they cannot properly be described as mutual cooperative institutions. In fact, the approximately 500 "stock" savings and loan associations, some of which are owned by holding companies listed on the stock exchanges, can not be distinguished from other lending institutions organized for the private profit of stockholders.

At the end of 1960, the savings and loan associations had assets of $71.5 billion, and had reserves, surplus, and undivided profits of $5 billion. Approximately 85% of their assets are invested in real estate mortgages. During 1959, the latest year for which detailed statistics are available, the savings and loan associations had net operating income of $2.3 billion, paid dividends of $1.8 billion, and retained earnings of $514 million. For 1958, the savings and loan associations paid total Federal income taxes of $7.3 million.

(c) Treasury Department Proposal of 1951

Prior to 1952, mutual savings banks and savings and loan associations were accorded outright exemption from the Federal income tax. In 1951, the Treasury Department proposed taxing the retained earnings of these institutions on the same basis as commercial banks, which are permitted to establish bad debt reserves equal to three times the bank's average loss experience over a 20-year period. This proposal, which was set forth in a document prepared by the staffs of the Treasury and the Joint Committee on Internal Revenue Taxation, was estimated to increase revenues by $150 million annually. The proposal was reported favorably by the Senate Finance Committee but was amended on the Senate floor to permit these institutions to continue to retain reserves tax-free until the total of their reserves, surplus and undivided profits equaled 10 percent of deposits. In conference this limitation was raised to 12 percent of deposits and this formula became law.

At the end of 1950, the mutual savings banks and savings and loan associations had combined assets of \$39 billion and annual retained earnings of \$240 million. Ten years later, at the end of 1960, these institutions had almost tripled in size, having combined assets of \$110 billion and annual retained earnings of over \$700 million.

In 1951, the report of the Senate Finance Committee noted that: *

> "At the present time, mutual savings banks are in active competition with commercial banks and life insurance companies for the public savings, and they compete with many types of taxable institutions in the security and real estate markets. * * * [C]ontinuance of the tax free treatment * * * would be discriminatory. So long as they are exempt from income tax, mutual savings banks enjoy the advantage of being able to finance their growth out of earnings without incurring the tax liabilities paid by ordinary corporations when they undertake to expand through the use of their own reserves.* * *
>
> "It has been suggested that mutual savings banks might be taxed only on their net income in excess of some specified reserve. However, if the funds going into this reserve represent income there would appear to be no reason for not taxing them. If they are funds which are necessary to offset future losses, allowance will already have been made for them through a loss reserve deduction which will afford these institutions at least as generous treatment as is accorded their chief competitors, namely, commercial banks.* * *"

The report further noted that the reasons for taxing mutual savings banks, after an allowance for bad debt reserves, were equally applicable to savings and loan associations. The report stated:

---

* Senate Report No. 71, 82d Cong., 1st Sess. 25-28 (1951)

"Another basis on which it is argued that the savings and loan associations do not have income is that all their receipts are either paid out as expenses or as dividends to members or accumulated for the mutual benefit of the members. However, an individual member or depositor has no claim to a share of the accumulated earnings unless he remains in the organization until its dissolution. The idea that income of a savings and loan association belongs to a member even though it is not paid to him or allocated to his account is a more extreme concept of cooperative ownership than that used by cooperatives.

"The income which is added to reserves and undivided profits * * * is income of the associations. The fact that it is retained for the benefit of the members makes it analogous to the income retained by an ordinary taxable corporation for the benefit of stockholders."

## III. CONSIDERATIONS FROM THE VIEWPOINT OF TAX ASPECTS

### (a) General Conclusions

The conclusions reached by the Treasury Department as to the tax aspects of the present situation, based upon the recent review of the tax status of the mutual thrift institutions, are as follows:

1. The existing 12 percent formula for computing bad debt reserves of the mutual thrift institutions cannot be justified in terms of established tax concepts for computing corporate income.

2. Rules of supervisory authorities establishing high loss reserves take into account loss contingencies and margins of safety which are not allowed under Federal income tax law for other financial institutions. Capital cushions in excess of true bad debt reserves which are required by most other business enterprises must be built up after corporate income tax.

3. Alleged differences between the mutual thrift institutions and other financial intermediaries which have been advanced in the past to justify special tax treatment for the mutuals, such as encouragement of thrift, mutuality, lack of access to capital markets, and supervisory requirements, no longer are persuasive in justifying a special tax treatment amounting to tax exemption.

4. From the viewpoint of a logical and equitable application of the Federal income tax, the mutual thrift institutions should be able to retain corporate earnings tax free only in accordance with established concepts for computing bad debt reserves.

(b) The 12% Formula is not a True Bad Debt Reserve

The savings and loan associations now have reserves averaging 8% of deposits and the mutual savings banks have reserves of 10.4% of deposits.

The extraordinary nature of the 12% bad debt reserve formula applicable to these institutions is demonstrated by the fact that the reserve is based upon deposit liabilities, which can never result in a bad debt, rather than against risk assets, such as mortgage investments, from which bad debts will arise. Since the savings banks have a large percentage of their funds invested in nonrisk assets such as cash and Government securities, it is estimated that their present reserves are equivalent to reserves of 24% of uninsured loans and that, if their reserves should increase to 12% of deposits, it would be equivalent to reserves of 27.6% of uninsured loans. The savings and loan associations have a higher percentage of their funds invested in risk assets such as mortgages, and it is estimated that their present reserves are equivalent to reserves of 9.4% of uninsured loans but could become 14.1% of uninsured loans if they ever reached the 12% of deposits limitation.

Most taxable institutions, in establishing bad debt reserves for Federal income tax purposes, are not permitted to base their anticipated loss experience upon the experience of the economic collapse of the 1930's. However, because of considerations peculiar to certain financial institutions, the commercial banks are permitted to establish bad debt reserves equal to three times their average loss experience for the worst 20 consecutive year period beginning after 1927. This formula, therefore, does take into account depression experience. The average reserve ratio established by commercial banks using the reserve method amounts to 2.4% of uninsured loans. It is estimated that application of a comparable formula to mutual thrift institutions would produce a reserve ratio of between 2% and 3% of uninsured loans.

Under the present tax formula, even if the mutual institutions were at the 12% of deposits ceiling (which few would attain within the foreseeable future at present growth rates) they could retain, tax-free, \$12 of earnings for each \$100 of deposits. Since the net annual additions to deposits are in the neighborhood of \$9 billion, they could retain, tax-free, earnings of more than \$1 billion annually even if the institutions were at the 12% ceiling.

It is clear that the special bad debt reserve provision applicable to the mutual thrift institutions is not a true bad debt reserve but rather is a tax-free reserve for catastrophic contingencies. No other taxable enterprise is permitted such a reserve.

(c) The experience of the depression does not justify the existing reserve provision

Among the arguments advanced in favor of special tax treatment for the mutual thrift institutions are that they invest a large portion of their funds in long term mortgages, that their losses tend to be cyclical, and that they must build reserves sufficient to withstand a severe depression equal to that of the 1930's. These arguments, however, do not justify accumulating tax-free reserves which can amount to anywhere between 14% and 28% of uninsured loans under the present tax formula. Even setting aside the question whether it is reasonable to establish a reserve, completely tax-free, sufficient to provide complete protection from an economic collapse equal to that of the 1930's, the experience of mutual savings banks in Massachusetts indicates that the present reserve formula is greatly excessive. This study shows that, although the aggregate net losses on mortgages amounted to 17.4% of the average portfolio outstanding during the period, these losses amounted to only 1.16% of the portfolio of unforeclosed mortgages outstanding per year over the period. Moreover, these losses amounted to no more than 23.4% of the cash income provided by the mortgage account itself during these years. Thus, the savings banks were able to absorb their mortgage losses out of the current income received during the period in which the losses occurred.*

A study of the experience of savings and loan associations for the period between 1930 and 1945 indicates that there was an average annual loss in the neighborhood of 0.9% of the average mortgage portfolio of operating savings and loan associations.**

Requirements for bank capital based on experience during the great depression fail to take into account significant structural changes in the economy as well as in the banking business itself. These include the greater role of the Government in economic stabilization, unemployment compensation, amortization of mortgages, mortgage insurance, deposit insurance, and other factors. In any event, application of a bad debt reserve formula comparable to that applied to commercial banks would in fact take into account the depression experience.

---

* John Lintner, "Mutual Savings Banks in the Savings and Mortgage Markets" (Harvard University, Andover Press, 1948 pp. 304-305)

**Dr. Raymond Goldsmith, "A Study of Saving in the United States" (Princeton University Press, 1955)

(d) Reserve Requirements of Regulatory Authorities Should Not Determine Income Tax Deductions

The reserve requirements established by Federal and State regulatory rules vary greatly. State laws applicable to mutual savings banks frequently require that a percentage of net earnings, such as 5% or 10%, or an amount equal to a percentage of deposits, such as 1/8 of 1% or 1/2 of 1%, be set aside annually until certain overall reserve requirements are reached. These requirements vary from 3% of deposits to 12% of deposits, and several states have a 10% of deposits requirement. State reserve requirements applicable to savings and loan associations are quite similar to those applicable to mutual savings banks, and the most common overall reserve requirements are 5% of share accounts and 10% of share accounts. Federally chartered savings and loan associations generally are required to set aside 5% of net earnings until reserves equal 10% of share capital. Federally insured savings and loan associations must build up reserves equal to 5% of insured accounts within a 20-year period.

For Federal income tax purposes, deductions for bad debt reserves should be based upon a reasonable anticipation of bad debt losses, and not upon reserve requirements established by supervisory authorities to provide for a variety of loss contingencies which are not bad debts. Supervisory authorities must take into account losses from sales of securities, from embezzlements, and from other contingencies; in addition, they must view the possibility of losses with a great deal of pessimism in order to insure the maximum safety of these financial institutions. However, Federal income tax law does not permit other financial or commercial enterprises to build up reserves tax free for such contingencies. The mutual thrift institutions are able, and under a consistent application of the tax law, would be required, to build up reserves for catastrophic contingencies out of after-tax dollars, as other enterprises are required to do. The issue in this light is not whether these institutions should have large reserves as a capital cushion against catastrophic contingencies, but whether they should be able to acquire them tax-free. The need for capital reserves does not justify accumulating a tax-free reserve of $12 to protect a saver's deposit of $100, particularly when the saver himself cannot obtain such tax-free protective accumulations if he were to lend his money as an individual or through investment in any other public financial intermediary.

(e) Miscellaneous Arguments for Special Tax Treatment

One argument frequently advanced in favor of special tax treatment for the mutual thrift institutions is that they can secure additional reserves only from retained earnings whereas stock institutions can secure capital cushions by the sale of additional stock. Although this is an admitted difference between the structural organization of the two types of institutions, it does not justify accumulating a tax-free reserve of $12 to protect a saver's deposit of $100. If the funds going into the corporation's reserve do represent corporate income, there would appear to be no reason, from the viewpoint of tax policy, for not taxing them. Moreover, other financial institutions which compete for the savers' dollars, such as commercial banks, do in fact have to depend primarily on surplus built up after taxes, rather than on access to the equity capital market, in order to obtain the protective capital cushions which all businesses need.

Another argument for special tax treatment is that the earnings retained in the mutual institution do not belong to the present depositors or shareowners but generally would belong to those persons who are depositors or shareowners at the time of liquidation. This argument, however, would seem to emphasize the fact that the retained earnings are truly corporate funds which, if they represent income, should be taxed as such. Moreover, these retained funds do increase the rate of return to existing depositors or shareowners, and thus are analogous to the income retained by an ordinary taxable corporation for the benefit of stockholders.

Other differences between the mutual thrift institutions and competing financial institutions are sometimes advanced in favor of special tax treatment. These differences include limitations on investment powers, inability to attract demand deposits, and inability to attract savers with "one stop" banking facilities. Although these differences do exist, they would appear to be matters outside the scope of relevant criteria for establishing an appropriate tax policy. A nondiversified commercial enterprise generally is subject to the same rules of income tax computation as are applicable to a diversified competitor.

(f) Summary

The reasons which have been advanced in the past for special tax treatment of the mutual thrift institutions no longer seem sufficient to justify a special tax treatment amounting to tax exemption, particularly in the context of the national need for appropriate sources of revenue and the financial strength of these institutions. From the viewpoint of a logical and equitable application of the Federal income tax, the mutual thrift institutions should be able to retain corporate earnings tax-free only in accordance with established concepts for computing bad debt reserves.

## IV. CONSIDERATIONS FROM THE VIEWPOINT OF NATIONAL HOUSING POLICIES

As previously noted, the continuation of proper housing programs requires an adequate supply of funds for home mortgages. Consequently, from the viewpoint of our housing programs, any change in the tax treatment of the mutual thrift institutions which invest the great majority of their funds in residential mortgages must be weighed in the light of its possible effect on those programs.

Estimates of the reduction in funds available for home mortgages, which might result from ordinary corporate income taxation of the mutual thrift institutions, show great disparity. Such estimates require assumptions as to the reduction in rates of interest and dividends paid to savers, the response of savers to a reduction in such rates, and the response of other financial intermediaries in filling any gap in home mortgage requirements resulting from a reduction in savings inflow to the mutual thrift institutions. To the extent that estimates of the response of other financial intermediaries, such as commercial banks, in filling residential mortgage requirements are based on past responses in given situations, these estimates may not give sufficient weight to a new investment environment resulting from a policy of tax neutrality. In addition, estimates based on past records cannot take into account the effect on the mortgage market of the relatively new and growing participation by pension trusts.

On the one hand, estimates have been made that ordinary corporate taxation of the mutual thrift institutions would produce only a negligible reduction in the supply of funds available for home mortgages. These estimates assume that the mutual thrift institutions generally could maintain present dividend and interest rates for several years by paying the corporate tax out of funds which otherwise would have been retained as reserves, and that, to the extent that these institutions have less funds for investment in home mortgages, other financial institutions would fill the gap.

On the other hand, estimates also have been made that full taxation of the mutual thrift institutions would reduce the supply of home mortgage funds by at least \$1 billion annually. These estimates assume that the mutual thrift institutions would reduce their dividend and interest rates paid to savers by about 1/4 of 1%, and this would reduce savings inflow by at least \$2 billion annually, and that other financial institutions in a tight money market would increase their investment in home mortgages by only \$1 billion. Even larger estimates of the effect upon the supply of home mortgage funds have been made by some.

The intermediate view is that ordinary corporate income taxation of the mutual thrift institutions without any transitional period probably would reduce the supply of home mortgage funds by about \$500 million in the first year followed by a gradual diminution in this impact as other financial institutions adjusted their investments. A reduction of $500 million in the supply of home mortgage funds might be equivalent to about 35 thousand housing starts. In 1960, there was a total of 1.25 million nonfarm housing starts.

In weighing the effect to be given to the possible impact on national housing programs, it is essential to keep in mind that the counterbalancing factors include more than the considerations of tax policy previously discussed under III above. A tax policy of neutrality towards competing financial intermediaries not only promotes tax equality but also promotes the most efficient utilization of economic resources as established by the market place demands of our free enterprise system. To the extent that our housing programs require special incentives, tax subsidies may not be the most efficient or appropriate means of accomplishing these national goals.

Whatever long-run conclusions may be drawn as respect the effect of full taxation on the supply of home mortgage funds, the risk of a possible adverse impact on the home mortgage market resulting from a sudden imposition of ordinary corporate income taxation on the mutual thrift institutions may in any event justify consideration of alternative methods of taxing these institutions over a period of transition to full taxation.

## V. METHODS OF TAXATION

### (a) Full Taxation

If full taxation in a manner generally comparable to that imposed on other corporations, and financial institutions in particular, were to be considered, it could appropriately take the following form. The savings banks and savings and loan associations would be allowed to retain earnings tax free only in accordance with a bad debt reserve formula comparable to the formula applied to commercial banks, i.e., their bad debt reserve ceiling would be limited to three times their average annual loss experience over the worst consecutive 20-year period since 1927. Institutions organized after the depression period would be entitled to utilize the experience record of older institutions. This method of taxation could be applied immediately or after a period of transition to avoid any adverse impact on the home mortgage market.

It is estimated that application of the above bad debt reserve formula would produce an average bad debt reserve ceiling of between 2% to 3% of uninsured loans. This approximates the average ceiling of 2.4% applicable to commercial banks.

In computing tax deductible additions to bad debt reserves for the future, the full amount of existing reserves which have been accumulated tax free in the past would not be taken into account. Instead, the existing reserves would be split between a "true" bad debt reserve (of between 2% to 3% of uninsured loans) and an "excess" bad debt reserve. Only the true bad debt reserve would be taken into account in computing future additions which could be made as uninsured loans increase and as losses are sustained. In establishing true bad debt reserves for mutual thrift institutions, it would be appropriate to consider correction of certain defects under existing law which place an artificial emphasis on bid prices in computing bad debt losses resulting from mortgage foreclosures.

Since these institutions increased their uninsured loans by more than $7 billion during 1960, the above bad debt reserve formula would permit them to retain, tax free, between $140 million and $210 million annually at current growth rates.

Estimated corporate income tax revenues under this approach are set forth below. These estimates assume that the tax impact will be divided evenly between reduced dividends and reduced additions to reserves, that the mutual thrift institutions will have a growth rate of about 9.5% each year, and that the bad debt reserve ceiling will be about 3% of uninsured loans.

(In millions of dollars)

| | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|
| Mutual banks | 102 | 112 | 118 | 127 | 134 |
| Savings & Loan Associations | 276 | 304 | 339 | 376 | 415 |
| Total | 378 | 416 | 457 | 503 | 549 |

(b) Transition

If, because of the risk of possible adverse impact on the home mortgage market resulting from a sudden imposition of ordinary income taxation, transitional methods of taxation were regarded as appropriate, the following alternative could be considered. Under this transitional approach, mutual thrift institutions would be allowed a "true" bad debt reserve and in addition would be allowed to deduct for tax purposes a diminishing percentage of any additional retained earnings. Under a three-year period of transition, the institution could deduct, in the first year of transition, 2/3 of the amount of "excess" retained earnings. The fraction would be reduced to 1/3 in the second year, and no excess deduction would be allowed in the third year. Revenue estimates under this 3-year transition are:

(In millions of dollars)

| | 1962 | 1963 | 1964 |
|---|---|---|---|
| Mutual Banks | 34 | 75 | 118 |
| Savings & Loan Associations | 92 | 203 | 339 |
| Total | 126 | 278 | 457 |

A five-year period of transition, under which a deduction of 4/5 of excess retained earnings would be allowed in the first year, 3/5 in the second year, etc., would produce the following estimated corporate income tax revenues:

(In millions of dollars)

| | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|
| Mutual Banks | 20 | 45 | 71 | 102 | 134 |
| Savings & Loan Associations | 55 | 122 | 203 | 301 | 415 |
| Total | 75 | 167 | 274 | 403 | 549 |

(c) Alternative Formula

If it should be decided that any impact on the mortgage market is to be avoided, consideration also might be given to an alternative formula which would not subject these institutions to full taxation. An example of a method of partial taxation would be the application of regular corporate tax rates to the institutions' earnings on their reserves. Depending upon the detailed manner in which such a tax might be imposed, the annual revenue yield at the current earnings level would be between $125 and $150 million.

# TAXATION OF MUTUAL FINANCIAL INSTITUTIONS

(Savings and Loan Associations and Mutual Savings Banks)

The Secretary of the Treasury has stated that by the end of June he will send to the Ways and Means Committee his recommendations on taxing mutual financial institutions. This means that the decision will have to be made within the next few days. It is expected that there will be consultation with the White House prior to final determination. The following items should be kept in mind when the decision is being made.

1. The savings and loan business has supported the Administration and the Democrats in Congress financially and morally, and is the only member of the financial world who has done so.
2. A big tax burden on the savings and loan industry will remove from \$2 to \$5 billion from the housing market. Savings and loans and mutual savings banks finance about 60% of all of our housing, and the economic effect of a big tax would be severe to the housing field.
3. A tax proposal which would exact in the neighborhood of \$150 million from the two groups would not have a severe impact and could go through with a minimum of opposition. Such a tax would increase the direct taxes paid by these institutions 20 times and would be a compromise between what the savings and loan business wants and what the commercial bankers want. To come out with the proposal suggested by the commercial bankers would not be in keeping with the President's desire to stimulate housing.

6/22/61

capacity available or to charge rates for such capacity may file a petition for relief with the Commission; (2) this petition must state concisely the facts constituting a violation of the FCC's leased access rules and the specific rule or regulation violated, and certify that the petition for relief was served on the cable operator; and (3) any petition for relief must be filed within 60 days of the alleged violation. A cable operator would then have 30 days from the date of filing the petition in which to respond. These requirements are designed to assure that the leased access option brings about the intended diversity of programming and competition in programming delivery. The information will be reviewed by FCC staff to resolved access disputes. These expedited leased access procedures may obviate the need for oral rulings or other emergency processing of leased access disputes.

Federal Communications Commission.

William F. Caton,

*Acting Secretary.*

[FR Doc. 94-14216 Filed 6-10-94; 8:45 am]

BILLING CODE 6712-01-M

## FEDERAL DEPOSIT INSURANCE CORPORATION

### Mutual-to-Stock Conversions of State Nonmember Savings Banks

**AGENCY:** Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Notice; request for comments.

**SUMMARY:** As previously indicated in Congressional testimony and in public statements, the FDIC has been at work on a fundamental review of the process by which mutual thrifts convert to stock form. This request for comments reflects that study. The intended effect of this notice is to obtain comments on the suggested approach to resolving fundamental concerns about the current mutual-to-stock conversion process.

**DATES:** Written comments must be received by the FDIC on or before August 12, 1994.

**ADDRESSES:** Written comments shall be addressed to the Office of the Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429. Comments may be hand-delivered to room F-400, 1776 F Street, NW., Washington, DC, on business days between 8:30 a.m. and 5 p.m. (FAX number: (202) 898-3838). Comments will be available for inspection in room 7118, 550 17th Street, NW., Washington, DC between 9 a.m. and 4:30 p.m. on business days.

**FOR FURTHER INFORMATION CONTACT:** Robert H. Hartheimer, Acting Director, Division of Resolutions (202/898-8789), John G. Finneran, Jr., Acting Deputy General Counsel, Legal Division (202/898-3766), Robert F. Miailovich, Associate Director, Division of Supervision (202/898-6918), Robert W. Walsh, Manager, Planning and Program Development Section, Division of Supervision (202/898-6911), Joseph A. DiNuzzo, Counsel, Legal Division (202/898-7349), Federal Deposit Insurance Corporation, Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:**

### Historical Background

Mutual savings institutions were founded to fill gaps in the market—and for a social purpose. Commercial banks have not always welcomed retail customers as either depositors or borrowers. Mutual savings banks were in many respects charitable organizations designed to encourage and facilitate thrift on the part of urban wage-earners. Their trustees were self-perpetuating groups of leading citizens, some of whom may have contributed the capital to establish the bank in the first place, who took no fees and did no business with the bank. Savings and loan associations were essentially cooperatives. One became a "member" in order to save—in order eventually to borrow the money to build a home. There were limitations on the ability to withdraw one's funds. The right to be the next borrower, when enough funds had accumulated, was often decided by lot. Trustees were elected by the members—and in the early days members were required to attend meetings and take their turn as officers. The notion of "self-help" motivated both sorts of formations. At one time, people spoke of the spread of these institutions as a "movement."

As a legacy of that tradition, today there are approximately 1,100 mutuals in the United States. (Ten years ago there were about 2,500, five years ago 1,775.) From time to time, one or another of them desires to convert to stock form. It may be that they need more capital—in some cases on an urgent basis. It may be that they see expansion opportunities and need a currency (stock) with which to acquire. For many small institutions, it makes sense to join a larger organization, and they often need to convert to be able to do so. Based on our own research and analysis, as well as published cases, there is also little question that some institutions have converted primarily to enrich those who controlled them.

The existing form of transaction by which both federal and state mutuals convert was developed by the Federal Home Loan Bank Board ("FHLBB") in 1974. What happens, essentially, is that the mutual sells itself, for cash, to whoever buys its newly issued stock. Various categories of potential purchasers get priority. In general, depositors stand at the head of the line. To the extent depositors and others with priority rights do not subscribe for stock, an attempt is made to sell it locally. If stock is still left over, it is sold to investors with no particular connection to the converting institution.

The FHLBB was conscious, when it first wrote rules for conversions, that there might be value to the right to subscribe for stock in a conversion. For example, if a mutual with $100 million of net worth raised only $20 million of new capital in converting, whoever got to buy the stock would have a claim on $120 million of net worth. In such a situation, the stock would almost certainly be worth much more than the buyers had paid for it. For about a year, in the early '70s, the FHLBB took the view that rights to buy stock in a converting institution should be distributed to its depositors, who could either exercise and become owners or sell the rights for their intrinsic value.

The FHLBB subsequently abandoned this approach, however, primarily out of concern that depositors would shift funds from association to association, hoping to capture the intrinsic value of the rights when the conversion occurred—and on a scale that could be destabilizing. At the same time, it adopted the current approach, which included an "appraisal" requirement, providing that a converting institution issue and sell its capital stock at a total price equal to the estimated *pro forma* value of such stock in the converted institution.

Because of moratoria imposed in 1973 and 1974, the existing form of transaction was not tested in great numbers until the '80s. At that point, it worked quite well, because many converting institutions had little net worth or economic value, and the market was extremely wary even of those that did. Depositors and other investors who subscribed for stock got securities with a market value approximately equal to what they paid for them.

### Problems With the Existing Process

In the last two-plus years, as non-viable institutions have been closed and the industry has returned to health, the existing form of transaction has delivered windfalls to those who subscribed. In the more than 100 standard conversions in 1992 and 1993, the trading price at the end of the first day has exceeded the subscription price by, on average, 26%. In 40 instances, this price increase (the "pop") has exceeded 30%; in 6 instances it exceeded 50%.

As it has become obvious to everyone familiar with the process that buying stock in a conversion is an easy way to make money, a class of "professional depositors" has emerged—wealthy individuals and investment partnerships with $50 to $500 accounts at literally hundreds of mutuals across the country. Investment banking firms active in the conversion arena advise us that there are perhaps 500 to 1,000 such professional depositors, and that they can take the account list of almost any mutual in the nation and recognize hundreds of names at sight. These professional depositors buy the maximum amount of stock allowed—and consequently the overwhelming majority of the stock issued in almost every conversion. Market participants have told us that in a typical conversion, less than 5% of depositors participate at all—and that the majority of them are professionals or insiders.

Giving depositors the *opportunity* to subscribe for stock has not resulted in broad distribution of stock among them. The vast majority of depositors in mutual savings institutions keep their savings there precisely because they are risk-averse. They are likely to read and ignore or discard the offering circular. The money they keep in a savings institution has been put aside for retirement, or for emergencies, or for the down payment on first house, and cannot be invested in an initial public offering. They do not participate. The existing conversion process does not benefit them at all.

As it has become obvious to everyone who understands the process that the stock of converting institutions often trades up sharply on the first day of issue, those who control mutual institutions have become more and more interested in converting. Managers and even non-executive trustees have been awarded free stock and options (at the subscription price). Employee Stock Ownership Plans ("ESOPs") have been created and given priority in buying stock. These and other devices have resulted in substantial transfers of value.

As it has become clear that most conversions would be oversubscribed, the "allocation" process has clearly been subject to abuse. For example, we have been told that in transactions where allocations were likely to be based on size of deposit because of expected oversubscription, insiders and others in a position to know the relevant record date have been able to transfer large amounts of money into their accounts on that single day. Where the right to subscribe has been limited to long-term depositors, or depositors with local addresses, we are told that professionals are sometimes able to persuade other depositors to "front" for them (despite rules to the contrary).

*Problems With Appraisals*

As market valuation of thrifts has risen (and as conversions have come to be oversubscribed, with stocks generally trading up), the integrity of the appraisal process has been compromised. The FDIC's experience with appraisals is that they typically follow a certain pattern. A "peer group" of stock savings institutions is identified. (How they were selected out of the much larger universe of potential "peers" typically is not well explained.) The peer group market/book ratio is calculated. It is then stated that the converting institution should be valued (on a pro forma basis) at a discount from that ratio. Two reasons for this are typically given. The first is that the converting mutual is actually inferior to the peer group—which raises the question, why were they chosen as peers in the first place. The second, discussed below, is the need for a "new issue discount." (Price/earnings ratios are also calculated, but there is rarely a cogent analysis of the converting institution's earnings potential once it appropriately deploys its new capital.)

At March 31, 1994, the thrift industry average market/book ratio was 99% and the median was 95%. (At year-end 1993, those figures were five percentage points higher; a year before that 15 percentage points lower.) The market tends to value recently converted institutions below the industry average—primarily, in our judgment, because the return on a newly converted institution's book, or capital, will be low by industry standards until it is able to leverage the new capital it raises in the conversion. During 1992 and 1993 as a whole, the average market/book ratio of a newly converted institution, at the end of the first day of trading, was 72%. To meet the "appraisal" requirement that an institution's stock trade at what it was sold for in a situation where a 72% market/book ratio was a reasonable expectation, a mutual would have to more than triple its capital base. To be precise, a mutual with a $100 million net worth would need to raise $257 million (ignoring expenses and the effects of establishing an ESOP or a management retention plan), since 72% of $357 million (the resulting book value) equals $257. It is extremely hard for a company in a highly competitive industry prudently to employ that much new capital.

What appraisal firms did, in 1992 and 1993, was to "appraise" converted institutions on average at 57% of book. They did this despite the fact that, on average, these institutions traded up the first day by 26%.

Appraisers' principal rationalization for this discrepancy has been that, in the context of an initial public offering, a "new issue discount" is required. While it is certainly true that it is difficult to bring a company public without pricing the shares at a level that stimulates unfilled demand—resulting in a "pop"—we question the magnitude required in an environment where virtually all conversions are trading up. In some circumstances, the need for a "new issue discount" has been asserted in appraisal updates issued *after* the end of the subscription period, and in the face of 100–300% oversubscriptions. We would also observe that the literal language of the OTS regulations and guidelines on conversion appraisals does not allow for a market discount. The question to be answered is: how much stock has to be sold to eliminate any "pop"?

We suspect that the practices we describe developed over time as appraisers, and mutuals and their advisers, attempted to deal in good faith with the inherent contradictions of, on the one hand, a form of transaction perfectly suited to institutions on the brink of failure, or which the market feared, and, on the other, a thrift industry that has returned to health.

As a footnote to the conversions of the 80's, it is worth observing that many institutions which emerged with very high capital ratios were so anxious to earn a good return for their new, demanding stockholders, that they grew their balance sheets more quickly than they should have and took risks they did not fully understand. A total of 77 New England savings banks converted in the years 1984 through 1989; these transactions increased their weighted average capital ratio to 15.2% from 6.6%; 16 of them (or 21%) subsequently failed.[1] In addition, the rush by converted institutions to increase assets quickly tended to reduce credit standards throughout the market, imperiling other institutions.

[1] "Understanding the Experience of Converted New England Savings Banks," Eccles and O'Keefe, FDIC (1994).

### Changing the Process

What this history demonstrates is the need for fundamental change:

• The "appraisal" process puts the government in the awkward position of substituting its judgement for that of the market...

• . . . and forces most converting institutions to raise far more capital than they can prudently deploy...

• . . . but still fails to eliminate windfalls.

• This has put well-intended individuals involved in more than a few conversions in the ethically uncomfortable position of pretending the appraisal requirement is met when they know it isn't.

• The required form of transaction transfers the existing value of the mutual to a small group of individuals with the cash, sophistication and risk appetite to buy the stock.

• Because value is being "given away," the process invites insider abuse. And because the value has to go somewhere, the ingenuity of market participants eventually frustrates attempts to eliminate the problem.

We share with others a desire to address problems arising under the existing rules. We do not in any way want to prevent valid conversions from taking place—nor encourage conversions that fail to meet a valid business need. We also desire that our handling of conversions be generally consistent with that of the OTS.

For these reasons we are publishing elsewhere in this issue of the Federal Register a proposed rule which: (a) reaffirms our intention to review conversion applications submitted by state-chartered nonmember insured savings banks (and applications for insurance from newly established associations to be owned by mutual holding companies), and (b) explicitly establishes certain criteria which are comparable to those of the OTS.

At the same time, we feel it is only fair to put the public on notice that we believe it may be difficult for a healthy mutual to develop a sound business plan while raising enough new capital to receive a valid appraisal.

The noted investment manager, Peter Lynch, describes this problem, and the existing form of conversion generally, in graphic terms. Buying stock in a converting mutual, he writes, is like going to an automobile dealer to buy a car, giving him a check for the purchase price, and discovering on the way home that the dealer has put your check in the glove compartment of the car. Unless the car is an extraordinary lemon, this is bound to be a good deal. And increasing the size of the check—which is what "disciplining the appraisal process" amounts to—won't make it stop being a good deal.

It is possible that the recent OTS amendments (and the requirements in the FDIC proposed rule mentioned above) which aim to give long-term, local depositors more rights—but within the framework of the existing form of transaction—may produce similarly frustrating results. As noted earlier, "real" depositors are not going to benefit, no matter what priorities they receive, because "real" depositors still may not subscribe in significant numbers.

We believe that "insider abuse," which is the focus of much recent discussion and of several of the OTS amendments and the requirements of the FDIC proposed rule, is only a piece of the problem. In one recent conversion, for example, state authorities forced the institution to rescind stock grants which would have benefited insiders by approximately $40 million.

This was laudable. But the "pop" in the price of the converted institution's shares benefited those who subscribed by more than $200 million on the first day of trading and by $275 million after one month's trading. All who had their subscriptions filled were depositors—but only 5% of all depositors subscribed. We question whether it can be an adequate response to the trustees' fiduciary duty to deliver that much value to the tiny fraction of a mutual institution's depositors with the capacity to line up and collect it.

We continue to believe—as stated in testimony before the Congressional Banking Committees—that the conversion process is fundamentally flawed. Thus, in addition to the proposed rule published elsewhere in this issue of the Federal Register (which is intended to address concerns within the existing mutual-to-stock conversion framework) we also are issuing this request for comments seeking views on an approach which might address the basic flaws in the existing scheme.

### The (Misguided) Question of "Ownership"

The most vexing question facing everyone who has ever dealt with mutual-to-stock conversions is: "Who owns mutuals?" That may be the wrong way to ask the question. As indicated earlier, mutuals were originally closer to charities or community organizations than to commercial enterprises. As a by-product of doing what they were founded to do, they have accumulated net worth. The trustees hold that value in trust. The right question more likely should be: "If the trustees decide to convert, to whom should that value be delivered?"

We believe there are two ways to answer the question: leaving it to the trustees in the reasonable exercise of their fiduciary duty, or legislation.

Leaving the decision to the trustees is logical, but may be impractical. The best argument in favor of this approach is that the history and circumstances of institutions vary, that boards are designed to balance competing interests and considerations, that existing law should be adequate to prevent abuse, and that the government should not interfere unless it has to. As different boards of trustees wrestle with the issues, a consensus should *tend* to emerge.

The argument against leaving the decision to the trustees is twofold. Taking the positive view of such boards, it places an unfair burden on them and their institutions. They will be lobbied by potential claimants. Someone will object to whatever decision they make. Taking the skeptical view—and there is no question that *some* boards have interpreted their fiduciary responsibilities rather loosely—leaving the decision to the trustees is unwise. The FDIC will in the end have to expend significant resources providing informal guidance to the conscientious and making sure that trustees' determinations *are* reasonable.

Some could well believe that the preferable way to answer the question of "to whom the value should be delivered" would be legislation. In fact, the main purpose of this notice and request for comments is to solicit views from the public on a legislative proposal that the FDIC could prepare and present to the appropriate legislative body(ies). Legislation could take the form of state law, through which each state would decide the question for the mutual banks it charters (or has chartered), or federal legislation, through which the Congress decides the issue on a nationwide basis. Uniformity argues for federal legislation, but questions of federal preemption of state law would have to be considered.

If federal legislation is decided upon, the Congress could either establish in the statute explicit value-distribution rights or authorize the appropriate federal agency (presumably, the FDIC for state savings banks and the OTS for federal and state savings associations) to determine to whom the value of the mutual institution should be delivered.

**Who Should Get the Value?**

We are aware of at least seven groups (in no particular order) which might lay a claim to a mutual's value:

(1) Depositors.

(2) Other creditors, including holders of subordinated debt.

(3) Borrowers.

(4) Employees—whether through the medium of an ESOP, which acquires shares in the conversion, or other arrangements designed for senior management.

(5) Trustees.

(6) The Bank Insurance Fund or the Savings Association Insurance Fund, the U.S. Treasury or the relevant state government.

(7) Charitable organizations or trusts serving the community and purposes for which the converting institution was originally founded.

The question of who receives the value is primarily a political one. Accordingly, we do not believe the FDIC should be the one to decide among these (or other) claimants. We have a supervisory interest in seeing the question answered, however, and answered in a way that is generally seen to be sensible and fair.[2] To that end, the following comments are intended to focus public discussion of the question.

Taking each of the seven parties in turn, we believe that at least some of the value will have to go to depositors. Although the law of many states implies that they are not "owners" of mutual institutions in the classic sense of the term, and, at least since the creation of the FDIC, they have not borne significant risk, they have supplied the institution with its resources and in many cases have a vote on conversion. Although we have scant sympathy for those professional depositors who have opened small accounts in the expectation of large windfalls and whose hopes would be disappointed by the reforms we propose, it is perhaps the case that some depositors of all types have known that conversion was a possibility, and in a sense may have "bargained for" at least some share of the value of the institution. The fact that existing OTS regulations and most states' laws give savings and loan association depositors preference in subscribing for stock may not create an *entitlement*, but it has probably created an *expectation*—which will probably have to be satisfied to some degree.

*Among* depositors, there are questions of allocation: by size, by tenure, by address. What is theoretically desirable is often beyond the scope of the converting institution's data processing systems. Attempts to favor "local" depositors can be frustrated in various ways. There is also the question of record date—and the problem of long-term depositors who unwittingly close their accounts shortly before the record date. Our current inclination would be to make the record date fairly recent (as a convenience) and to award one share of the aggregate value going to depositors for each year that each account has been open. We expect that allocating shares to accounts closed prior to the record date, while theoretically equitable, would prove impractical.

In contrast to depositors, creditors are uninsured and do take risk—especially since the adoption of federal depositor preference. On the other hand, most creditors have that status as an incident of some other relationship—*e.g.*, as a supplier of goods and services—and would be surprised (if delighted) to discover that it gave them any claim on the value of the institution. We would therefore expect a consensus to emerge favoring their exclusion.

The argument for giving debtholders part of the value is stronger. They have the position they do because of a conscious financial transaction. In most cases, such debt is subordinated and does represent capital. Debtholders, while subordinating themselves to depositors for a higher rate of return, did not "bargain for" any share of the mutual's net worth—but neither did most depositors. Were it to be established that subordinated debtholders were entitled to a share of the value, it might make it slightly easier for small mutuals to raise debt capital, which has appeal from a safety and soundness standpoint. As an equitable approach and from our perspective as insurer, we would favor giving debtholders some of the value of a converting institution, and we would not expect such a decision to strike people as unreasonable or unfair.

If such a decision is made, we believe the most feasible method of allocation is by size of holding, with debtholders as a whole receiving a share of the value going to debtholders and depositors combined that is proportionate to debt's share of the institution's combined liability to depositors and debtholders. The length of time the debt has been outstanding, or in any particular holder's hands in the case of tradable debt, should not, in our judgement, have bearing.

Federal Home Loan Bank advances are an important part of the liability structure of many banks. The question arises: if other debtholders should receive some of the value of a converting institution, why not the relevant Federal Home Loan Bank? We believe there is a good reason for excluding them: the fact that advances are fully secured, making the Banks effectively senior to depositors.

Although borrowers are technically "members" of some mutual savings institutions, we believe most borrowers think of the institution as having a claim on them, rather than the reverse. During that period when they are borrowers, they are in fact already receiving a benefit. Borrowers are typically required to open deposit accounts as well. Finally, borrowers' loans can be, and often are, sold to third parties; distinguishing their rights from those of borrowers whose loans have not been sold would present formidable legal and logistical challenges. For all these reasons, we do not believe the consensus would be to give them a claim, as borrowers, on the value being transferred.

We would point out, however, that at least some knowledgeable observers view the rights of depositors to a share of the converting institution's value as not really that much stronger than those of borrowers. The vast majority of both groups do business with mutuals on an arms-length basis, at market terms, at no significant risk, and with no expectation of a windfall. In the view of some observers, it is only the absence of any other "owners," the fact that depositors turn up on the side of the balance sheet where stockholders would be if there were any, and the practice of treating depositors as stand-ins for owners that give depositors the presumption of a right to receive value.

*Rewarding Employees and Managers*

It is sometimes said that managers—and to a lesser degree employees—of mutual institutions enjoy more job security and a less demanding work environment that their counterparts at organizations subject to stockholder discipline, but are in turn less well compensated. Conversion changes their situation. Some argue that these considerations—and years of loyal service—entitle managers to a share of the value. The opposing view is that managers of mutuals chose to work there and "bargained for" whatever pay they got.

We understand both sets of arguments. The no-entitlement view, if

[2] Pending a legislative determination of this question, we also have a supervisory interest in ensuring that the boards of mutual institutions fulfill their fiduciary duties in preserving the value of the institution. Accordingly, the FDIC will continue to review proposed conversion transactions of state mutual savings banks and take appropriate action where the transaction raises fiduciary concerns.

we can call it that, has logical purity. The view that managers deserve part of the value has emotional appeal, especially when they have spent decades at the converting institution. The issue of appropriate treatment of long-serving employees is a good example of the essentially political nature of the value-distribution question.

Were we required to decide this issue without legislative guidance, we would prefer to see all benefits to employees of insured institutions be delivered as *compensation*. We would certainly endorse the creation of an ESOP immediately after conversion. If the conversion process has entailed extra effort on the part of some (or all) employees, they may be entitled to bonuses. And if conversion entails a radical reduction in job security, it may be appropriate to adopt a severance policy consistent with standard industry practice for stock institutions.

Focussing on the top few executives and non-executive trustees, it is certainly the case that their jobs become harder and less secure following conversion. They may be entitled to significant raises. It may be appropriate for a few senior executives to receive employment contracts. Again, all such steps should be evaluated within the context of "compensation." We believe that for individuals who control the conversion transaction to lay any claim, in their capacity as managers and trustees, to a portion of the value being transferred creates a conflict of interest.

It is currently common practice for converting institutions to create stock option plans. We believe it is appropriate for stock institutions to have incentive compensation plans of this type. As indicated in the FDIC proposed rule mentioned above, we agree with the OTS that such plans should, at the earliest, be adopted at the first stockholders' meeting following conversion and that the exercise price for any such options should be set at that time, rather than being based on the conversion price. The latter practice, which had been common, gave those who controlled the transaction an incentive to underprice the shares, and masked transfers of value to those executives receiving options, which, if properly measured, and viewed as compensation, would have been deemed excessive.

*A "Government" Share?*

Several individuals and organizations have suggested that a share of the existing value of converting mutuals should go to one of the deposit insurance funds, or to the U.S. Treasury, or to the government of the state which chartered the institution. We are uncomfortable with the first suggestion. Converting institutions have been paying premiums, just as stock institutions have. No one would lay claim to a portion of the latter's net worth. The FDIC should not do so with regard to mutuals.

Some have advanced the argument—based on the cost of the savings and loan crisis—that taxpayers generally, through the medium of the Treasury, should get a portion of the value that conversion releases. As a fairness matter, we believe this argument is flawed: Institutions now converting have *not* failed, and have *not* cost taxpayers anything. Most state savings banks, whose conversions fall under our jurisdiction, are insured by the Bank Insurance Fund, which taxpayers have not had to support.

Another argument for conveying the value of converting mutuals to the government—whether state or federal—is that "no one owns them," and that the fairest course is therefore to avoid giving the value to anyone in particular. We will have more to say on this topic later in this Notice, but would observe that if the form of transaction suggested below is adopted, many of those who receive the value of the institution will get cash, and will pay taxes on it as income, giving government its "share."

*Fulfilling Mutuals' Original Purpose?*

As indicated earlier, mutuals were created for reasons that have now largely disappeared. Ordinary citizens have plenty of places to put their savings. A host of private- and public-sector entities facilitate home-ownership. The trustees of a mutual savings institution having regard for their fiduciary duties might liken their situation to that of the board of the March of Dimes, which had to redefine its mission after polio ceased to be a major threat. From that perspective, it may be appropriate for a portion of the value of a converting mutual to be transferred to one of more community organizations or charities.

This approach raises the question, "*Which* organizations?"—which could be extremely hard to answer. As with the matter of dividing up the value in the first place, leaving the decision to the trustees places a burden on them. Nevertheless, under this approach, the trustees are the ones to decide. If no appropriate vehicles existed, a trust might be established to receive the transferred value and make grants over time. The responsibility for allocating funds is borne by thousands of trustees of colleges and hospitals and foundations and charities all over the country; there are plenty of examples to follow—and laws to prevent abuse.

An alternative to endowing a new or existing charitable organization is for the converted institution to accept special obligations to serve the convenience and needs of the community for banking services. This is a very broad subject, which we are not prepared to explore exhaustively here. We would make three basic points, however. First, while all banks clearly have public obligations, it seems likely that imposing different burdens on institutions which are otherwise direct competitors will ultimately create safety and soundness concerns. For that reason alone we would oppose this approach.

Second, the value transfer inherent in an institution's voluntary acceptance of a special obligation to the community—*e.g.*, a promise to make affordable housing loans, or to open branches in distressed neighborhoods—is difficult to measure against immediately cashable value delivered to depositors or others. We think it would be difficult for trustees to know what they'd actually done.

Third, the history of mutual savings banks does suggest that organizations to which any portion of the value of a converting institution might be transferred should be locally focussed, and should have the encouragement of self-help as a major objective. To give only two of many possible examples, helping to capitalize a community development bank, or establishing a day care facility which permitted single mothers to work, would have satisfying historic resonance.

*No Entitlement; No Forced Conversion*

The idea that some of the value of a converting institution should be delivered to the "community" it was chartered to serve is as strongly opposed by some as it is supported by others. This is another excellent example of the political (rather than regulatory) character of the issue.

At least two arguments against a "community" share have been advanced. The first is that the "wrong" charities and community organizations would be chosen—wrong from the speaker's point of view, that is—because of their skill and persistence in lobbying the board. The second is that such organizations, seeing latent wealth available, would put pressure on boards to convert.

This second argument is also advanced, as it was in the early '70s, against giving *depositors* transferrable rights: if value is "available," they will put pressure on institutions to convert.

Being *exempt* from constituent "pressure" is unhealthy for any organization. Legislators have to face the voters. Independent agencies are subject to oversight. Stock organizations can be taken over. We do not believe that the trustees of mutuals should be allowed to ignore completely the views of those the institution exists to serve.

Nevertheless, we would emphasize that however one decides the value-distribution issue, that does *not* answer the (misguided) question, "Who owns a mutual?" It does not, in our view, give anyone standing to demand that an institution convert—any more than a group of private citizens could demand that the Red Cross "convert"! Conversion is a decision for the trustees, and until they make such a decision, the FDIC will not get involved—except where inadequate capital makes it desirable from a safety and soundness standpoint. Mutuality has a distinguished history in America. In the aggregate, mutuals have cost the FDIC proportionately less than have stock institutions. We would not endorse a system that compelled mutual institutions to change their character.

*New Form of Transaction*

Having adopted *an* answer to the question, "Who gets the existing value?", the problem of delivering that value is easier to address. We would suggest the following approach:

- The trustees decide how much capital they need to raise as a business matter. (There is no "appraisal" process.)
- The trustees hire underwriters to conduct an initial public offering—and an escrow agent for the purposes described below.
- Rights to subscribe for the stock of the converted institution are distributed to "rightholders" in accordance with the principles outlined above.
- Each of these rights will have value. For example, if a mutual with $100 million of net worth elected to raise $20 million, and distributed 4 million rights to buy 4 million shares (at $5 each), and the market valued the converted institution at 80% of resulting book (or $96 million), the shares would trade at $24 each, and the right to buy a share for $5 would be worth $19.
- The rights would be "transferrable" only in the sense that, at the end of the subscription period, the escrow agent would exercise on behalf of any rightholder who had not done so, turn the stock over to the underwriter for sale, give $5/share of the proceeds to the company and send the difference to the rightholder.

It is likely, under this form of transaction, that very few rightholders would chose to exercise, and that the underwriters would essentially be selling the whole institution. This gives rise to several questions. For example, wouldn't the transaction costs be awfully high, relative to the amount of new capital being raised? The answer has to be yes—but the cost should be measured relative to the major strategic accomplishment of conversion itself; presumably there was a reason to convert, or the trustees wouldn't have undertaken it. It is also worth observing that the need (opportunity) to sell nearly 100% of the stock will lead many more underwriting firms to compete for the business.

Another question is why not just distribute stock certificates instead of rights? The basic answer is that the selling effort of a public offering is what gets the market to focus on the fair value of the shares, and gets a group of underwriters committed to make a market in them afterwards. A direct distribution of shares could saddle the bank with an uneconomically large number of shareholders. It would leave unsophisticated holders of small numbers of shares in danger of being persuaded to sell at prices below intrinsic value. Finally, to the extent that rights were distributed to a community-oriented charity, a stock sale should probably be required to avoid leaving a controlling block of stock in the hands of a foundation or organization which might be governed by the directors of the converted mutual.

One argument advanced against this form of transaction is that the existing process has raised enormous amounts of money to recapitalize ailing thrifts, and that while the industry is healthy now, we may need to be able to do that again some day. True—but the approach here proposed would be able to do that as well. If a thrift with a low equity ratio wanted to convert, it could distribute rights and hire an escrow agent and an underwriter, just the same. The shares could be priced wherever they had to, to be sold. The rights just wouldn't have much value—but that would appropriately reflect the institution's perilous condition.

Another argument advanced is that the recent market is a highly unusual one, that the embarrassing increases in share price on the day of conversion have already begun to shrink and could soon disappear. They may or may not—and "pops" *per se*, though on a more modest scale, are effectively a requirement of the initial public offering market—but the transactions the existing conversion process requires would still be inefficient to the point of being improper. Under current rules, a well capitalized thrift is only able to avoid a "pop" by increasing its equity ratio to the point where its market/book ratio falls below industry norms—which says that a lot of the new capital will either be underutilized for several years, or used imprudently. What all parties at interest should want is the *highest* market/book ratio that can be obtained, because that suggests the right business judgements have been made regarding capital structure and growth prospects. The elimination of "pops" would suggest a destruction of the value the trustees hold in trust, and a violation of their fiduciary duty of care—regardless of who that duty is owed to.

*Merger Conversions*

The OTS interim final rule would prohibit merger conversions—whereby a stock institution acquires the assets and assumes the liabilities of a mutual with no significant payment to anyone—except where the survival of the converting institution is in question. The form of transaction we here propose would permit merger conversions, but would make them essentially a purchase of subscription rights by the acquiror, with the value paid for the rights—either in cash or other consideration—going to rightholders. This would have efficiency benefits for those smaller institutions whose decision to convert flowed from a decision to affiliate with a larger organization. Trustees who decided to convert and be acquired would of course have the same obligation to get the best possible price for rightholders.

*Mutual Holding Companies*

The Competitive Equality Banking Act of 1987 and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 authorized conversion of mutual savings institutions into federal mutual holding companies, which in turn transfer virtually all their assets and liabilities to new, stock savings institutions, part of whose stock is acquired by subscribers in the conversion, with the majority retained by the mutual parent. This structure has the benefit of permitting converting institutions to raise only the amount of new capital they actually need. It has, however, in our view, potential for even a higher level of insider abuse than in standard conversions. We note that many newly formed mutual holding companies propose to refuse dividends declared by their operating subsidiary—with no corresponding change in their percentage ownership of the subsidiary as dividends flowed to its minority stockholders. It seems to us that this could constitute a breach of fiduciary duty on the part of the trustees—which would be particularly acute were the trustees significant stockholders of the subsidiary. (It is worthy of note that "pops" in conversions involving mutual holding have been in the 40% range, compared to 26% for standard conversions.) As our suggested form of standard conversion would eliminate the need to raise excessive amounts of capital, we believe use of the mutual holding company structure should be discouraged in future conversions.

*Summary*

As we have studied the mutual-to-stock conversion process, it has become clear that there are two intertwined problems to be solved. One is technical: how to do it? The other is political: who should get the value? The first problem is interesting and challenging, but the second one is fundamental.

Deciding who should get the value makes a lot of people uncomfortable. Almost every answer makes someone angry. As we read the history, the FHLBB settled on the existing form of transaction precisely because it allowed them to avoid answering the value-distribution question. We have come to believe that the primary appeal of some value-distribution schemes—*e.g.*, giving it to depositors or to "the government"—is that they appear to disperse value enough to make the issue moot. As we have discussed the subject over the past two months, we have observed how tempting it is to continue to avoid it. Lawyers and investment bankers and professional depositors with a vested interest have urged us to drop the subject—which is not surprising. But even disinterested individuals wind up asking, "Do we care?"—and they reach that point with remarkable consistency.

We should care. The integrity of a banking system is a national treasure. Careless distribution of the value of converting institutions undermines that integrity. A form of transaction in part designed to avoid the value-distribution question—though it worked well for a while—today forces well-meaning bankers and lawyers and trustees and regulators to wink at polite fictions. Many have suggested that this is hardly a crime, since there is no victim. We disagree. Honor is the victim.

Life is full of compromises. There is no "right" answer to the value-distribution question. But there is a right process for addressing it. We invite broad participation in fashioning a compromise, as only democracy can, with which no one is entirely satisfied, but in which all can take pride.

*Questions on Which Comment Is Sought*

The FDIC is hereby requesting comment during a 60-day comment period on all aspects of this notice, including the following specific issues:

(1) Should a mutual institution be required, as a threshold issue, to demonstrate a need to convert—or is it sufficient that it provide an adequate business plan for the future?

(2) In the absence of legislation, could and should the FDIC adopt guidelines or set standards for the distribution of the existing value of a converting institution, or could or should the matter be left entirely to the trustees?

(3) Whether it is legislation or the FDIC or the board of trustees that sets standards, what should they be? Who should get some of the value, how much, and how specific should the rules be?

(4) If depositors (or creditors or borrowers or employees) are to receive some of the value, how should it be allocated among them? Should amount of deposit or tenure of association be accorded more weight? Must depositors and debtholders be treated identically? What practical constraints exist, based on mutuals' information systems and resources? What should the record date be?

(5) If charitable organizations or foundations are to receive a portion of the value, how should the suitability of the recipients be determined? Should there be a presumption that the trustees' selection of recipients is reasonable? Do there need to be rules to prevent abuse of such entities—*e.g.*, through "consulting contracts" with trustees? Should such entities be required to sell at the time of conversion, or should they be permitted to diversify over time, in accordance with existing federal tax and banking laws?

(6) Does "pressure to convert" from parties who would receive value if an institution did so represent a legitimate public policy concern? How great might that pressure be? How can trustees of institutions which have not elected to convert be protected from unreasonable litigation?

(7) What potential problems (including tax issues and insider abuses) are there with the proposed new form of transaction, and how can they be avoided or alleviated? On the assumption that the market will gradually improve on any form of transaction, how specific does legislation or regulation need to be in that area?

(8) Should converting institutions (including those doing merger conversions) be required or encouraged to obtain "fairness opinions" from independent financial advisors? Should the FDIC attempt to "police" the market judgements involved in the process in any way?

(9) Should new mutual holding company creations be permitted? If not, how should existing ones be regulated?

By the order of the Board of Directors.

Dated at Washington, D.C., this 31 day of May, 1994.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

*Acting Executive Secretary.*

[FR Doc. 94-14006 Filed 6-10-94; 8:45am]

BILLING CODE 6714-01-P

## FEDERAL RESERVE SYSTEM

### Banco Bilbao; Acquisition of Company Engaged in Permissible Nonbanking Activities

Banco Bilbao Vizcaya, S.A., Bilbao, Spain (Applicant), a foreign banking organization subject to the Bank Holding Company Act (BHC Act), has applied pursuant to section 4(c)(8) of the BHC Act and § 225.23(a)(2) and (3) of the Board's Regulation Y (12 CFR 225.23(a)(2) and (3)), to retain an interest in its indirect subsidiary, Probursa International Incorporated, New York, New York (Company), and thereby engage in the following securities-related activities:

(1) providing investment advisory services pursuant to § 225.25(b)(4) of the Board's Regulation Y (12 CFR 225.25(b)(4));

(2) providing full service brokerage services pursuant to §§ 225.25(b)(4) and (b)(15) of Regulation Y (12 CFR 225.25(b)(4) and (b)(15)), including exercising investment discretion on behalf of institutional customers;

(3) buying and selling, on the order of customers, all types of securities as a riskless principal; and

(4) engaging in the private placement of all types of securities as agent.

Section 4(c)(8) of the BHC Act provides that a bank holding company may, with Board approval, engage in any activity "which the Board, after due notice and opportunity for hearing, has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." This statutory test requires that two separate tests be met for an activity to be permissible for a bank holding company. First, the Board must

# 12 CFR § 239.8 - Operating restrictions.

CFR

## § 239.8 Operating restrictions.

**(a)** ***Activities restrictions.*** A mutual holding company may engage in any business activity specified in 12 U.S.C. 1467a(c)(2) or (c)(9)(A)(ii). In addition, the business activities of subsidiaries of mutual holding companies may include the activities specified in § 239.7(a)(6). A mutual holding company or its subsidiaries may engage in the foregoing activities only upon compliance with the procedures specified in §§ 238.53(c) or 238.54(b) of this chapter.

**(b)** ***Pledging stock.***

**(1)** No mutual holding company may pledge the stock of its resulting association, an acquiree association, or any subsidiary savings association that was in the mutual form when acquired by the mutual holding company (or its parent mutual holding company), unless the proceeds of the loan secured by the pledge are infused into the association whose stock is pledged. No mutual holding company may pledge the stock of its subsidiary holding company unless the proceeds of the loan secured by the pledge are infused into any subsidiary savings association of the subsidiary holding company that is a resulting association, an acquiree association, or a subsidiary savings association that was in the mutual form when acquired by the subsidiary holding company (or its parent mutual holding company). In the event the subsidiary holding company has more than one subsidiary savings association, the loan proceeds shall, unless otherwise approved by the Board, be infused in equal amounts to each subsidiary savings association. Any amount of the stock of such association or subsidiary holding company may be pledged for these purposes. Nothing in this paragraph shall be deemed to prohibit:

**(i)** The payment of dividends from a subsidiary savings association to its mutual holding company parent to the extent otherwise permissible; or

**(ii)** The payment of dividends from a subsidiary holding company to its mutual holding company parent to the extent otherwise permissible; or

**(iii)** A mutual holding company from pledging the stock of more than one subsidiary savings association provided that the stock pledged of each such subsidiary association is proportionate to the proceeds of the loan infused into each subsidiary association.

**(2)** Any mutual holding company that fails to make any payment on a loan secured by the pledge of stock pursuant to paragraph (b)(1) of this section on or before the date on which such payment is due shall, on the first day after such payment is due, provide written notice of nonpayment to the appropriate Reserve Bank.

**(c)** ***Restrictions on stock repurchases.***

**(1)** No subsidiary holding company that has any stockholders other than its parent mutual holding company may repurchase any share of stock within one year of its date of issuance (which may include the time period the shares issued by the savings association were outstanding if the subsidiary holding company was formed after the initial issuance by the savings association), unless the repurchase:

**(i)** Is in compliance with the requirements set forth in § 239.63;

**(ii)** Is part of a general repurchase made on a pro rata basis pursuant to an offer approved by the Board and made to all stockholders of the association or subsidiary holding company (except that the parent mutual holding company may be excluded from the repurchase with the Board's approval);

**(iii)** Is limited to the repurchase of qualifying shares of a director; or

**(iv)** Is purchased in the open market by a tax-qualified or non-tax-qualified employee stock benefit plan of the savings association (or of a subsidiary holding company) in an amount reasonable and appropriate to fund such plan.

**(2)** No mutual holding company may purchase shares of its subsidiary savings association or subsidiary holding company within one year after a stock issuance, except if the purchase complies with § 239.63. For purposes of this section, the reference in § 239.63 to five percent refers to minority shareholders.

**(d)** ***Restrictions on waiver of dividends.***

**(1)** A mutual holding company may waive the right to receive any dividend declared by a subsidiary of the mutual holding company, if—

**(i)** No insider of the mutual holding company, associate of an insider, or tax-qualified or non-tax-qualified employee stock benefit plan of the mutual holding company holds any share of the stock in the class of stock to which the waiver would apply; or

**(ii)** The mutual holding company gives written notice to the Board of the intent of the mutual holding company to waive the right to receive dividends, not later than 30 days before the date of the proposed date of payment of the dividend, and the Board does not object to the waiver.

**(2)** A notice of a waiver under paragraph (d)(1)(ii) of this section shall include a copy of the resolution of the board of directors of the mutual holding company together with any supporting materials relied upon by the board of directors of the mutual holding company, concluding that the proposed dividend waiver is consistent with the fiduciary duties of the board of directors to the mutual members of the mutual holding company.

The resolution shall include:

**(i)** A description of the conflict of interest that exists because of a mutual holding company director's ownership of stock in the subsidiary declaring dividends and any actions the mutual holding company and board of directors have taken to eliminate the conflict of interest, such as waiver by the directors of their right to receive dividends;

**(ii)** A finding by the mutual holding company's board of directors that the waiver of dividends is consistent with the board of directors' fiduciary duties despite any conflict of interest;

**(iii)** If the mutual holding company has pledged the stock of a subsidiary holding company or subsidiary savings association as collateral for a loan made to the mutual holding company, or is subject to any other loan agreement, an affirmation that the mutual holding company is able to meet the terms of the loan agreement; and

**(iv)** An affirmation that a majority of the mutual members of the mutual holding company eligible to vote have, within the 12 months prior to the declaration date of the dividend by the subsidiary of the mutual holding company, approved a waiver of dividends by the mutual holding company, and any proxy statement used in connection with the member vote contained—

**(A)** A detailed description of the proposed waiver of dividends by the mutual holding company and the reasons the board of directors requested the waiver of dividends;

**(B)** The disclosure of any mutual holding company director's ownership of stock in the subsidiary declaring dividends and any actions the mutual holding company and board of directors have taken to eliminate the conflict of interest, such as the directors waiving their right to receive dividends; and

**(C)** A provision providing that the proxy concerning the waiver of dividends given by the mutual members may be used for no more than 12 months from the date it is given.

**(3)** The Board may not object to a waiver of dividends under paragraph (d)(1)(ii) of this section if:

**(i)** The waiver would not be detrimental to the safe and sound operation of the savings association;

**(ii)** The board of directors of the mutual holding company expressly determines that a waiver of the dividend by the mutual holding company is consistent with the fiduciary duties of the board of directors to the mutual members of the mutual holding company; and

**(iii)** The mutual holding company has, prior to December 1, 2009—

**(A)** Reorganized into a mutual holding company under section 10(o) of HOLA;

**(B)** Issued minority stock either from its mid-tier stock holding company or its subsidiary stock savings association; and

**(C)** Waived dividends it had a right to receive from the subsidiary stock savings association.

**(4)** For a mutual holding company that does not meet each of the conditions in paragraph (d)(3) of this section, the Board will not object to a waiver of dividends under paragraph (d)(1)(ii) of this section if—:

**(i)** The savings association currently operates in a manner consistent with the safe and sound operation of a savings association, and the waiver is not detrimental to the safe and sound operation of the savings association;

**(ii)** If the mutual holding company has pledged the stock of a subsidiary holding company or subsidiary savings association as collateral for a loan made to the mutual holding company, or is subject to any other loan agreement, an affirmation that the mutual holding company is able to meet the terms of the loan agreement;

**(iii)** Within the 12 months prior to the declaration date of the dividend by the subsidiary of the mutual holding company, a majority of the mutual members of the mutual holding company has approved the waiver of dividends by the mutual holding company. Any proxy statement used in connection with the member vote must contain—

**(A)** A detailed description of the proposed waiver of dividends by the mutual holding company and the reasons the board of directors requested the waiver of dividends;

**(B)** The disclosure of any mutual holding company director's ownership of stock in the subsidiary declaring dividends and any actions the mutual holding company and board of directors have taken to eliminate the conflict of interest, such as the directors waiving their right to receive dividends; and

**(C)** A provision providing that the proxy concerning the waiver of dividends given by the mutual members may be used for no more than 12 months from the date it is given;

**(iv)** The board of directors of the mutual holding company expressly determines that the waiver of dividends is consistent with the board of directors' fiduciary duties despite any conflict of interest;

**(v)**

**(A)** A majority of the entire board of directors of the mutual holding company approves the waiver of dividends and any director with direct or indirect ownership, control, or the power to vote shares of the subsidiary declaring the dividend, or who otherwise directly or indirectly benefits through an associate from the waiver of dividends, has abstained from the board vote; or

**(B)** Each officer or director of the mutual holding company or its affiliates, associate of such officer or director, and any tax-qualified or non-tax-qualified employee stock benefit plan in which such officer or director participates that holds any share of the stock in the class of stock to which the waiver would apply waives the right to receive any dividend declared by a subsidiary of the mutual holding company;

**(vi)** The Board does not object to the amount of dividends declared by a subsidiary of the mutual holding company. In reviewing whether a declaration by a subsidiary of the mutual holding company is appropriate, the Board may consider, among other factors, the reasonableness of the entire dividend distribution declared if the waiver is not approved;

**(vii)** The waived dividends are excluded from the capital accounts of the subsidiary holding company or savings association, as applicable, for purposes of calculating any future dividend payments;

**(viii)** The mutual holding company appropriately accounts for all waived dividends in a manner that permits the Board to consider the waived dividends in evaluating the proposed exchange ratio in the event of a full conversion of the mutual holding company to stock form; and

**(ix)** The mutual holding company complies with such other conditions as the Board may require to prevent conflicts of interest or actions detrimental to the safe and sound operation of the savings association.

**(5)** *Valuation.*

**(i)** The Board will consider waived dividends in determining an appropriate exchange ratio in the event of a full conversion to stock form.

**(ii)** In the case of a savings association that has reorganized into a mutual holding company, has issued minority stock from a mid-tier stock holding company or a subsidiary stock savings association of the mutual holding company, and has waived dividends it had a right to receive from a subsidiary savings association before December 1, 2009, the Board shall not consider waived dividends in determining an appropriate exchange ratio in the event of a full conversion to stock form.

**(e)** ***Restrictions on issuance of stock to insiders.*** A subsidiary of a mutual holding company that is not a savings association or subsidiary holding company may issue stock to any insider, associate of an insider or tax-qualified or non-tax-qualified employee stock benefit plan of the mutual holding company or any subsidiary of the mutual holding company, provided that such persons or plans provide written notice to the appropriate Reserve Bank at least 30 days prior to the stock issuance, and the Reserve Bank or the Board does not object to the subsequent stock issuance. Subsidiary holding companies may issue stock to such persons only in accordance with § 239.24.

**(f)** ***Applicability of rules governing savings and loan holding companies.*** Except as expressly provided in this part, mutual holding companies shall be subject to the provisions of 12 U.S.C. 1467a and 3201 *et seq.* and the provisions of parts 207, 228, and 238 of this chapter.

**(g)** ***Separate vote for charitable organization contribution.*** In a mutual holding company stock issuance, a separate vote of a majority of the outstanding shares of common stock held by stockholders other than the mutual holding company or subsidiary holding company must approve any charitable organization contribution.

# 12 CFR § 239.24 - Issuances of stock by subsidiary holding companies of mutual holding companies.



## § 239.24 Issuances of stock by subsidiary holding companies of mutual holding companies.

**(a)** *Requirements.* No subsidiary holding company of a mutual holding company may issue stock to persons other than its mutual holding company parent in connection with a mutual holding company reorganization, or at any time subsequent to the subsidiary holding company's acquisition by the mutual holding company, unless the subsidiary holding company obtains advance approval of each such issuance from the Board. Approval of a mutual holding company reorganization filed pursuant to § 239.3(a) shall be deemed to constitute approval of any stock issuance specifically applied for pursuant to this section in connection with the reorganization, unless otherwise specified by the Board. The Board shall approve any proposed issuance that meets each of the criteria set forth below in paragraphs (a)(1) through (a)(7) of this section.

**(1)** The proposed issuance is to be made pursuant to a Stock Issuance Plan that contains all the provisions required by § 239.25.

**(2)** The Stock Issuance Plan is consistent with the terms of the subsidiary holding company's charter (or any proposed amendments thereto), including terms governing the type and amount of stock that may be issued.

**(3)** The Stock Issuance Plan would provide the subsidiary holding company, its mutual holding company parent, and any subsidiary savings associations of the subsidiary holding company with fully sufficient capital and would not be inequitable or detrimental to the subsidiary holding company or its mutual holding company parent or to members of the mutual holding company parent.

**(4)** The proposed price or price range of the stock to be issued is reasonable. The Board shall review the reasonableness of the proposed price or price range.

**(5)** The aggregate amount of outstanding common stock of the subsidiary holding company owned or controlled by persons other than the subsidiary holding company's mutual holding company parent at the close of the proposed issuance shall be less than 50 percent of the subsidiary holding company's total outstanding common stock, unless the subsidiary holding company was a stock holding company when acquired by the mutual holding company, in which case the foregoing restriction shall not apply. Any amount of preferred stock may be issued by any subsidiary holding company of a mutual holding company to persons other than the subsidiary holding company's mutual holding company, consistent with any other applicable laws and regulations.

**(6)** The subsidiary holding company furnishes the information required by the Board in connection with the proposed issuance.

**(7)** The proposed stock issuance meets the convenience and needs standard of § 239.55(g).

**(8)** The proposed issuance complies with all other applicable laws and regulations.

**(9)** Unless otherwise determined by the Board, the limitations on the minimum and maximum amounts of the estimated price range required by § 239.59(c) shall apply.

**(b)** ***Related approvals.*** Approval by the Board of any stock issuance pursuant to this section shall also be deemed to constitute:

**(1)** Approval of the form of stock certificate proposed to be utilized in connection with the stock issuance, provided such form was included in the application materials filed pursuant to this section; and

**(2)** Approval of any charter or bylaw amendment required to authorize issuance of the stock, provided such amendment was proposed in the application materials filed pursuant to this section.

**(c)** ***Offering restrictions.***

**(1)** No representations may be made in any manner in connection with the offer or sale of any stock issued pursuant to this section that the price, price range or any other pricing information related to such stock issuance has been approved by the Board or that the stock has been approved or disapproved by the Board or that the Board has endorsed the accuracy or adequacy of any securities offering documents disseminated in connection with such stock.

**(2)** The sale of minority stock of the subsidiary holding company to be made under the minority stock issuance plan, including any sale in a public offering or direct community marketing, shall be completed as promptly as possible and within 45 calendar days after the last day of the subscription period, unless extended by the Board.

**(3)** In the offer, sale, or purchase of stock issued pursuant to this section, no person shall:

**(i)** Employ any device, scheme, or artifice to defraud;

**(ii)** Make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

**(iii)** Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser or seller.

**(4)** Prior to the completion of a stock issuance pursuant to this section, no person shall transfer, or enter into any agreement or understanding to transfer, the legal or beneficial ownership of the stock to be issued to any other person.

**(5)** Prior to the completion of a stock issuance pursuant to this section, no person shall make any offer, or any announcement of any offer, to purchase any stock to be issued, or knowingly acquire any stock in the issuance, in excess of the maximum purchase limitations established in the Stock Issuance Plan.

**(6)** All stock issuances pursuant to this section must:

**(i)** Comply with § 239.59 and, to the extent applicable, the form or forms specified by the Board; and

**(ii)** Provide that the offering be structured in a manner similar to a standard conversion under subpart E of this part, including the stock purchase priorities accorded members of the issuing subsidiary holding company's mutual holding company, unless the subsidiary holding company would qualify for a supervisory conversion if it were to undertake a conversion under subpart E of this part; or demonstrates to the satisfaction of the Board that a non-conforming issuance would be more beneficial to the savings association and subsidiary holding company compared to a conforming offering, considering, in the aggregate, the effect of each on the savings association and subsidiary holding company's financial and managerial resources and future prospects, the effect of the issuance upon the savings association and subsidiary holding company, the insurance risk to the Deposit Insurance Fund, and the convenience and needs of the community to be served.

**(7)** Notwithstanding the restrictions in paragraph (c)(6)(ii) of this section, a subsidiary holding company of a mutual holding company may issue stock as part of a stock benefit plan to any insider, associate of an insider, or tax qualified or non-tax qualified employee stock benefit plan of the mutual holding company or subsidiary of the mutual holding company without including the purchase priorities of subpart E of this part.

**(8)** As part of a reorganization, a reasonable amount of shares or proceeds may be contributed to a charitable organization that complies with §§ 239.64(b) to 239.64(f), provided such contribution does not result in any taxes on excess business holdings under section 4943 of the Internal Revenue Code (26 U.S.C. 4943).

**(d)** ***Procedural and substantive requirements.*** The procedural and substantive requirements of subpart E of this part shall apply to all mutual holding company stock issuances and subsidiary holding company stock issuances under this section, unless clearly inapplicable, as determined by the Board. For purposes of this paragraph, the term *conversion* as it appears in the provisions of subpart E of this part shall refer to the stock issuance, and the term *mutual holding company* shall refer to the subsidiary holding company undertaking the stock issuance.

CFR Toolbox

Law about... Articles from Wex
Table of Popular Names
Parallel Table of Authorities

LII > Electronic Code of Federal Regulations (e-CFR) > Title 12—Banks and Banking
> CHAPTER II—FEDERAL RESERVE SYSTEM
> SUBCHAPTER A—BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
> PART 239—MUTUAL HOLDING COMPANIES (REGULATION MM)
> Subpart C—Subsidiary Holding Companies
> **§ 239.25 Contents of Stock Issuance Plans.**

# 12 CFR § 239.25 - Contents of Stock Issuance Plans.

CFR Table of Popular Names

## § 239.25 Contents of Stock Issuance Plans.

**(a)** *Mandatory provisions.* Each of the provisions mandatory for all stock issuance plans under this paragraph (a) shall be deemed regulatory requirements. Each Stock Issuance Plan shall contain a complete description of all significant terms of the proposed stock issuance (including the information specified in § 239.65(f) to the extent known), shall attach and incorporate the proposed form of stock certificate, the proposed stock order form, and any agreements or other documents defining the rights of the stockholders, and shall:

**(1)** Provide that the stock shall be sold at a total price equal to the estimated *pro forma* market value of such stock, based upon an independent valuation;

**(2)** Provide that the aggregate amount of outstanding common stock of the subsidiary holding company owned or controlled by persons other than the subsidiary holding company's mutual holding company parent at the close of the proposed issuance shall be less than fifty percent of the subsidiary holding company's total outstanding common stock (This provision may be omitted if the proposed issuance will be conducted by a subsidiary holding company that was in the stock form when acquired by its mutual holding company parent);

**(3)** Provide that all employee stock ownership plans or other tax-qualified employee stock benefit plans (collectively, ESOPs) must not encompass, in the aggregate, more than either 4.9 percent of the outstanding shares of the subsidiary holding company's common stock or 4.9 percent of the subsidiary holding company's stockholders' equity at the close of the proposed issuance;

**(4)** Provide that all ESOPs and management recognition plans (MRPs) must not encompass, in the aggregate, more than either 4.9 percent of the outstanding shares of the subsidiary holding company's common stock or 4.9 percent of the subsidiary holding company's stockholders' equity at the close of the proposed issuance. However, if the subsidiary holding company's tangible capital equals at least ten percent at the time of implementation of the plan, the Board may permit such ESOPs and MRPs to encompass, in the aggregate, up to 5.88 percent of the outstanding common stock or stockholders' equity at the close of the proposed issuance;

**(5)** Provide that all MRPs must not encompass, in the aggregate, more than either 1.47 percent of the common stock of the subsidiary holding company or 1.47 percent of the subsidiary holding company's stockholders' equity at the close of the proposed issuance. However, if the subsidiary holding company's tangible capital is at least ten percent at the time of implementation of the plan, the Board may permit MRPs to encompass, in the aggregate, up to 1.96 percent of the outstanding shares of the subsidiary holding company's common stock or 1.96 percent of the savings subsidiary holding company's stockholders' equity at the close of the proposed issuance;

**(6)** Provide that all stock option plans (Option Plans) must not encompass, in the aggregate, more than either 4.9 percent of the subsidiary holding company's outstanding common stock at the close of the proposed issuance or 4.9 percent of the subsidiary holding company's stockholders' equity at the close of the proposed issuance;

**(7)** Provide that an ESOP, a MRP or an Option Plan modified or adopted no earlier than one year after the close of: the proposed issuance, or any subsequent issuance that is made in substantial conformity with the purchase priorities § 239.59(a) set forth in subpart E of this part, may exceed the percentage limitations contained in paragraphs (a)(3) through (6) of this section (plan expansion), subject to the following two requirements. First, all common stock awarded in connection with any plan expansion must be acquired for such awards in the secondary market. Second, such acquisitions must begin no earlier than when such plan expansion is permitted to be made;

**(8)**

**(i)** Provide that the aggregate amount of common stock that may be encompassed under all Option Plans and MRPs, or acquired by all insiders of the subsidiary holding company and subsidiary savings association and associates of insiders of the subsidiary holding company and subsidiary savings association, must not exceed the following percentages of common stock or stockholders' equity of the subsidiary holding company, held by persons other than the subsidiary holding company's mutual holding company parent at the close of the proposed issuance:

| Institution size | Officer and director purchases (percent) |
|---|---|
| $ 50,000,000 or less | 35 |
| $ 50,000,001-100,000,000 | 34 |
| $100,000,001-150,000,000 | 33 |
| $150,000,001-200,000,000 | 32 |
| $200,000,001-250,000,000 | 31 |
| $250,000,001-300,000,000 | 30 |
| $300,000,001-350,000,000 | 29 |
| $350,000,001-400,000,000 | 28 |
| $400,000,001-450,000,000 | 27 |
| $450,000,001-500,000,000 | 26 |
| Over $500,000,000 | 25 |

**(ii)** The percentage limitations contained in paragraph 8(i) of this section may be exceeded provided that all stock acquired by insiders and associates of insiders or awarded under all MRPs and Option Plans in excess of those limitations is acquired in the secondary market. If acquired for such awards on the secondary market, such acquisitions must begin no earlier than one year after the close of the proposed issuance or any subsequent issuance that is made in substantial conformity with the purchase priorities set forth in subpart E of this part.

**(iii)** In calculating the number of shares held by insiders and their associates under this provision, shares awarded but not delivered under an ESOP, MRP, or Option Plan that are attributable to such persons shall not be counted as being acquired by such persons.

**(9)** Provide that the amount of common stock that may be encompassed under all Option Plans and MRPs must not exceed, in the aggregate, 25 percent of the outstanding common stock held by persons other than the subsidiary holding company's mutual holding company parent at the close of the proposed issuance;

**(10)** Provide that the issuance shall be conducted in compliance with, to the extent applicable, the forms required by the Board;

**(11)** Provide that the sales price of the shares of stock to be sold in the issuance shall be a uniform price determined in accordance with § 239.24;

**(12)** Provide that, if at the close of the stock issuance the subsidiary holding company has more than thirty-five shareholders of any class of stock, the subsidiary holding company shall promptly register that class of stock pursuant to the Securities Exchange Act of 1934, as amended (15 U.S.C. 78a-78jj), and undertake not to deregister such stock for a period of three years thereafter;

**(13)** Provide that, if at the close of the stock issuance the subsidiary holding company has more than one hundred shareholders of any class of stock, the subsidiary holding company shall use its best efforts to:

**(i)** Encourage and assist a market maker to establish and maintain a market for that class of stock; and

**(ii)** List that class of stock on a national or regional securities exchange or on the NASDAQ quotation system;

**(14)** Provide that, for a period of three years following the proposed issuance, no insider of the subsidiary holding company or his or her associates shall purchase, without the prior written approval of the Board, any stock of the subsidiary holding company except from a broker dealer registered with the Securities and Exchange Commission, except that the foregoing restriction shall not apply to:

**(i)** Negotiated transactions involving more than one percent of the outstanding stock in the class of stock; or

**(ii)** Purchases of stock made by and held by any tax-qualified or non-tax-qualified employee stock benefit plan of the subsidiary holding company even if such stock is attributable to insiders of the subsidiary holding company and subsidiary savings association or their associates;

**(15)** Provide that stock purchased by insiders of the subsidiary holding company and subsidiary savings association and their associates in the proposed issuance shall not be sold for a period of at least one year following the date of purchase, except in the case of death of the insider or associate;

**(16)** Provide that, in connection with stock subject to restriction on sale for a period of time:

**(i)** Each certificate for such stock shall bear a legend giving appropriate notice of such restriction;

**(ii)** Appropriate instructions shall be issued to the subsidiary holding company's transfer agent with respect to applicable restrictions on transfer of such stock; and

**(iii)** Any shares issued as a stock dividend, stock split, or otherwise with respect to any such restricted stock shall be subject to the same restrictions as apply to the restricted stock;

**(17)** Provide that the subsidiary holding company will not offer or sell any of the stock proposed to be issued to any person whose purchase would be financed by funds loaned, directly or indirectly, to the person by the subsidiary holding company;

**(18)** Provide that, if necessary, the subsidiary holding company's charter will be amended to authorize issuance of the stock and attach and incorporate by reference the text of any such amendment;

**(19)** Provide that the expenses incurred in connection with the issuance shall be reasonable;

**(20)** Provide that the Stock Issuance Plan, if proposed as part of a Reorganization Plan, may be amended or terminated in the same manner as the Reorganization Plan. Otherwise, the Stock Issuance Plan shall provide that it may be substantively amended by the board of directors of the issuing subsidiary holding company as a result of comments from regulatory authorities or otherwise prior to approval of the Plan by the Board, and at any time thereafter with the concurrence of the Board; and that the Stock Issuance Plan may be terminated by the board of directors at any time prior to approval of the Plan by the Board, and at any time thereafter with the concurrence of the Board;

**(21)** Provide that, unless an extension is granted by the Board, the Stock Issuance Plan shall be terminated if not completed within 90 days of the date of such approval; or

**(22)** Provide that the subsidiary holding company may make scheduled discretionary contributions to a tax-qualified employee stock benefit plan provided such contributions do not cause the subsidiary holding company to fail to meet any of its regulatory capital requirements.

**(b)** ***Optional provisions.*** A Stock Issuance Plan may:

**(1)** Provide that, in the event the proposed stock issuance is part of a Reorganization Plan, the stock offering may be commenced concurrently with or at any time after the mailing to the members of the reorganizing association and any acquiree association of any proxy statement(s). The offering may be closed before the required membership vote(s), provided the offer and sale of the stock shall be conditioned upon the approval of the Reorganization Plan and Stock Issuance Plan by the members of the reorganizing association and any acquiree association;

**(2)** Provide that any insignificant residue of stock of the subsidiary holding company not sold in the offering may be sold in such other manner as provided in the Stock Issuance Plan, with the Board's approval;

**(3)** Provide that the subsidiary holding company may issue and sell, in lieu of shares of its stock, units of securities consisting of stock and long-term warrants or other equity securities, in which event any reference in the provisions of this section and in § 239.24 to stock shall apply to such units of equity securities unless the context otherwise requires; or

**(4)** Provide that the subsidiary holding company may reserve shares representing up to ten percent of the proposed offering for issuance in connection with an employee stock benefit plan.

**(c)** ***Applicability of provisions of § 239.63(a)(1) to minority stock issuances.*** Notwithstanding § 239.24(d), § 239.63(a)(1)(ii) do not apply to minority stock issuances, because the permissible sizes of ESOPs, MRPs, and Option Plans in minority stock issuances are subject to each of the requirements set forth at paragraphs (a)(3) through (a)(9) of this section. Section 239.63(a)(4) through (a)(14), apply for one year after the subsidiary holding company engages in a minority stock issuance that is conducted in accordance with the purchase priorities set forth in subpart E of this part. In addition to the shareholder vote requirement for Option Plans and MRPs set forth at § 239.63(a)(1)(vi), any Option Plans and MRPs put to a shareholder vote after a minority stock issuance that is conducted in accordance with the purchase priorities set forth in subpart E of this part must be approved by a majority of the votes cast by stockholders other than the mutual holding company.

CFR Toolbox

# GUT v. MACDONOUGH, No

Decided Aug 14, 2007

No. 2007-1083-C.

August 14, 2007.

PETER W. AGNES, JR., Justice of the Superior Court.

## I. INTRODUCTION

This is a civil action in the nature of a shareholder derivative action by Philippe Gut and Gwen Pratt Gut ("plaintiffs"), two minority shareholders of defendant Westboro Financial Services, Inc., a mid-tier holding company of defendant Westboro Bank. Defendant Westboro Financial Services, Inc. is majority owned by defendant Westboro Bancorp, MHC, a Massachusetts-chartered mutual holding company.[2] Defendant Westboro Bancorp, MHC owns approximately 64% of the outstanding shares of defendant Westboro Financial Services, Inc. and is controlled by a board of trustees most or all of whom also serve as its directors.

[2] For convenience, throughout this decision the three entities which are defendants will be referred to as "Westboro" unless a specific reference to one particular entity is required.

The plaintiffs allege that a pending merger agreement between Westboro and Assabet Valley Bancorp ("Assabet") whereby Assabet will acquire the outstanding publically owned shares of Westboro Financial's common stock for the price is $35 per share should be enjoined under Massachusetts law because the price per share is "grossly inadequate."[3] In a nutshell, the plaintiffs claim that the merger deal has been driven by defendant Joseph F. MacDonough, who is the CEO and a director of Westboro and that he and other directors of Westboro are "conflicted" and not disinterested, and have pursued a course of conduct which amounts to self-dealing to the great detriment of the minority shareholders of Westboro. The plaintiffs allege, in particular, that (1) the process leading to the merger was flawed and unlawful because Westboro pursued a one-party negotiation with Assabet instead of "shopping" the bank around in hope of attracting a merger partner willing to pay a higher price for the common stock, (2) that upon reaching a tentative deal with Assabet, Westboro entered into an unreasonable "lock-up" agreement which contained a 5% termination fee that effectively foreclosed other potentially interested parties from entering the merger competition and correspondingly prevented Westboro from giving meaningful consideration to any other bidders, and (3) that following the agreement with Assabet, Westboro rejected out of hand several offers which would have resulted in a price per share of Westboro common stock of $38.50, $40.00 and $41.00 respectively.

[3] See plaintiff's Verified Complaint, paragraph (1). "The merger agreement involves what is known as a 'remutualization transaction.' In a remutualization transaction, no payment is made for the disappearing mutual institution because there are no shareholders of a mutual institution. Thus, no payment will be made for the shares of Westborough Financial that are owned by Westborough MHC." Affidavit of Joseph F. MacDonough, para. 26.

The defendants deny each and every one of these
3 allegations. The defendant Directors of *3 Westborough maintain that they are disinterested and that they have acted at all times in accordance with their fiduciary obligations which under Massachusetts law are owed to the investors in defendant Westboro Bancorp, MHC, local economic and community interests, *and* the minority shareholders. The defendants maintain that the decision to enter into a one-party negotiation was not a rush to judgment, but rather a considered, tactical choice after receiving neutral and expert advice from their independent financial advisor, Richard Lewis Quad of RBC Capital Markets ("RBC"), and after a Board evaluation that identified Assabet as the strongest prospect. The defendants also maintain that the compensation and benefits to be paid by Assabet to certain officers and directors of Westboro as a result of the merger did not result in a windfall, but rather was less than the compensation these individuals were entitled to as a result of pre-merger agreements they had with Westboro. The defendants also maintain that they did not foreclose consideration of potentially better merger deals after entering into an agreement with Assabet and that there was nothing in their agreement with Assabet that effectively prevented others from exploring a merger with Westboro. Finally, the defendants maintain that there was never a offer higher than $35.00 per share of common stock from a potential merger partner that was in the best interests of Westboro.

This matter came before the Court for argument on August 9, 2007. Under the terms of the merger agreement between Westborough and Assabet, if the merger is not consummated by August 15, 2007, Assabet can walk away from the deal and leave Westborough to pursue whatever other options may exist.

## II. STANDARD FOR GRANTING A PRELIMINARY INJUNCTION

4 *4

In deciding whether to grant a preliminary injunction, the court is required to perform a multi-part analysis. *Packaging Industries Group, Inc. v. Cheney*, 380 Mass. 606, 616-17 (1980). Initially, the court must determine whether the moving party has demonstrated a likelihood of success on the merits, and that it faces a substantial risk of irreparable harm-losses that cannot be repaired or for which compensation will not be adequate after final judgment-if the motion for the preliminary injunction is not granted. *Id. at 617* n. 11. See *Hull Mun. Lighting Plant v. Massachusetts Municipal Wholesale Elec. Co.*, 399 Mass. 640, 641 (1987). If the moving party has met this burden, the court must then engage in a balancing test in which the irreparable harm faced by the moving party is compared to the harm that an injunction would inflict on the other party. "If the judge is convinced that failure to issue the injunction would subject the moving party to a substantial risk of irreparable harm, the judge must then balance this risk against any similar risk of irreparable harm which granting the inunction would create for the opposing party." *Id.* at 617. In balancing these factors, "[w]hat matters as to each party is not the raw amount of irreparable harm the party might conceivably suffer, but rather the risk of sch harm in light of the party's chance of success on the merits. Only where the balance between these risks cuts in favor of the moving party may a preliminary injunction properly issue." *Id.* Furthermore, in an appropriate case, "the risk of harm to the public interest also may be considered." *Brookline v. Goldstein*, 388 Mass. 443, 447 (1983). *See also LeClair v. Town of Norwell*, 430 Mass. 328, 337 (1999); *Commonwealth v. Mass. CRINC*, 392 Mass. 79, 89 (1984).

## III. FACTUAL BACKGROUND

Unlike the typical case in which a preliminary injunction is sought on the basis of an abbreviated and often incomplete set of facts, the parties in this
5 case have engaged in pretrial *5 discovery and have supplied the court with a substantial record

consisting of pleadings, depositions, affidavits and various attachments. The court has reviewed the record in its entirety. Nonetheless, the following factual findings are preliminary in nature and not necessarily controlling on the court at trial.

## A. Events Leading Up to the Consideration of a Merger by Westboro.

Westboro bank was chartered in 1869 (coincidently, the same year as Assabet) and operated as a state chartered mutual savings back until 2000. In that year, Westboro reorganized into a Massachusetts mutual holding company. The Westboro Bank became a Massachusetts chartered stock savings bank, wholly-owned by Westboro Financial. Westboro MHC was formed and became the mutual holding company parent of Westboro Financial. Westboro MHC owns approximately 64% of Westboro Financial's outstanding common stock. The remaining 36% is publically owned.

Westboro Bank is headquartered in Westboro and maintains offices in the towns of Northboro and Shrewsbury. I accept as credible the characterizations by Joseph F. MacDonough who is the President and Chief Executive Officer ("CEO") of Westboro Bancorp MHC, Westboro Financial Services, Inc., and the Westboro Bank of the bank's mission and the nature of its business:

> Westboro Bank is a community-oriented financial institution, offering a variety of financial services to meet the needs of the communities it serves. In addition to offering traditional banking services, Westboro Bank sponsors a host of community activities to enhance the social and economic welfare of the communities it serves.
>
> Westboro Bank's principal business consists of attracting retail deposits from the general public and investing those funds primarily in loans secured by first mortgages on owner-occupied, one-to four-family residences, and, to a lesser extent, in commercial real estate and commercial loans to small businesses. Total assets as of June 30, 2007 were approximately $298 million, of which loans comprised approximately $205 million, and total deposits were approximately $213 million.

*6

Affidavit of Joseph F. MacDonough, para. 5-6.

It is apparent from the record before me that over several years prior to 2006, Westboro Bank began to experience financial difficulties. Mr. McDonough described the decline as a result of a combination of factors including competition from less regulated financial service providers, local expansion of cred't unions and large national banks, and "interest margin compression" due to the increasing cost of compliance with new federal laws and the bank's emphasis on residential lending. Affidavit of Joseph F. MacDonough, para. 8. According to Mr. James N. Ball, a trustee of Westboro Bancorp MHC, and a director of both Westboro Financial Services, where he serves as chair of the Nondeposit Investment Products Committee, and the Westboro Bank, where he serves as a member of the Long Range Planning Committee, concerns about the bank's financial future in the period prior to 2006 stemmed from litigation expenses and adverse publicity due to a theft by an employee, the firing of another employee for not reporting certain commissions he was required to share with the bank, the "net interest margin compression" resulting from an increase in the Federal Reserve Bank's interest rate, and the lower profit earned by the bank due to its "heavy reliance on residential lending." Affidavit of James N. Ball, para. 7-8.

I accept as credible Mr. Ball's characterization of the motives that led Westboro Bank to begin looking for a merger partner.

> The impact of the flat yield curve on the Bank's residential-heavy loan portfolio, together with intense competition for residential mortgage loans, prompted the Board to look for ways to become more involved in the more interest rate-sensitive commercial loan arena. Commercial deposits are attractive because they are low cost (no or low interest). For these reasons, the Board became interested in finding a merger partner with an established commercial department, which Westboro lacked.

7 Affidavit of James N. Ball, para. 9. *7

## B. Westboro Obtains Independent Expert Advice About its Options

RBC is an international corporate and investment bank. Mr. Richard Quad is a director in the Financial Institutions Group of RBC who has a background in commercial banking in the northeast United States with experience in mergers and acquisitions involving banks both smaller and larger than Westboro. At the end of 2004, the Westboro Bank hired RBC to serve as its independent financial advisor regarding the potential for a going private transaction. Richard Quad was assigned by RBC as the advisor to Westboro and tasked with the responsibility to gather the required data and prepare the necessary presentations to enable Westboro to make appropriate business decisions. I generally credit the statements contained in his affidavit. Following a delay attributable to Westboro's need to resolve some complications over unrelated litigation, both the Westboro Bank's board and Mr. Quad reached the conclusion that "expenses saved by a going private transaction would not be sufficient to cope with endemic and systematic problems with earnings and profitability that Westboro was facing." Affidavit of Richard Quad, para. 8. The Westboro Board also considered and rejected another alternative involving a "second-step" conversion in which it would raise funds by selling to the public the 64% of its shares held by Westboro Financial. "This transaction was inappropriate, however, primarily because Westboro had not fully utilized the capital it raised in the partial conversion in 2000 and was not projected to need capital throughout the term of the five year forecast that we [RBC] constructed in conjunction with this assignment." Quad affidavit, para. 9. "By the end of 2005, Westboro had decided to abandon the potential going private transaction and focus on a transaction where Westboro would combine with another institution to help its sagging performance." Quad affidavit,
8 para. 10. *8

To assist the Westboro board in making a decision, Richard Quad prepared and delivered to them a slide presentation consisting of an analysis of three different types of transactions: (1) acquisition by Westboro of a smaller institution, (2) mergers with similar size institutions, and (3) acquisitions of Westboro by larger size institutions.[4] The Quad presentation was delivered to the Westboro Board on November 21, 2005 and included a notation that the bank and its directors had at least two interests to consider going forward-a duty to the "customers, employees and the community," on the one hand, and a duty to the "public shareholders." Quad affidavit, exhibit 1 at 5. It was at this November 21, 2005 presentation, based on an analysis by Mr. Quad, that RBC offered to Westboro an opinion consisting of "an estimated range of $30.00-$35.00 per share for the public shares." Quad Affidavit at para. 12.

[4] The presentation in its entirety is part of the record before me and can be found as exhibit one to the affidavit of Richard Quad.

## C. The Decision to Pursue a Single-Party Negotiation With Assabet

Following the presentation of November 21, 2005, the Westboro Board had several discussions about merger possibilities and the best process to undertake. Prior to the involvement of RBC, CEO MacDonough had had informal discussions, over the years, about the possibility of combinations involving the Westboro bank and other financial institutions. I credit the statement by Mr. MacDonough that

> "[a]s part of my job as CEO of Westborough, I frequently met with CEOs of different banks. At times, these meetings resulted in some informal discussion of possible combinations. Starting in early 2005, I remember having such informal discussions with Assabet Valley Bancorp, Marlborough Savings Bank and Commonwealth National Bank. The informal discussions I had with both Oliver Nunes and Mark O'Connell at Assabet provided me with credible evidence that Assabet could be a viable merger partner, both geographically and financially. However, no agreement, formal or informal, relating to a merger or any other transaction between the two entities was considered or reached in *9 2005 . . . It was not until November, 2006 that the parties [Assabet and Westboro] entered into the Agreement and Plan of Merger. . . .

MacDonough Aff. Para. 13-14. I also credit the statement by Director Ball that prior to 2005, Westboro had no interest in a merger with Assabet or any other bank. Aff. Of James Ball, para. 15. Other members of the Westboro Board were aware of Mr. MacDonough's informal discussions. See Affidavit of Paul McGrath, para. 5. I also credit Mr. MacDonough's further statement that Westboro made the decision to pursue a single-party negotiation with Assabet as a result of a process that involved a consideration of Westboro's fiduciary obligations "to all of the bank's constituencies, including its shareholders and depositors, and, at all times throughout the process, the Board met with and sought advice from its legal and financial advisors." MacDonough Aff., para. 15.

The process followed by the Westboro Board, with the assistance of Mr. Quad, was to develop criteria to help it identify viable merger candidates. According to Mr. Quad,

> These criteria included: geographic proximity, established commercial lending and trust departments, culture (a focus on community banking with small to mid-sized customers), as well as a history of community involvement and commitment to charity. The Board was also interested in not having to close branches or terminate employees and being able to continue to have some control over the newly merged entity to ensure that it would continue to meet the community's needs.
>
> During the merger discussions, I presented what has been called "the grid" which contained several potential merger candidates. It included six candidates that I initially culled from the original list of potential merger candidates in November, 2005, and one, Southbridge Savings Bank, which I added after the Board asked me to further review the original list and make sure that I found all of the entities that met their selection criteria.

> At this same meeting, James Ball, a Westborough director, also prepared a grid comparing the same seven entities. There was extensive discussion of the merits of each candidate and the Board members provided their personal knowledge of the management for the various entities. A significant open issue was whether to approach one entity or multiple entities to discuss the possibility of a merger. This 10 issue was the primary topic at several *10 subsequent meetings over a three week period.
>
> To assist the Board in this process, I prepared a two page handout that listed both "pros" and "cons" associated with engaging in merger negotiations with one or multiple parties.
>
> Also during this time, I prepared a substantial binder of materials containing all of the information on Westborough that a potential merger partner would find useful, regardless of whether Westborough decided to negotiate with one or multiple partners.
>
> Eventually, the Board decided to negotiate with Assabet, and the binder of information was delivered to them and their investment banker, Robert Hutchinson of Keefe, Bruyette Woods, Inc.

Quad Aff. Para. 14-19. I also credit Director Ball's statements about the process, including in particular, his observation that the Westboro Board,

> generated criteria and characteristics that were desirable to the Board in a merger partner. These included mutual holding company form, geographic proximity to Westborough; community bank philosophy; asset/loan portfolio mix complementary to Westborough (sic); growth (both loans and assets); recent expansion; deposit portfolios; investment portfolios; additional products and services; management talent; and a strong commercial department. The Board determined that only other mutual holding companies should be considered because a full stock bank was undesirable due to the Bank's overcapitalization. At meetings with RBC, in late 2005 and early 2006, LPRC and Board members asked many questions of RBC to make sure each of the criteria was being adequately considered.
>
> The Board provided RBC with the characteristics and criteria for a merger partner, and RBC reverted with a list of banks that had at least some of those characteristics to some degree that were also not more than fifty (50) miles from the Bank's current home office in Westborough. Eventually the list was reduced to seven banks: Assabet Valley Bancorp ("Assabet"); Webster Five Cents Savings Bank; Marlborough Savings Bank; Bay State Savings Bank; Clinton Financial Services; Unibank; and Southbridge Savings Bank.

Affadavit of James N. Ball, para. 11-12.

Once the Westboro Board had developed its criteria and identified viable merger partners based on the analytical work performed by RBC, it undertook a process of review and evaluation. I credit the statement by Director Ball concerning this phase of the process.

> As part of the process of evaluating prospective merger partners, I created a 11 chart that *11 roughly outlined some of my initial impressions of the seven banks we were considering. [See Pl. Dep. Ex. 4, annexed to the affidavit of Kenneth E. Lee as Exhibit 4]. The chart reflected only my preliminary understanding of the application of some of the characteristics the Board was considering to the various candidates. It by no means represents either my final view or any other Board member's view at any time of the relative merits of any of the banks it depicts. In fact, it is now my understanding that the chart is inaccurate in certain respects. For example, it indicates that Assabet lacked a charitable foundation, which I subsequently learned is not the case. In addition, it suggests that several banks would have made equally good merger partners as Assabet, and after several months of deliberation in early 2006, the consensus view of the Board was clearly that Assabet was the stronger candidate by a comfortable margin.

12 Aff. Of James Ball, para. 13.[5] *12

> [5] I also credit Mr. Ball's detailed explanation of the specific factors considered by the Westboro Board that led it to conclude that Assabet was the strongest potential partner for a merger. See Aff. Of James Ball, para. 14 (discussing factors including "Complementary Services;" "Size;" "Asset and Liability Mix;" "Community Orientation;" and "Geography.").

I also credit Director Ball's statements that the ultimate decision to pursue a single party negotiation with Assabet was a judgment based on three factors-First, a sense that the potential advantage of a multi-party process, which could lead to a higher price for the publically owned shares, was offset by the risk that a lengthy multi-party negotiation process would so expose Westboro's "eroding earnings" that it could produce a lower price for the publically held shares;[6] Second, a sense that the Board's research and analysis, aided by the independent advice supplied by RBC, "revealed that Assabet was uniquely positioned to fulfill the criteria Westborough considered critical for any merger partner" based on its complementary products and services, geographic proximity and similar culture; and Third, a sense "that if negotiations with Assabet did not produce an acceptable offer on all terms, the Board always had the option to open up negotiations with other banks." Aff. James N. Ball, para. 16-17. As Mr. MacDonough put it, " [t]he Board sought the advice of its financial advisors as to the range of value it might obtain for the shares in a merger transaction. The Board determined that if a transaction with Assabet would not result in sufficient value for Westborough Financial's public shareholders, then Westborough would hold discussions with additional potential partners." Aff. Joseph F. MacDonough, para. 21.

> [6] There is evidence in the record that the directors and officers of the Westboro Bank were aware in late 2005 of projections that the bank would lose money in 2006 and absent a merger would not become profitable again. "Indeed the Bank has suffered a net loss for fiscal year 2006." See Aff. Of Robert Klugman, para. 7. Also, I credit the observation by Mr. Quad that " [t]he $35.00 per share offered by Assabet is at the top of the range of values that I expected Westborough Financial would be able to obtain for its public shares when I conducted my initial analysis in November of 2005. Since that point, the overall market has been stagnant if not in decline and Westborough's financial condition has only gotten worse." Aff. Richard Quad, para. 27.

## D. The Process Leading to the Decision to Merge With Assabet

The negotiation between Westborough and Assabet took place primarily during the months of April and May, 2006. CEO MacDonough did
13 discuss the subject of his continued *13 employment and the acceptance of his terms of employment with Westborough following the merger. I credit his statement that "no specific compensation or financial terms for . . .[his] continued employment were discussed until the fall of 2006." Aff. Joseph F. MacDonough, para. 23. On or about August 4, 2006, Assabet delivered to Westborough draft term sheet highlighting some of the key components of a merger including an offer to "cash-out" Westboro's publically owned shares for $33.00 per share.[7] This draft was considered by the Westborough board and rejected. The Westborough board directed RBC to attempt to obtain an increase in the per share price of Westboro's common stock to $35.00. The was accomplished. Assabet agreed to increase the price
14 per share to $35.00. See Aff. Joseph F. MacDonough, para. 23-24; Aff. Richard Quad, para. 21-22; Aff. Of Robert A. Klugman, para. 18.

> [7] Sometime prior to this, the Chairman of Westborough's Board raised the question whether the Board could consider a lower price for its publically owned shares in exchange for a greater number of seats on the new Board. The immediate response from Mr. Quad was that this idea was unacceptable and the issue was not raised again. Aff. Richard Quad, para. 20.

Negotiations between Westborough and Assabet continued until November 13, 2006 when a special meeting of the Westborough board and its legal and financial advisors was held which resulted in a unanimous approval. I credit the statements of Mr. MacDonough as follows:

> The Board consulted with its legal counsel and reviewed the terms of the Merger Agreement and RBC fairness opinion, which opinion concluded that the $35.00 per share that Assabet offered as consideration for Westborough Financial's public shareholders was fair from a financial point of view. The $35.00 per share price represents a 12.9% premium over the closing price of $31.00 per share on November 13, 2006, the business day immediately preceding the public announcement of the merger, as reported on the Over-the-Counter Bulletin Board. It is also a 22.9% premium over the average trading price of the stock for the 30-day period prior to November 13, 2006; a 25% premium over the average trading price of the stock for the previous year.

*14

Aff. Of Joseph F. MacDonough, para. 25.[8] Despite the claim by the Defendants at oral argument that the merger agreement also has been approved by a majority of the public shareholders, the Plaintiffs are correct that of the minority shareholders who actually cast a vote on the merger at the July 24, 2007 meeting, a majority voted against the agreement. See Plaintiffs' Reply Brief at 1.

> [8] The updated "fairness opinion" supplied by RBC and dated November 13, 2006 is set forth as exhibit 2 to the affidavit by Richard Quad.

## E. The Terms of the Proposed Merger (1) Financial Terms

The above mentioned $35.00 per share price to be paid by Assabet as part of the "cash out" of shareholders applies equally to any Directors of Westborough who also are public shareholders of Westborough Financial. Aff. Of John L. Casagrande, para. 24. Other financial terms of the merger have a special impact on Westborough CEO Joseph F. MacDonough and Westborough CFO John L. Casagrande. In the case of Mr.

McDonough, he will continue to occupy a senior position in the new bank although by no means a position of comparable influence and authority. I credit his statement as follows:

> In order to facilitate Westborough and Assabet's transition from two independent financial institutions to one merged entity, Assabet and Westborough have employed measures intended to ensure that both parties are represented in the New Entity. Among other things, upon the completion of the Proposed Merger, I will continue to be employed by the new bank, albeit in a more limited capacity than my current positions with Westborough. I also anticipate serving on the board of directors of New Bank and as trustee of the merged mutual holding company.
>
> My employment agreement with Westborough dated March 17, 2000 will be terminated *15 upon consummation of the Proposed Merger in exchange for a cash payment at that time in the amount of $330,000.
>
> In recognition of my work, including my efforts that led to the Merger Agreement, Westborough agreed to pay me a bonus in the amount of $250,000 for calendar year 2006.

Aff. Joseph F. MacDonough, para. 27-29; Aff. Joseph Casagrande, para. 5-13. . I also credit the statements of CFO Casagrande to the effect that under the terms of his employment agreement with Westborough, he is entitled to a "severance payment" of $373,000 in the event of a demotion or loss of significant authority or responsibility. Under the Proposed Merger, since he will not serve as the CFO (but instead will serve as a consultant), he would be entitled to the "severance payment." As an alternative, the Proposed Merger includes a term that will give Mr. Casagrande a lower "termination payment" in the amount of $126,000 plus accrued unpaid salary and vacation. Aff. Joseph Casagrande, para. 5-13. While Assabet also may become liable for certain excise taxes that may be owed by Mr. MacDonough and Mr. Casagrande, each of them has waived their rights under their preexisting employment agreements to be indemnified for such taxes by Westborough. Aff. Joseph Casagrande, para. 9.

In addition to these payments to Mr. MacDonough and Mr. Casagrande, the Proposed Merger agreement affects the terms of certain of Westborough's Supplemental Executive Retirement Plans (SERP) for Mr. MacDonough, Mr. Casagrande, and Vickie A. Bouvier (Westborough's senior Vice-President and Senior Operations Manager). Each of these individuals were fully vested in these agreements before the Proposed Merger. First, benefits were calculated on a going forward basis for each of the SERPs as if the individual in question had continued to *16 work until age 65 and had received an annual salary increase and bonus of 5% per year. Second, on December 18, 2006 the "change of control" provisions of the three SERPs were amended to provide for a lump sum payment of benefits (discounted for present value) to Mr. MacDonough, Mr. Casagrande and Ms. Bouvier on completion of the Proposed Merger whether nor not employment is terminated.[9]

[9] In particular, this change of control provision will result in a payment to Mr. MacDonough of approximately $243,723; to Ms. Bouvier of $436,478; and to Mr. Casagrande of $166,108. If each of these individuals worked to age 65 and received annual salary and bonus increases of 5%, they would be entitled at that future date to SERP payments of $1,173,261 (Mr. MacDonough); $597,040 (Ms. Bouvier); and $711,589 (Mr. Casagrande). See Aff. Joseph Casagrande, para. 17-18. Since the SERP obligations are to be handled as lump sum payments, the new entity will avoid the obligation to carry them as accruing debts on its books to be paid at a future date. As Mr. Casagrande put it, "it is

> an early payout of money to which we would be entitled if the SERP were honored by any merger partner involving a change of control, at a calculation designed to discount the estimated future benefits to take into consideration the time value of money. . . [T]hese payments have no overall adverse economic impact on the company." Aff. Joseph Casagrande, para. 16, 19.

The Proposed Merger also affects the interests of employees of Westborough who participate in Westborough Financial's employee stock plan. Essentially, employees, including officers, will become fully vested in their accounts and upon repayment in full of stock ownership plan (ESOP) loan balances, unallocated shares of Westborough common stock will be allocated to the employee accounts at the $35.00 per share price. The total amount of this allocation is estimated to be $530,984 of which Mr. MacDonough will receive $64,617, Ms. Bouvier will receive $33,032, and Mr. Casagrande will receive $45,726. Aff. Of Joseph Casagrande, para. 20.

Finally, with regard to Westborough's Supplemental Compensation Agreement with non-
17 employee *17 directors who have not reached the age of 75, benefits for these employees will be fully vested upon completion of the merger, but only four directors who will not continue to be employed with the new bank will receive payments totaling $363,618. at the time of the merger. Because it is anticipated that nine of Westborough's Directors will become directors under the new entity, they will not receive any payments under these Supplemental Compensation Agreements. Aff. Joseph Casagrande, para. 21-22.

## (2) Other terms of the Proposed Merger ("No Shop" and "Termination Fee")

In addition to the above financial terms, the Proposed Merger Agreement contains some limitations that are designed to protect Assabet. The "No Shop" provision prohibits Westborough from actively seeking competing bids, but allows Westborough to begin discussions with any bidder which is judged "likely" to offer a "superior proposal" to Assabet. See Agreement and Plan of Merger Section 7.7 found as Exhibit A to Proxy Statement (Aff. Mr. Coney, ex. 2). The Proposed Merger also required approval by at least 2/3rds of Westborough Finan ial's shareholders. Finally, the Proposed Merger Agreement contains a provisions requiring Westborough to pay Assabet a flat fee of 5% of the value of the deal in the event of a termination. These terms were reviewed and determined to be fair and reasonable by RBC as well as by Westborough's Directors.

## F. Consideration and Rejection by Westborough of Additional Offers

On or about December 27, 2006, Westborough received an unsolicited offer from Robert T. Williamson, who has described himself as a "professional investor," and who expressed an interest in acquiring the common stock of Westborough Financial that is not owned by Westborough MHC for the price of $38.50 per share. I credit the statements by Mr. MacDonough
18 *18 that this offer and a subsequent offer by Mr. Williamson was unanimously rejected by the Westborough Board as not likely to lead to a "superior offer" on grounds that it did not involve a complementary financial institution, and because its terms ran counter to the underlying needs that led Westborough to seek a merger partner (e.g., Williamson insisted on continued independent operation of the Westborough bank), and were inconsistent with Massachusetts law (Williamson insisted on control of the Westborough Boards even though Massachusetts law requires a mutual holding company to retain at least 51% voting control of the entity). Aff. Joseph F. MacDonough, para. 32-34.

Westborough also received two other unsolicited proposals from Mark L. Bistricer, on behalf of a group of investors, who also offered to buy the common stock of Westborough Financial that is not owned by Westborough MHC for the price of $40.00 per share (February 28, 2007) and then $41.00 per share (March 27, 2007). I credit the statements by Mr. MacDonough that this offer also was unanimously rejected by the Westborough Board as not likely to lead to a "superior offer" on grounds that it sought to maintain the continued, independent operation of the Westborough Bank. However, in order to fully consider Bistricer's second and higher offer (which did not insist on control of the Board), the Westborough Board sought and obtained from Assabet a limited waiver of the merger agreement to allow for a meeting between the Bistricer group and members of Westborough's Long Range Planning Committee. This meeting took place on April 30, 2007. Aff. Joseph F. MacDonough, para 35-36.

I credit Mr. MacDonough's assessment of these offers as follows:

> Each of these buyers was interested in acquiring only the 36% publically-owned shares. Neither buyer was a banking concern in Massachusetts, and neither buyer had any experience running a Massachusetts banking concern. Thus,
> 19 both buyers were proposing *19 to maintain Westborough Bank as a stand-alone entity, which our Board of Directors did not believe to be in the best interests of the Bank and its customers.
>
> The Board carefully considered these proposals before rejecting them. The Board was generally concerned with the anticipated problems in obtaining regulatory approval for a buyer to acquire 36% of Westborough financial yet take control of the mutual holding company, the lack of any strategic advantage given the buyers' lack of experience in running a bank and the fact that they were not banks themselves. The Board was also concerned with Williamson's ability to finance his proposal.

Aff. Joseph F. MacDonough, para. 37-38. See also Aff. James N. Ball, para. 23-28; Aff. Robert A. Klugman, para. 23-32.[10]

[10] Mr. Klugman indicates that both Mr. Williamson and Mr. Bistricer, who together reportedly owned or controlled approximately 40% of the publically held shares of Westborough, were interested in completing a "full stock conversion or second-step transaction. Messrs. Williamson and Bistricer both wished to ignore the fact that a full stock conversion would be a poor strategic decision for the bank as a business because the Bank was already overcapitalized." Also, Mr. Klugman asserts that Mr. Bistricer acknowledged that he offered up to $41.00 per share because "he possessed other investments that would suffer if the transaction were to be completed at $35.00, and he was willing to make the acquisition himself to support his other investment positions." Aff. Klugman, para. 29, 30.

## IV. DISCUSSION

### A. The Standard Governing Judicial Review of the Fiduciary Duty Owed by Westborough's Board to the
20 Owners of the Public Stock *20

The general duty owed by a director to the shareholders of a corporation under Massachusetts law is that he or she must discharge the duties of a

director "(1) in good faith; (2) with the care that a person in a like postion would reasonably believe is appropriate under similar circumstances; and (3) in a manner [the director] believes to be in the best interests of the corporation." G.L. c. 156D, § 8.30(a). The parties in this case have offered radically different views about the appropriate standard of judicial review that should govern this court's determination whether the Westborough Board of Directors fulfilled its fiduciary duties to its stockholders in pursuing a merger. The plaintiffs maintain that this court should follow an influential Delaware case, *Revlon, Inc. v. MacAndrews Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986), which held that "[t]he duty of the board . . . [is] the maximization of the company's value at a sale for the stockholders' benefit." When directors engage in a transaction involving the "cash out" of minority shareholders, as is proposed in this case, the plaintiffs argue that the duty of the directors is simple-"the board must act in a neutral manner to encourage the highest possible price for its shareholders." *Barkan v. Amsted Indus.*, 567 A.2d 1279, 1286 (Del. 1989).[11] The plaintiffs assert that the Directors of Westborough, in particular Mr. MacDonough, violated their fiduciary duties in several ways, but principally by not shopping the bank around in the marketplace to determine the highest price that could be obtained for its shareholders before entering into a single party negotiation, and by securing financial benefits for a limited number of directors that were not extended to the
21 shareholders.[12] *21

[11] As Plaintiff's counsel, attorney DeValerio, explained it at oral argument, applying the Revlon test to the facts of this case means that the directors of Westborough were under a duty to act as "auctioneers" — to simply ensure the highest possible value for the stock owned by Westborough's shareholders.

[12] In one important respect, Plaintiffs' counsel misstated the facts during his argument when he maintained that the Westborough Directors did not reassess the fairness of the $30-$35 price range estimated by RBC as fair value for the Westborough stock in November, 2005. The record clearly shows that RBC obtained an updated fairness opinion from RBC on November 13, 2006 indicating that the per share merger consideration of $35. per share to be paid by Assabet "is fair, from a financial point of view, to the public shareholders of the Company." Aff. Richard Quad, exh. 2.

The defendants, on the other hand, maintain that they are entitled to the benefit of the "business judgment rule" whereby "directors are presumed to act in the best interests of the corporation." See *Harhen v. Brown*, 431 Mass. 838, 844-45 (2000). See also *Seidman v. Cent. Bancorp, Inc.*, 16 Mass. L. Rptr. 383, 2003 WL 21528509 (Mass.Super. No. 030547 BLS; 030554BLS and 032287BLS 2003). This follows, the defendants say, in part as a result of the "constituency" provision of G.L. c. 156D, § 8.30(a)(3), which authorizes a director to take into account the interests of the corporation's employees and customers, the local, regional and national economy, and the long-term and short-term interests of the shareholders. The remedy for disgruntled minority shareholders, according to the defendants, is to exercise their apprisal rights pursuant to G.L. c. 156B, § 98. These two approaches involve substantially different degrees of judicial scrutiny and substantially different methodologies in order to determine whether Directors have honored or breached their fiduciary duties. See, e.g., *Cinerama, Inc. v. Technicolor, Inc.*, 17 Del. J. Corp. 551, 1991 WL 111134 (Del Ct. Ch. 1991) (Chancellor Allen provides a comprehensive analysis explaining the differences between use of the Business Judgment Rule and
22 the *Revlon* standard). *22

Neither the Plaintiffs nor the Defendants have presented a wholly satisfactory analytical framework for determining the nature of judicial review of the question whether the Westborough Directors met their fiduciary duties to their stockholders. The *Revlon* standard, as articulated by the Plaintiffs, is premised on the assumption that the transaction under scrutiny involves the merger of a 100% publically owned entity. The Defendants correctly explain that in the year 2000, the Westborough Bank transformed itself from a mutual bank in which the ownership lies totally with the depositors into a partially publically owned bank as a result of the sale of 36% interest to minority stockholders with the majority ownership interest retained by a Massachusetts Mutual Holding Company. It is undisputed that at the time of this transaction in year 2000, as a result of the terms of the Prospectus accompanying the sale of stock, the minority shareholders such as the Plaintiffs were made aware that the Boards of Westborough Financial Services, Inc., a mid-tier holding company of defendant Westboro Bank and its majority owner, Westboro Bancorp, MHC, a chartered mutual holding company, would exercise control over the entities and that their votes might not always have the effect of maximizing the share price of the minority shares. The reason for this is obvious. Since year 2000, the Boards controlling the Westborough entities have had multiple and potentially competing interests to serve-they must consider the interests of depositors, employees, suppliers, creditors etc. *as well as* the minority shareholders. See also Defendants' Memorandum of Law in Opposition to the Plaintiffs' Motion for a Preliminary Injunction at 30-31.

On the other hand, the Plaintiffs are correct in
23 noting that in a merger involving a "cash-out" *23
of minority shareholders, as in this case, just as in the case of a "freeze-out" in which a controlling stockholder and corporate director chooses to eliminate public ownership, the reasons for the presumption that Directors will act in the best interests of the minority shareholders is lacking and, therefore, greater judicial scrutiny is appropriate.

The business judgment rule allows courts to presume that the board of directors acted in the best interests of the corporation and, therefore, to largely abstain from evaluating the validity of the board's decisions. *Harhen v. Brown*, 431 Mass. 838, 865 (2000). However, some transactions involve a higher ri.k of abuse of fiduciary duty and warrant higher judicial scrutiny. See *Coggins v. New England Patriots Football Club*, 397 Mass.
24 525, 533 (1986). The transaction *24 at issue in
this case is somewhat analogous to a so-called "freeze-out" merger, where a controlling stockholder and corporate director chooses to eliminate public ownership. "The dangers of self-dealing and abuse of fiduciary duty are greatest in freeze-out situations" like this. *Id.* at 532. "It is in these cases that a judge should examine with closest scrutiny the motives and the behavior of the controlling stockholder." *Id.* at 533.

The Supreme Judicial Court has developed a two-part test in evaluating this type of transactions. "Because the danger of abuse of fiduciary duty is especially great in a freeze-out merger, the court must be satisfied that the freeze-out was for the advancement of a legitimate corporate purpose. If satisfied that elimination of public ownership is in furtherance of a business purpose, the court should then proceed to determine if the transaction was fair by examining the totality of the circumstances." *Coggins* at 534. The burden of showing, first, that the merger was for a legitimate business purpose, and, second, that considering totality of circumstances, it was fair to the minority is on the defendants. *Id.* at 534, 535.

## B. Consideration of Likelihood of Success on the Merits.

The approach suggested by the Supreme Judicial Court in *Coggins, supra*, must be applied in the context of the traditional test for determining whether to issue a preliminary injunction. The first consideration is whether the Plaintiffs have demonstrated a reasonable likelihood of success.

(1) Business Purpose Test. The record before the Court is compelling (and Plaintiffs do not seriously dispute) that Westborough's merger with Assabet serves a legitimate business purpose. Westborough was experiencing a decline in performance in 2004 and 2005, it lost money in fiscal year 2006, and there are grave concerns
25 about its future performance as an *25 independent bank. The record also shows that the board directors came to the conclusion that to improve Westborough's position, it was necessary to merge the bank with another financial institution. It is also undisputed that Assabet's current business structure mandates elimination of public ownership of Westborough in order to complete the merger. Thus, this Court is satisfied, based on the record available at this stage of the proceedings, that the merger at issue here will serve a legitimate business purpose.

(2) Fairness Under the Totality of the Circumstances. "The concept of fairness has two aspects: fair dealing and fair price." *Coggins* at 531, citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). Plaintiffs claim that the process of negotiations employed by Defendants in reaching the merger agreement with Assabet was unfair because Westborough chose to negotiate with only one potential partner. The Court disagrees. The above facts show that the Westborough Board gave careful consideration to the issue of whether to negotiate with multiple parties at the same time or focus on one, most compatible in their view, partner. They hired independent financial and legal consultants who outlined pros and cons of each approach for the Board. The Board's decision to concentrate their efforts on securing a deal with one partner, whom they identified as the most desirable, was made only after a thorough evaluation and ranking of seven potential partners,[13] an articulation of reasons for the choice, and in light of an independent assessment of what price should be
26 paid by a merger partner for each share of *26 publically owned stock.[14] The plaintiffs rely on a recent Delaware case to support their contention that the Westborough Board did not fully inform itself of the merger possibilities before entering into a one party negotiation. However, the authority is question is distinguishable in several important respects. Contrast, *In re Prime Hospitality, Inc.*, 2005 WL 1138738, Civ. Action A-652-N (Del.Ch. 2005) (first, application of the *Revlon* standard was interpreted by the court to require the directors to assume "the sole responsibility of maximizing shareholder value;" and second, the record contained little, if any evidence, that the directors had received unbiased financial advice or done any meaningful market check before approving an acquisition by another entity). Thus, I conclude that the defendants have demonstrated on the basis of the evidence before me that the decision to pursue a one party negotiation was reasonable under the circumstances and that the process utilized by the Westborough Board was fair. There is simply no evidence in this record that a compatible and complementary banking partner exists which is willing to pay Westborough's stockholders more than $35 per share.

13 Plaintiffs rely on deposition testimony of several Westborough Directors in which they concede that they might have learned more about the strengths and weaknesses of the other banks who were potential merger partners if they had shopped Westborough bank around before beginning a negotiation with Assabet. See Plaintiffs Reply Brief at 9. However, Plaintiffs overlook the compelling reasons given by Westborough Board members for moving ahead once they had done the initial ranking and identified Assabet as the best candidate. There were legitimate risks that engaging in what would likely be a lengthier process of shopping the bank around could put the prospects for a successful merger in question due to Westborough's declining performance.

14 The Plaintiffs concede that even under the Revlon standard, it is not necessarily unfair or unreasonable for Directors to pursue a single-party negotiation instead of first shopping the company around.

In terms of the Plaintiffs' allegation that the Westborough Directors engaged in self-dealing and were conflicted and that they put their own personal interests ahead of the interests of the shareholders, the record does not support their claim. Even if the effect of applying a *Coggins*-type analysis is to place the burden of demonstrating fairness and reasonableness on the shoulders of the Westborough Directors in a cash-out merger transaction such as this, it is my view that they have met their burden. Thus, mindful of the Plaintiffs' obligation to demonstrate a likelihood of success on a motion for a Preliminary Injunction, the burden shifts to them
27 to rebut *27 the defendants' evidence and establish that in fact the Westborough Directors were conflicted and engaged in self-dealing. I do not believe the Plaintiffs have carried their burden.

For the reasons stated above, in the negotiation with Assabet, Mr. MacDonough had a duty to consider not only the price to be paid to minority shareholders as a result of a merger, but other interests such as the importance of continuing to serve Westborough's customers and local and regional economic and community interests. See 12 U.S.C., §§ 1842(c)(2) 2901(a)(3); G.L. c. 167, § 14; G.L. 156D, 8.30(a)(3). It was legitimate for Mr. MacDonough to pursue merger terms that would result in his continued involvement as a member of the Board of the new entity along with the involvement of other Westborough Directors so long as this goal was not achieved at the expense of achieving fairness in terms of the price per share to be paid to the minority shareholders. Since the negotiation process inevitably places these goals in competition with each other as central bargaining points in any proposed merger agreement, Mr. MacDonough could not fulfill his fiduciary duties by attempting to maximize either goal *i.e.*, by simply trying to obtain merger terms whereby Westborough would obtain as close to a controlling interest in the new entity as possible by securing a seat for every current Westborough Director on the new Board regardless of the price to be paid for each share of Westborough common stock, or, conversely, by simply trying to obtain the highest possible offer for Westborough's common stock without regard for the impact on Westborough's customers or the local community and the region.

The plaintiffs have vastly overstated and incorrectly characterized the financial terms and adjustments set forth in the Proposed Merger Agreement with respect to Mr. MacDonough, Mr. Casagrande and the other Westborough Directors.
28 With the exception of the SERP plans, the *28 above facts indicate that Mr. MacDonough and Mr. Casagrande will receive a lower net amount of compensation as a result of the merger than they would have received under preexisting employment and benefit agreements each of them had with Westborough. While the accelerated payment of SERP benefits, discounted for present value, and the tax adjustments are undoubtedly benefits that will be received by Mr. MacDonough, Mr. Casagrande and Ms. Bouvier, some resolution of these matters was unavoidable *i.e.*, a merger could not be completed without addressing the change in control features of the preexisting employment and benefits agreements that Westborough Directors had secured prior to 2005. Moreover, none of the benefits that were negotiated for certain Westborough Directors under the merger agreement are independent of and unrelated to benefit provisions they enjoyed under preexisting contracts with Westborough. Contrast *Demoulas v. Demoulas Supermarkets, Inc.*, 424 Mass. 501, 531-44 (1997) (Directors violated their fiduciary duties by self-dealing). I do not regard these adjustments as unreasonable or unfair and do not find any evidence that they adversely affected the ultimate question of what price per share would be paid by Assabet for

Westborough's common stock.[15] A Director participating in a merger negotiation such as the one involved in this case does not engage in self-dealing and become conflicted simply because he or she negotiates terms of his own compensation and that of other fellow Board members in the new entity when (1) the continued participation of the Director is in the best interests of the merging corporation, (2) the terms of his own compensation represent the translation of terms and benefits under preexisting employment and benefit agreements with the merging corporation into present cash value, and (3) *29 these terms are fully disclosed to the Board prior to its approval of the merger. *See Cinerama, Inc., supra*, 1991 WL at *12-*15. See Defendants' Memorandum of Law at 26-28, and cases cited.

> [15] Likewise, the payment by Westborough of a $250,000 "bonus" to Mr. MacDonough for his work during 2006 relating to the merger negotiations is not unreasonable or unfair on its face. The fact that he received no bonus in 2004 and only a $6,000 bonus in 2005 is of no consequence whatsoever.

Plaintiffs further contend that inclusion of "no shop" provision and termination fee in the merger agreement created a fairness concern. The affidavits establish that such provisions are customarily included in agreements of this nature. Case law indicates that so-called "No Talk/No Shop" clauses and termination fees are not uncommon in merger agreements. See, e.g., *In re Guidant Corp. Shareholders Deriv. Litig.*, 2006 WL 2900524 *10-*13 (S.D. Ind. 2005). It is significant that the independent financial consulting firm hired by Westborough, RBC, concluded that the terms of "no shop" clause and the amount of the termination fee were reasonable. See *id.*, 2006 WL at 290524 *10. It was not unreasonable for the Westborough Board to rely on their recommendation. There is no evidence here that these features of the Proposed Merger Agreement were used by Westborough or otherwise served to dissuade others who had an interest in competing for a merger opportunity with Westborough. While Plaintiffs have cited cases that suggest that termination fees in the range of 3.5 to 5% are regarded as high, no authority has been brought to my attention that indicates per se rule should be applied that a proposed merger agreement is unfair and unreasonable because it contains a termination fee of 5%.

Plaintiffs' only remaining point of contention is the per share price of $35 that they would receive as the result of the merger. The price negotiated for the publicly owned shares appears to be at the top of the range indicated by RBC as reasonable. Record further establishes that Assabet hired its own independent consultant, who also determined a $35/share price to be fair. In addition, the cash-out price is significantly higher than the trading price of the Westborough stock on the open market on the day prior to public announcement of the merger agreement. Thus, under the totality of the circumstances, the transaction appears to be fair to both the majority and minority shareholders.

Therefore, Plaintiffs failed to show that they are likely to succeed on the merits and are not entitled to a preliminary injunction.

## C. Balance of the Harms.

In light of the conclusion above, it is not necessary to determine whether Plaintiffs would suffer irreparable harm if the injunction were not granted. Nevertheless, even presuming that the difficulty of ascertaining the exact per share price Plaintiffs could receive if Westborough were to merge with a different partner presents the irreparable harm, the balance of harms does not cut in Plaintiffs' favor. In view of the fact that Assabet may walk away from the merger and no other partners expressed any interest in merging with Westborough, Defendants stand to loose a valuable and, possibly, their only opportunity to merge with a strong strategic partner. This harm may be very difficult, if not impossible, to rectify later should the defendants eventually prevail at trial. There is a basis for the genuine concern expressed by a number of the Westborough Directors that the bank will not remain viable as an independent bank. Considered in light of the court's conclusion that Plaintiffs have not established a likelihood of their success on the merits, it would be inappropriate to issue a preliminary injunction in this case.

## ORDER

A preliminary injunction is an extraordinary remedy, and the party which seeks such relief must shoulder the burden of establishing a likelihood of success, the prospect of irreparable
30 harm *30 without the relief, and that the balance of harms weighs in favor of granting it relief. Issuance of an injunction in this case could jeopardize the only opportunity for the Westborough Bank to achieve a merger that not only is fair and reasonable to its shareholders, but that meets the needs of its customers and the community. The failure to issue an injunction, on the other hand, does not foreclose a remedy if the Plaintiffs succeed in the underlying case. For the above reasons, the Plaintiffs' Motion for a Preliminary Injunction is hereby DENIED.

**Meeting Between Federal Reserve Board Staff and Representatives of Luse Gorman Pomerenk & Schick, P.C., Northfield Bank, Stifel, Nicolaus & Company, Inc., and RP Financial, LC.**
**November 22, 2011**

**Participants:** Amanda Allexon, Robert Brooks, Christine Graham, Walter McEwen, Susan Motyka, Alison Thro, and Tate Wilson (Federal Reserve Board)

Eric Luse, John J. Gorman (Luse Gorman Pomerenk & Schick, P.C.); John W. Alexander (Northfield Bank); Ben A. Plotkin (Stifel, Nicolaus & Company, Inc.); William E. Pommerening (RP Financial, LC.)

**Summary:** Staff from the Federal Reserve Board met with representatives of Luse Gorman Pomerenk & Schick, P.C., Northfield Bank, Stifel, Nicolaus & Company, Inc., and RP Financial, LC. to discuss the dividend waiver provision in Regulation MM (12 C.F.R. 239.8(d)), which was issued as an interim final rule on September 13, 2011. The representatives of the organizations listed above provided a historical perspective on savings and loan holding companies in mutual form ("MHCs") and presented views on the dividend waiver provision in Regulation MM. Specifically, the representatives suggested that the member vote requirement be removed and that grandfathered and non-grandfathered MHCs be subject to the same requirements with respect to waiving their right to receive dividends. A copy of the materials distributed at the meeting is provided below.

Attachments

LUSE GORMAN POMERENK & SCHICK
A PROFESSIONAL CORPORATION

# AGENDA

**Meeting With Staff of Board of Governors of Federal Reserve System**

**November 22, 2011 – Washington, D.C.**

1. **Introduction**
2. **Brief Review of MHC Structure and the Capital Raising Success of MHCs**
3. **Review of Why MHCs Waive and Should Waive Dividends**
4. **The Direct and Indirect Consequences of Not Waiving Dividends**
5. **The Shortcomings of the Interim Final Rule**
   - **(i) A member vote is infeasible and unnecessary**
   - **(ii) All MHCs should be treated the same and be allowed to waive dividends without adverse consequences**
   - **(iii) There should be no dilution of minority stockholders if an MHC waives dividends**
   - **(iv) There are other simpler and more equitable ways to address any concerns of the Federal Reserve without damaging the ability of MHCs to raise capital**
6. **Why an MHC Dividend Waiver Does Not Create an Inherent Conflict of Interest**
   - **(i) The rights of members under state and federal law**
   - **(ii) Minority stockholders have paid for their shares**
   - **(iii) How a mutual interest is converted to stock form**
   - **(iv) Directors owe a fiduciary duty to all of the entities in the MHC group**
   - **(v) Fiduciary duties of directors**

7. **Suggested Changes to Interim Final Rule to Address Perceived Conflicts**

   (i) **Tracking and requiring that waived dividends not be available for distribution to minority stockholders**

   (ii) **Adding waived dividends to a liquidation account in the event of a second step conversion**

   (iii) **Having members approve dividend waivers as part of an MHC reorganization**

LUSE GORMAN POMERENK & SCHICK
A PROFESSIONAL CORPORATION

# DISCUSSION POINTS

**Meeting With Staff of Board of Governors of the Federal Reserve System**

**November 22, 2011 – Washington, D.C.**

## 1. Brief Review of MHC Structure and History

a. How an MHC is formed and sells stock publicly.

(i) The mutual interest of a savings bank is "pushed up" into a holding company (the MHC), and a stock holding company subsidiary is formed which offers stock for sale to depositors and the public.

(ii) A part of the MHC's mutual interest is offered for sale to depositors at fair value.

(iii) The remaining unsold mutual interest is held by the MHC.

b. Why MHCs are an important alternative to standard conversions.

(i) Allows mutuals to raise as much capital as they need thereby avoiding reinvestment risks and stockholder pressures associated with too much capital.

(ii) Allows mutual boards to transition to full public ownership. Many mutual institutions are not equipped for the immediate change to full stock ownership, which is almost unique to mutual-to-stock conversions. The widespread distribution of common stock and immediate stockholder pressures can be very disruptive to a recently converted savings bank.

(iii) Allows mutual institutions to have a longer term game plan for going public, leveraging their capital and remaining independent. See, e.g., First Niagara Bancorp; Hudson City Savings Bank; Northwest Savings Bank and Peoples' United Bank, all of which began as mutual holding companies.

c. How the mutual interest in a mutual savings bank or MHC is converted to stock form.

(i) Members do not receive a distribution of stock or anything of value.

(ii) The board of directors/trustees essentially eliminates the mutual interest entirely in exchange for giving members the priority right to subscribe for stock at the same price as the public.

(iii) The residual interest of members is preserved in a liquidation account equal to the pre-conversion net worth of a mutual savings bank or MHC.

**2. Why MHCs Waive Dividends**

a. MHCs are typically shell corporations and have no use for dividends
b. Dividends paid to an MHC are taxed at both the federal and state levels. Not waiving dividends is arguably a breach of fiduciary duty by the MHC board.
c. While the MHC is a stockholder like the public stockholders, its shares are very different. MHC shares cannot be traded or transferred, nor do members have a right to any dividends received by an MHC. Public stockholders have invested additional capital in their mid-tier stock holding company in exchange for their shares, while the MHC has not. As a matter of equity, the MHC may not be entitled to the same dividends as public stockholders.
d. Waiving dividends increases the overall capital of the MHC organization and enhances the capital position of the mid-tier holding company and its subsidiary savings bank.

**3. Shortcomings of the Interim Final Rule**

a. The IFR presumes that there is an inherent conflict of interest when an MHC board decides to waive dividends declared by its subsidiary. There is no inherent conflict of interest and clearly no conflict of interest that cannot be addressed like other conflicts. The IFR reads as a proposal to erect barriers to the payment of dividends by MHCs under the guise of fiduciary responsibility. There has been no evidence of abuse of dividends waivers, certainly on a systemic basis.
b. The IFR would effectively prohibit all MHCs from waiving dividends since a member vote to approve dividends is neither desirable nor feasible.
c. The requirement of a member vote for "grandfathered MHCs" is contrary to the express language of Section 625(a) of the Dodd-Frank Act (the "DFA").
d. The IFR's treatment of non-grandfathered MHCs is draconian and tantamount to a prohibition against MHC dividend waivers.
e. The IFR would discourage officers and directors from investing in their subsidiary holding companies, which would have an adverse impact on the ability of mutual holding companies to raise capital, would contradict applicable banking regulation, and would be bad public policy.
f. The IFR would make it more difficult for MHCs to raise capital, which is bad public policy particularly in the current weak economic environment.
g. The IFR creates new corporate law voting standards for depositors and eliminates authority that is traditionally granted to a board of directors.
h. The IFR *should* treat all MHC dividend waivers the same by allowing boards to waive dividends according to the standards adopted previously by the OTS.
i. The IFR leaves open the possibility that minority stockholders of non-grandfathered MHCs will be diluted in the event of a second-step conversion of an MHC to stock form.
j. The IFR ignores the fact that when members vote to approve an MHC reorganization, the proxy materials disclose whether the MHC intends to waive dividends. Members,

therefore, have the opportunity to vote against an MHC reorganization if they object to an MHC's waiving dividends.

k. The FRB can address any perceived conflicts/abuses associated with dividend waivers without effectively eliminating MHCs as a viable alternative for mutual institutions.

   (i) The FRB has the authority to approve all dividend waivers. This would address any concerns about the amount of dividends being disproportionate to the earnings of a company.
   (ii) Waived dividends (which the FRB believes represent capital due to the members) could be treated in the same way the mutual interest in a mutual savings bank is treated when a mutual converts to stock form. The waived dividends could be tracked and added to a liquidation account for the benefit of members, which reflects the only economic interests that members have in a mutual institution. The liquidation account would not be available for distribution to stockholders in the form of dividends, etc.
   (iii) With a liquidation account, the members' interests are protected in precisely the same way that they have been protected under state and federal law for mutual-to-stock conversions for over 30 years.
   (iv) The FRB could require enhanced disclosure of an MHC's intent to waive dividends in the proxy materials sent to members in connection with an MHC reorganization.

**4. Detailed Discussion Points**

a. *Requiring members of a "grandfathered MHC" to approve a dividend waiver is a substantive additional requirement that is contrary to the express language and intent of Section 625(a) of DFA.*

   (i) Section 625(a) provides that "the Board may not object to a waiver of dividends" by a grandfathered MHC if the MHC board determines that the waiver is not detrimental to the safe and sound operation of the subsidiary savings association and that the waiver is consistent with the fiduciary duties of the board of directors to the members of the MHC.
   (ii) A member vote requirement is unrelated to the "form and substance" of a resolution of the board of directors.
   (iii) If Congress wanted a member vote requirement for dividend waivers, it could easily have included it in the legislation.
   (iv) The clear intent of Section 625(a) relating to grandfathered MHCs was to preserve the dividend waiver model implemented by OTS. The language of Section 625(a) tracks verbatim the regulations of the former OTS governing dividend waivers by MHCs.

b. *A board of directors of an MHC can satisfy its fiduciary duties without a member vote.*

(i) It is common in the banking industry for boards of directors of a holding company and subsidiary bank to consist of the same persons. In fact, it is desirable to have overlapping boards because a poor understanding of the overall mission of an organization could cause boards to act at cross purposes to each other and damage the safety and soundness of the organization as a whole.

(ii) It is expected in a mutual to stock conversion or MHC minority stock offering that board members and management purchase common stock in the offering. This is often key to the success of an offering.

(iii) The FRB should defer to the business judgment of a board of directors in its decision to waive dividends, with the retained ability to monitor and prevent abuse.

(iv) Dual directorships are not unusual, and the courts have recognized that directors in such a position owe a fiduciary duty to each corporation.

(v) In Delaware, the applicable standard requires that individuals who act in a dual capacity as directors of two corporations, one of whom is the parent and the other the subsidiary, owe the same duty of good management to both corporations, and this duty is to be exercised in light of what is best for both companies. See *Weinberger v. UOP, Inc.*, 757 A. 2d 701, 710-711 (Del. 1983).

(vi) It is a well settled principle of corporate law that a director is considered to be "interested" in a matter if he or she will be materially affected, either to his benefit or detriment, by a decision of the board of directors, in a manner not shared by the corporation and the stockholders.

(vii) Each director of an MHC is typically a stockholder of the mid-tier holding company subsidiary and a depositor/member of the MHC.

(viii) The determination by a board of an MHC that a dividend waiver is in the best interests of the MHC and its members affects each director to the same degree as any other member of the MHC. There is no benefit or detriment to the MHC members that is any different than any perceived benefit or detriment to directors of the MHC who are also members.

(ix) There is no detriment to the members of an MHC if an MHC waives the right to dividends, since members have no legal rights to the assets or capital of an MHC except to the extent an MHC dissolves or liquidates.

(x) When an MHC undertakes a "second-step" conversion, members are not disadvantaged by MHC dividend waivers (the OTS required no dilution of minority stockholders in a second-step conversion) since members must purchase stock at fair value at the same price as all other investors.

(xi) Even if one assumes that a waiver transfers value from members to stockholders, this could be addressed more logically and consistently by adding waived dividends to any liquidation account created in a second-step conversion.

c. *There would be significant costs and time associated with obtaining member approval of MHC dividend waivers.*

(i) Members are depositors of mutual institutions and are different from stockholders of a stock company.

(ii) Members typically do not understand the difference between a mutual and a stock entity, and rarely exercise their right to vote if voting rights exist.

(iii) The IFR uses the same voting standard to approve dividend waivers (a majority of the eligible votes of members) that is used for MHC reorganizations and mutual-to-stock conversions. The latter are significant transactions in the life of a mutual entity, whereas the decision to waive dividends from its subsidiary holding company is a decision for the board of directors.

(iv) The IFR significantly departs from well-established corporate law requirements that the distribution of capital is a matter for a board of directors.

(v) Obtaining a member vote would involve the costs of retaining legal counsel, a proxy solicitation firm, and printing and mailing proxy materials. These costs would likely be significant especially since members will have little interest in voting, have no stake in the outcome of the vote, and will simply not understand the issues involved in a dividend waiver.

d. *The IFR and the FRB's dividend waiver policy elevate the rights of mutual members to the detriment of public stockholders.*

(i) It is well established that the rights members of a mutual institution or an MHC are extremely limited and have essentially no value. See Society for Savings v. Bowers, 349 U.S. 143 (1955).

(ii) Members or depositors have a right to vote (except in the case of state chartered mutual savings banks under various state laws) for the election of directors and to vote on major corporate reorganizations, such as a conversion to stock form. Members, for example, do not have the right to vote to approve a merger of a mutual institution.

(iii) Members have no authority under federal or state law to approve MHC dividend waivers.

(iv) Members of an MHC do not have the right to share in any dividends received by an MHC. Members only have the right to share in any remaining surplus in the event of a liquidation of a mutual institution or MHC. There has never been a liquidation of a solvent MHC.

(v) Members do not benefit from an MHC's receipt of dividends, nor are they harmed by an MHC's waiver of dividends.

(vi) The value of an MHC or mutual savings bank accrues to its members only if all of the following events occur: 1) the MHC converts to stock form; 2) the mutual members exercise their right to purchase stock in the conversion; and

3) the conversion stock increases in value. We note that only a very small percentage of depositors exercise their subscription rights.

(vii) While the interests of members are remote, highly contingent and unquantifiable, the interests of stockholders are definite and easily quantified by the cash investment each stockholder has made in an MHC subsidiary.

(viii) The IFR's assumption of a conflict of interest associated with a board's decision to waive dividends presumes that value is being transferred from the mutual interest to minority stockholders to the detriment of mutual members. No value is being transferred from mutual members since the members receive no benefit from dividends paid to the MHC.

(ix) Minority stockholders have contributed additional capital to the MHC organization in exchange for their shares. The MHC is merely a place holder for the unsold mutual portion of the MHC group. As a result, it is reasonable to expect that minority shareholders should receive dividends that may not otherwise be paid to the MHC. The only way to implement this is by having the MHC waive its receipt of dividends.

*e. The MHC essentially owns a separate class of stock from that held by minority stockholders.*

(i) As noted above, an MHC does not pay for the shares that it owns. Instead, the unsold mutual interest is issued to an MHC in exchange for common stock.

(ii) By contrast, the shares issued to minority stockholders are sold at fair value as determined by an independent appraisal. The capital contribution to the MHC group represented by minority stockholders will always be greater on a per share basis than that represented by the MHC's shares.

(iii) The dividend waiver issue has resulted entirely from the fact that while both the MHC and the minority stockholders own the same class of stock, their shares are fundamentally different. The MHC cannot sell or transfer its shares since they represent nothing more than the unsold mutual interest of an MHC. Since the MHC regulations were never drafted to reflect these differences in share ownership, the only way to avoid paying dividends to a party (the MHC) that was not necessarily entitled to such dividends, is by waiving the receipt of such dividends.

(iv) The FRB could easily resolve the dividend waiver issue by authorizing mid-tier holding companies to issue two classes of stock with the same voting and other rights. In this way, a dividend payable to one group of stockholders (minority stockholders) would not necessarily trigger a dividend payable to the MHC.

*f. Waiving dividends avoids a waste of corporate assets, preserves the capital of the MHC group and avoids adverse tax consequences.*

(i) Waiving dividends avoids adverse tax consequences to the MHC group and allows the mid-tier stock holding company to act as a source of strength to the subsidiary savings bank.

(ii) If the MHC accepts dividends, it must pay federal and state taxes on such dividends which can exceed 10% of the amount of the dividends.

(iii) Most MHCs are shell corporations and have no use for dividends from their subsidiaries.

(iv) The funds waived by an MHC and retained by its subsidiary stock holding company increase the capital resources available to the subsidiary savings bank and can be used more effectively by the subsidiary to fund loans and other investments.

(v) It makes no sense from a corporate governance and safety and soundness perspective to require a parent entity to receive dividends and reduce the overall capital resources of the organization.

(vi) The funds retained by the mid-tier stock holding company will increase the value of the stock holding company, which will benefit all stockholders, including the MHC.

(vii) If the ownership rights of members essentially consist of a liquidation interest in the subsidiary savings bank, then waiving dividends will increase the amount of such liquidation interest by the tax savings on the waived dividends. That is, if an MHC waives dividends, a larger amount will be added to the liquidation account of members in the event of a second-step conversion of an MHC to stock form.

# UNDERSTANDING A BANK THROUGH ITS FINANCIAL STATEMENTS

## *SOURCES*

- Published Bank Financial Statements
  - Public v. privately held banks and bank holding companies (BHCs)
  - More information is available for publicly held banks and BHCs through SEC and bank agency securities filings
  - Financial statements are prepared for investors and creditors.
- Reports of Condition ("Call" Reports)
- Banks are required by law to prepare these for regulators and the public.
  - FFIEC
    - http://www2.fdic.gov/ubpr/UbprReport/SearchEngine/Default.asp
  - FDIC Institution Directory
    - http://www2.fdic.gov/idasp/main.asp

## SOURCES

- Publically Held Bank Holding Companies
  - BHCs file with the Securities and Exchange Commission:
    - Financial statements and comprehensive comments annually on Form 10-K
    - Quarterly on Form 10-Q (not audited, less comprehensive)
  - https://www.sec.gov/edgar/searchedgar/companysearch.html
  - Form 10-K includes "Regulation and Supervision" discussion – a must read for bank regulatory lawyers

## *BASIC FINANCIAL STATEMENTS*

- Balance Sheet or Statement of Condition
  - "Solvency" presentation
- Income Statement
  - "Profitability" report

# Balance Sheet

# PROTOBANK, N.A.
# Statement of Condition

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

6

# PROTOBANK, N.A.
# Statement of Condition

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

7

## General Premises

**N.A.** stands for "National Association" and indicates that the bank is a national bank, a commercial bank chartered by the federal government and supervised by the Comptroller of the Currency. Most banks are subsidiaries of bank holding companies in which cases the banks' financial statements are consolidated into those of the parent BHCs. BHCs' names often include such descriptive words as "Bancorp" and "Bancshares".

The **Statement of Condition** is the bank's balance sheet.

a. The "Assets" on the left side of the balance sheet include the bank's funds and other property used in its business.

b. "Liabilities & Capital" on the right side of the balance sheet indicate the source of the bank's funds: borrowed in the case of liabilities and supplied by shareholders or earned in the case of capital. Investments and loans are the bank's principal assets, and deposits are its principal liabilities.

c. A deposit is a loan to the bank by a depositor, and depositors are creditors of the bank. Contrast with a money market mutual fund where the customer is a shareowner of the fund. A deposit represents the liability of the bank to repay the depositor, either on demand or at the time agreed.

d. The funds deposited are assets of the bank. The depositors' assets are their claims against the bank. The bank invests the deposited funds, and relends them to its borrowers, or puts them into its liquidity reserve. The investments, the loans, and the cash belong to the bank, not to the depositors.

# PROTOBANK, N.A.
# Statement of Condition

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

## Cash & Due from Banks

This is the bank's primary liquidity reserve, the cash in its vaults, in its tellers' drawers, or on deposit with other banks (including Federal Reserve Banks). These are the funds that are immediately available to pay deposit and other obligations.

a. "Liquidity" refers to a bank's ability to meet its deposit and other obligations as they become due. No bank is liquid in the sense of being able to meet all of its obligations if they were all presented at one time, but in fact they are not likely to be presented at one time.

b. **The law of large numbers**, reinforced by deposit insurance and the safety net of the Federal Reserve System, makes it possible for banks to operate with fractional reserves (reserves that are only a small fraction of their liabilities).

**c. Up until 2020, all depository institutions had to maintain a certain percentage of "transaction account" deposits as fractional reserves, set aside at the local Federal Reserve Bank as required by Regulation D. In 2020, the Federal Reserve determined that we were operating in an "ample reserve environment" and reduced reserve requirements to zero.**

# *PROTOBANK, N.A.*
# *Statement of Condition*

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

11

## Investments

The investment portfolio is the bank's secondary liquidity reserve because it consists, or should consist, of investments that, for the most part, may he quickly liquidated and converted to cash to pay deposit and other obligations.

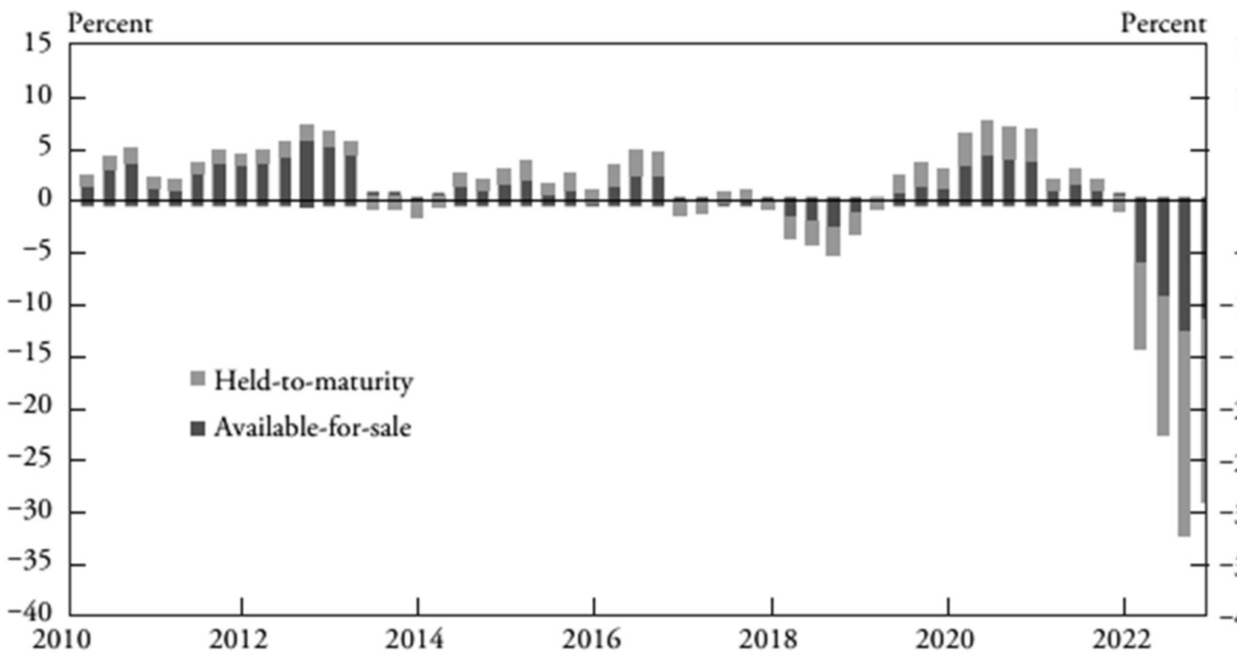
a. With few exceptions, the investments will be debt instruments, such as bonds or notes that are regularly quoted and readily marketable. They will usually be government obligations: federal, state, or municipal. They may also include high-grade corporate debt instruments.

b. With some exceptions, they do not include stock or other equity investments.

c. The three most important aspects of a bank's investment portfolio for regulatory purposes are: (1) the size of the portfolio relative to the bank's liabilities, (2) the credit quality of the obligors, and (3) the average maturity or duration of the instruments. The shorter the maturity, the nearer the market value of the investment or loan will be to its book value and the more likely it will be that it can be liquidated without substantial loss.

d. Investments are grouped as “held to maturity” (HTM) and “available for sale" (AFS) HTM are not intended to be sold and are recorded at amortized cost. AFS are marked-to-market on an ongoing basis. The largest banks must report changes in the market value of AFS in book equity as “accumulated other comprehensive income” (AOCI).

# Unrealized Losses on Securities



# *PROTOBANK, N.A.*
# *Statement of Condition*

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

| Ratios | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

## Investments and Loans

In a basic sense, bank investments and bank loans are really the same thing, loans by the bank to borrowers.

a. However, a loan is usually a "one of a kind" transaction, with the amount, maturity and other terms worked out by agreement between the bank and the borrower. Its value is a matter of judgment, which depends on the credit worthiness of the borrower, the maturity, and other factors. It is not readily marketable and therefore illiquid.

b. In the case of an investment, the bank lends its money by purchasing bonds, notes, or other debt securities issued by the borrower, which is usually a government or a business corporation. The debt obligations are issued in standard denominations, such as $10,000. Investments are a source of liquidity, while loans generally are not, although loans may be turned into securities through securitization.

**Loans.** Both "gross" and "net" loans appear on the balance sheet. The difference is the amount that the bank has set aside for anticipated credit losses (the "Allowance for Loan and Lease Losses").

**Allowance for Loan and Lease Losses (ALLL).** (Also called loan loss reserve, bad debt reserve, for credit losses, etc.) Loan and lease losses are charged against the Allowance, and the Allowance is replenished from the "Provision for Loan and Lease Losses," which appears on the Income Statement.

# *PROTOBANK, N.A.*
# *Statement of Condition*

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| | | (Billions) | | |
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

## Premises, Equipment & Other Assets

Fixed assets usually make up only a small part of a bank's assets, only 4% in ProtoBank's case.

a. Bank's have legal limitations on the fixed assets they may own, typically only as necessary for the operation of the business.

b. They may only own real property for their main offices and branches and, to some extent, for future growth. While some state banks and savings and loan associations may legally own real estate to develop, it is on a limited basis and the general rule is they may not speculate on land.

c. "OREO" means Other Real Estate Owned. This is property the bank forecloses on and they may hold it for approximately 3 years, with the possibility of extensions.

# *PROTOBANK, N.A. Statement of Condition*

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

| Ratios | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

18

## Deposits

Deposits are the bank's principal liability and its principal source of funds. Different types of deposits have different maturities and other terms, may pay different interest rates, and may require different reserves. If a bank is liquidated, deposits have priority over other unsecured liabilities.

a. Demand deposits (regular checking accounts) are corporate and individual transaction accounts. They permit immediate withdrawal and are used for payments.

b. NOW (Negotiable Order of Withdrawal) is a special type of transaction account. Like a savings account it pays interest, and like a checking account it can be used for payments. It is not available to businesses.

Both are considered “transaction accounts”.

# *PROTOBANK, N.A.*
# *Statement of Condition*

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

## Non-Transaction Deposits

Because of historical reserve requirements on "transaction accounts," Regulation D includes definitions for other accounts, with the intent that they not require reserves. Banks must specify that it may take up to 7 days to pay these types of accounts.

**Money Market Accounts.** A special type of savings account historically permitting a limited number (6) of transactions and originally intended, when interest rates were controlled, to permit the payment of a rate competitive with the return on money market mutual funds.

**Savings & Time Deposits.** Includes deposits that permit withdrawal but not checking – savings accounts- and deposits that have fixed maturities – certificates of deposit.

**In an "ample reserves environment," these definitions are irrelevant and have been deleted from Regulation D. Nevertheless, banks may maintain the requirements by contract.**

# *PROTOBANK, N.A.*
# *Statement of Condition*

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

# Other Borrowing

Other borrowing includes

a. long-term borrowing that for some regulatory purposes may count as capital, and

b. short-term borrowing (such as "federal funds" transactions and other money market borrowing).

Borrowing may enable a bank to make loans and investments when deposits are insufficient or to repay deposits if cash reserves are inadequate.

# *PROTOBANK, N.A.*
# *Statement of Condition*

(Billions)

| Assets | | | Liabilities & Capital | |
|---|---|---|---|---|
| Cash & Due from Banks | | $ 0.8 | Deposits | |
| Investments | | 2.2 | Demand Deposits | $ 2.0 |
| Loans | | | NOW Accounts | 1.4 |
| Gross | 6.65 | | | |
| ALLL | 0.15 | | Money Market Accounts | 2.3 |
| Net Loans | | 6.5 | Savings & Time Deposits | 2.5 |
| Trading Account Assets | | .2 | Total Deposits | 8.2 |
| Premises, Equipment & Other Assets | | .2 | Trading Liabilities | .5 |
| OREO | | 0 | Other Borrowing | .5 |
| Goodwill | | .1 | Total Liabilities | 9.2 |
| | | | Capital | 0.8 |
| Total Assets | | $10.0 | Total Liabilities & Capital | $10.0 |

Ratios

| | |
|---|---|
| Allowance/Gross Loans | 2.25% |
| Loans/Deposits | 81.10% |
| Leverage Capital Ratio (Capital/Total Assets) | 08.00% |

## Capital

Capital or Net Worth is the difference between the bank's assets and its liabilities. These funds have been supplied by the bank's shareholders or retained from earnings. If the bank's assets shrink, its capital provides a "cushion" to absorb losses and protect the bank's depositors, other lenders, and the FDIC.

a. Note that the amount of ProtoBank's capital, like that of most banks, is small in relation to its total assets. Thus, if the bank loses as little as 8% of its assets (through imprudent investments or loans, or a mismatch between the interest rates for assets and liabilities, etc.), its capital will be exhausted and it will be on the verge of insolvency. Any further deterioration will result in loss to depositors or lenders, or the FDIC to the extent that deposits are insured.

b. Capital may be classified into subcategories such as capital, paid-in surplus, earned surplus, and retained earnings; or into common stock and one or more classes of preferred stock. These categories can be important for the purposes of corporate law and the relative rights of different classes of shareholders.

# *Capital Calculations*
# *Balance Sheet (in $000's)*

| | |
|---|---|
| Subordinated Capital Notes due four years (1/3), five years (1/3), six years (1/3/) | 990,000 |
| Shareholders Equity | |
| Preferred Stock | |
| 8% non-cumulative perpetual - $25 par value; issued 500,000 shares | 12,500 |
| 8% cumulative perpetual - $25 par value; issued 1,750,000 shares | 42,750 |
| **Common Stock, $1 par value – authorized 10,000,000 shares, issued 6,500,000 shares** | 6,500 |
| **Surplus** | 81,000 |
| **Retained Earnings** | 62,500 |
| **Shareholders Equity** | 205,250 |

## *Consider*

- What are the primary threats to a bank's financial stability?
- What are the primary protections from those threats as shown on the balance sheet?
- What can a bank do to improve its financial stability?

# Income Statement

# PROTOBANK, N.A. Income Statement

(Millions)

| | | |
|---|---|---|
| Interest Income on Earning Assets | | $640 |
| Interest Expense | | |
| Interest on Deposits | 150 | |
| Interest on Other Borrowing | 40 | |
| Total Interest Expense | | (190) |
| Net Interest Income | | 450 |
| Provision for Loan and Lease Losses | | |
| For increase in loans outstanding | 10 | |
| For credit losses | 15 | |
| Total Loan Loss Provision | | (25) |
| Net Interest Income after Provision for Loan Losses | | 425 |
| Non-Interest Income (Fees, etc.) | | 190 |
| Net Interest Income plus Non-Interest Income | | 615 |
| Non-Interest Expense | | (450) |
| (Employee compensation and benefits, occupancy, services, depreciation, etc.) | | |
| Income before taxes | | 165 |
| Federal and State Taxes (33%) | | (55) |
| Net Income | | $110 |

## *General Premises*

Note the structure of the **Income Statement**.

a. **The first half of it focuses on the bank's income and expense from its main business of buying and selling money.**

b. Interest Income less Interest Expense equals Net Interest Income. Net Interest Income less the Provision for Loan and Lease Losses equals Net Interest Income after the Provision.

c. The second part of the Income Statement adds Non-Interest Income and subtracts Non-Interest Expense to arrive at Income before Taxes. Finally, taxes are subtracted to arrive at Net Income.

## Interest Expense

The cost of borrowing the funds that the bank lends and invests.

**Interest on Deposits**: Interest on time and savings deposits. (The costs the bank incurs in servicing non-interest-bearing demand deposits (most checking accounts) are not included in "Interest Expense," but are a general operating expense and included in "non-interest expense.")

**Interest on Other Borrowing**. Note that the cost of these funds is much higher than the cost of deposit funds, 4% ($40 million/$1 billion) as compared with 2.4% ($150 million/$6.2 billion). The costs of servicing deposits and deposit insurance account for some of the difference.

**Net Interest Income** is the difference between "Interest Income" and "Interest Expense". "Net Interest Margin" is the difference between the average interest rate earned by the bank on all of its loans and investments ("earning assets") and the average interest rate paid by the bank on all of its interest-bearing deposits and borrowed funds.

# *PROTOBANK, N.A. Income Statement*

(Millions)

| | | |
|---|---|---|
| Interest Income on Earning Assets | | $640 |
| Interest Expense | | |
| Interest on Deposits | 150 | |
| Interest on Other Borrowing | 40 | |
| Total Interest Expense | | (190) |
| Net Interest Income | | 450 |
| Provision for Loan and Lease Losses | | |
| For increase in loans outstanding | 10 | |
| For credit losses | 15 | |
| Total Loan Loss Provision | | (25) |
| Net Interest Income after Provision for Loan Losses | | 425 |
| Non-Interest Income (Fees, etc.) | | 190 |
| Net Interest Income plus Non-Interest Income | | 615 |
| Non-Interest Expense | | (450) |
| (Employee compensation and benefits, occupancy, services, depreciation, etc.) | | |
| Income before taxes | | 165 |
| Federal and State Taxes (33%) | | (55) |
| Net Income | | $110 |

## Provision for Loan and Lease Losses

This is a deduction from "Net Interest Income" that provides for anticipated losses. The Provision appears on the income statement and is added to the Allowance for Loan and Lease Losses, which appears on the balance sheet, and against which losses are charged. The "provision" is added to and replenishes the "allowance".

a. The size of the allowance reflects both external and internal considerations. **The new accounting method, Current Expected Credit Losses (CECL), is changing the way in which banks must assess future losses**. A bank in an area where the economy is strong may not need as large an allowance as one in an area where the economy is showing signs of stress. A bank with inadequate management and loan information systems will need a higher allowance than a bank with a good system. If loans have grown from one period to the next, the Allowance will need to be increased if its ratio to outstanding loans is to be maintained at the previous level.

b. Similarly, if loans have been charged off, the Allowance will need to be replenished if it is to be restored to its previous level. ProtoBank's Provision reflects both an increases in the level of loans outstanding since the last accounting period and replenishment of the Allowance to compensate for credit losses that have been charged against it. (There has been some disagreement between bank regulators and the SEC about how certain or probable losses should be before they are provided for.)

# *PROTOBANK, N.A. Income Statement*

(Millions)

| | | |
|---|---|---|
| Interest Income on Earning Assets | | $640 |
| Interest Expense | | |
| Interest on Deposits | 150 | |
| Interest on Other Borrowing | 40 | |
| Total Interest Expense | | (190) |
| Net Interest Income | | 450 |
| Provision for Loan and Lease Losses | | |
| For increase in loans outstanding | 10 | |
| For credit losses | 15 | |
| Total Loan Loss Provision | | (25) |
| Net Interest Income after Provision for Loan Losses | | 425 |
| Non-Interest Income (Fees, etc.) | | 190 |
| Net Interest Income plus Non-Interest Income | | 615 |
| Non-Interest Expense | | (450) |
| (Employee compensation and benefits, occupancy, services, depreciation, etc.) | | |
| Income before taxes | | 165 |
| Federal and State Taxes (33%) | | (55) |
| Net Income | | $110 |

## Non-Interest

**Non-Interest Income.** In addition to interest income, ProtoBank earns income from other sources. This appears as "Non-Interest Income" on the Income Statement. Some examples are service fees for account maintenance, fees for trust and custodial services, fees for commitments to extend credit, and rent from the leasing of space not currently needed by the bank. In addition, whenever a bank acts as an agent or broker, the fees are non-interest income – insurance agency, broker-dealer, travel agency, etc.

**Non-Interest Expense.** This is the expense of running the bank. The greatest part of it consists of employee compensation and benefits. Other costs are administrative expenses, account maintenance, rental payments for premises and equipment, and depreciation.

**Net Income.** Banks don't make much money relative to their size. Historically, a 1% return on assets has been a respectable performance, one often not achieved by large banks.

## *CONCEPTS*

- Interest on a loan is revenue; interest paid on a deposit is an expense.
- Fee income (noninterest income) has become increasingly important for banks as managing the spreads in rates (net interest margin) has become more difficult.
  - Fees can be overdraft or other loan fees. Or they can be earned on the sale of nonbanking products.

# Capital and Liquidity Regulation

**Fundamentals of Banking Law**
**June 2024**

**Hugh C. Conroy Jr.**

## What is Capital?

Many correct answers:

| | |
|---|---|
| CORPORATE BALANCE SHEET | • In its simplest form, represents a banking institution's **shareholders' equity**<br>• In other words = Assets minus liabilities |
| REGULATORY OVERLAY | • In its more complicated form, it is defined by **complex regulations** that add to, subtract from, and limit the instruments and balance sheet line items that can be calculated toward regulatory capital adequacy |
| POLICY GOALS | • **Cushion** in case<br>  • asset values decline, or<br>  • liabilities rise<br>• **Intended to protect** certain parties from losses:<br>  • Depositors (and via the FDIC, protects the U.S. government and ultimately taxpayers)<br>  • Other bank customers<br>  • Bank counterparties |


2

## Strong Forms of Capital | Weak Forms of Capital

**Common Stock**
- No requirement to be repaid; perpetual
- No required dividends
- In insolvency, receives residual value only after all other claimants (including preferred stock and subordinated debt) are paid
- "Going concern" capital:
  - **"Common Equity Tier 1"**
  - **"Additional Tier 1"** (certain types of preferred stock)

**Subordinated Debt**
- Must be repaid; limited duration
- Right to receive interest payments
- In insolvency, paid before preferred stock and common stock, but after more senior classes of debt are paid
- "Gone concern" capital: **"Tier 2"**

3

## Basic Capital Requirements

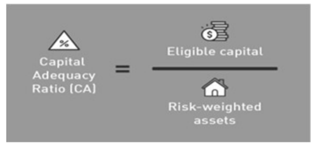
**Requirements**
- Regulations impose **minimum capital ratio requirements.**
- Two types:
  1. **Risk-based capital ratios:** Expressed as a percentage of **"risk-weighted assets" (RWA)**
  2. **Leverage ratios: Not risk-based;** expressed as a percentage of an asset or exposure base that is not risk-weighted

**Scope – Which entities are covered?**
- Bank regulatory capital requirements in the U.S. are typically applicable to:
  – Insured depository institution / bank (separately, even if it is part of BHC)
  – Bank holding company / top-tier
  – For certain foreign banks, their top-tier U.S. intermediate / bank holding company
- Small Bank Holding Company Policy Statement
  – BHCs with less than $3 billion in total assets are exempt from specific capital rules, but will have certain tailored capital requirements imposed by Federal Reserve
- "Community bank leverage ratio" – If holding company
  – has less than $10 billion total assets,
  – has off balance sheet assets that are less than 25% of total assets,
  – has trading assets and liabilities less than 5% of total assets, and
  – maintains a tier 1 leverage ratio of 9% or greater

  then the institution need not maintain compliance with the risk-based capital ratios

4

# Risk-Based Capital Ratios




**NUMERATOR – CAPITAL**

Capital Components:

- Common equity
- Preferred equity
- Sub debt
- Regulatory Adjustments

**DENOMINATOR – RWA**

Total Risk-Weighted Assets (RWA)

- Multiply the dollar amount of every **on-balance-sheet asset** by the risk weight assigned to that asset
- The face amount of **off-balance-sheet items** are first multiplied by a credit conversion factor (CCF) then the applicable risk weight

**RISK WEIGHTING**

Risk weighting is essential to understanding how the capital rules affect the "attractiveness" of assets. **Assets with higher risk weights require more capital to maintain compliance** with the minimum capital ratios.

- A risk weight of less than 100% → Asset is "favored" under the capital rules
- A risk weight of 100% or more → A risk weight of higher than 100% indicates that the regulators believe (for policy or other reasons) that the asset is risky
- A risk weight of 1250% under an 8% total capital minimum is essentially a requirement to hold dollar-for-dollar capital against that asset or exposure



# Non-Risk Based: Leverage Ratios

Leverage Ratio = Tier 1 Capital / Non Risk-Weighted Average Assets / Exposure Calculation

**NUMERATOR** Typically Tier 1 Capital

**US TIER 1 LEVERAGE RATIO**

**Denominator =**

- Average total consolidated GAAP balance sheet assets (does not include certain off-balance sheet assets)
- Without risk weighting and without incorporating effects of collateral or other credit risk mitigants

**BASEL (SUPPLEMENTARY) LEVERAGE RATIO**

**Denominator =**

- Takes into account both on- and off-balance sheet exposures, such as guarantees, derivatives, and securities financing transactions
- Again, without risk weighting and with only limited effects of collateral or other risk mitigants
- U.S. calls this ratio the "supplementary leverage ratio"
- Applicable to larger banks:
  - Category I (GSIB)
  - Category II (total assets of $700bn, or $75bn in cross-jurisdictional activity)
  - Category III (total assets of $250bn, or $75bn in certain other risk-based indicators)

**COMMUNITY BANK LEVERAGE RATIO (CBLR)**

**Denominator =**

- Like the Tier 1 leverage ratio, CBLR denominator is average total consolidated GAAP balance sheet assets
- Banking organizations with < $10 billion in total assets can opt into the CBLR as their sole regulatory capital minimum requirement (risk-based ratios no longer apply)
- Currently set at 9% (was temporarily lowered to 8% during the COVID-19 national emergency)


- **<u>Risk Weighting Example: Bank owns a Chinese bank's bond</u>**
- A senior, unsecured bond issued by a Chinese bank has a risk weight of 50% because China's OECD "country risk classification" is 2 (out of 7).
  - Bank that owns a $1 million bond issued by a Chinese bank would have a denominator RWA value of 50% x $1 million = $500,000
  - Capital of $50,000 would be required to meet a capital ratio of 10%

Compare

- **<u>Risk Weighting Comparison: Bank owns an Argentine bank's bond</u>**
- A senior unsecured bond issued by an Argentine bank has a risk weight of 150% because Argentina's OECD "country risk classification" is 7 (out of 7)
  - A U.S. bank that owns a $1 million bond issued by an Argentine bank would have a denominator RWA value of 150% x $1 million = $1,500,000
  - Capital of $150,000 would be required to meet a capital ratio of 10%
  - Capital of $50,000 would result in a shortfall in the capital ratio as it would equate to only 3.33%

Compare

- **<u>Leverage Ratio Comparison: Bank owns same Chinese bank bond</u>**
- A senior unsecured bond issued by a Chinese bank has a risk weight of 50%
  - A U.S. bank that owns a $1 million bond issued by a Chinese bank would have $1 million of balance sheet assets to include in the leverage ratio denominator
  - The bond's favorable risk weight does not matter for the leverage ratio
  - Capital of $60,000 would be required to meet a leverage ratio of 6% (see the "eSLR"), but only $30,000 to meet a leverage ratio of 3%

# Where Do I Look to Understand a Bank's Capital?

| *In millions of dollars* | Institutional Clients Group | Personal Banking and Wealth Management | Legacy Franchises | Corporate/Other and consolidating eliminations[2] | Citigroup parent company-issued long-term debt and stockholders' equity[3] | Total Citigroup consolidated |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Cash and deposits with banks, net of allowance | $ 108,289 | $ 6,411 | $ 3,251 | $ 224,074 | $ — | $ 342,025 |
| Securities borrowed and purchased under agreements to resell, net of allowance | 364,673 | 425 | 303 | — | — | 365,401 |
| Trading account assets | 319,376 | 2,250 | 639 | 11,849 | — | 334,114 |
| Investments, net of allowance | 140,613 | 73 | 1,516 | 384,380 | — | 526,582 |
| Loans, net of unearned income and allowance for credit losses on loans | 279,337 | 324,260 | 36,650 | — | — | 640,247 |
| Other assets, net of allowance | 111,477 | 25,559 | 27,764 | 43,507 | — | 208,307 |
| Net intersegment liquid assets[4] | 406,143 | 134,852 | 26,592 | (567,587) | — | — |
| **Total assets** | $ 1,729,908 | $ 493,830 | $ 96,715 | $ 96,223 | $ — | $ 2,416,676 |
| **Liabilities and equity** | | | | | | |
| Total deposits | $ 845,364 | $ 437,813 | $ 50,994 | $ 31,783 | $ — | $ 1,365,954 |
| Securities loaned and sold under agreements to repurchase | 199,895 | 80 | 2,469 | — | — | 202,444 |
| Trading account liabilities | 168,550 | 1,636 | 258 | 203 | — | 170,647 |
| Short-term borrowings | 34,785 | 2 | 4 | 12,305 | — | 47,096 |
| Long-term debt[3] | 93,219 | 189 | 75 | 11,866 | 166,257 | 271,606 |
| Other liabilities | 99,353 | 14,514 | 27,868 | 15,356 | — | 157,091 |
| Net intersegment funding (lending)[3] | 288,742 | 39,596 | 15,047 | 24,061 | (367,446) | — |
| **Total liabilities** | $ 1,729,908 | $ 493,830 | $ 96,715 | $ 95,574 | $ (201,189) | $ 2,214,838 |
| **Total stockholders' equity[5]** | — | — | — | 649 | 201,189 | 201,838 |
| **Total liabilities and equity** | $ 1,729,908 | $ 493,830 | $ 96,715 | $ 96,223 | $ — | $ 2,416,676 |

Source: Citigroup 2022 10-K, p. 11

# Where Do I Look to Understand a Bank's Capital?

| | | | | |
|---|---|---|---|---|
| **Stockholders' equity** | | | | |
| Preferred stock ($1.00 par value; authorized shares: 30 million), issued shares: **759,800 as of December 31, 2022** and 759,800 as of December 31, 2021, at aggregate liquidation value | **$** | **18,995** | $ | 18,995 |
| Common stock ($0.01 par value; authorized shares: 6 billion), issued shares: **3,099,669,424 as of December 31, 2022** and 3,099,651,835 as of December 31, 2021 | | **31** | | 31 |
| Additional paid-in capital | | **108,458** | | 108,003 |
| Retained earnings | | **194,734** | | 184,948 |
| Treasury stock, at cost: **1,162,682,999 shares as of December 31, 2022** and 1,115,296,641 shares as of December 31, 2021 | | **(73,967)** | | (71,240) |
| Accumulated other comprehensive income (loss) (*AOCI*) | | **(47,062)** | | (38,765) |
| **Total Citigroup stockholders' equity** | **$** | **201,189** | $ | 201,972 |
| Noncontrolling interests | | **649** | | 700 |
| **Total equity** | **$** | **201,838** | $ | 202,672 |

Source: Citigroup 2022 10-K, p. 141



# Where Do I Look to Understand a Bank's Capital?

***Components of Citigroup Capital***

| *In millions of dollars* | | **December 31, 2022** | | December 31, 2021 |
|---|---|---|---|---|
| **CET1 Capital** | | | | |
| Citigroup common stockholders' equity[1] | $ | **182,325** | $ | 183,108 |
| Add: Qualifying noncontrolling interests | | **128** | | 143 |
| **Regulatory capital adjustments and deductions:** | | | | |
| Add: CECL transition provision[2] | | **2,271** | | 3,028 |
| Less: Accumulated net unrealized gains (losses) on cash flow hedges, net of tax | | **(2,522)** | | 101 |
| Less: Cumulative unrealized net gain (loss) related to changes in fair value of financial liabilities attributable to own creditworthiness, net of tax | | **1,441** | | (896) |
| Less: Intangible assets: | | | | |
| Goodwill, net of related DTLs[3] | | **19,007** | | 20,619 |
| Identifiable intangible assets other than MSRs, net of related DTLs | | **3,411** | | 3,800 |
| Less: Defined benefit pension plan net assets; other | | **1,935** | | 2,080 |
| Less: DTAs arising from net operating loss, foreign tax credit and general business credit carry-forwards[4] | | **12,197** | | 11,270 |
| Less: Excess over 10%/15% limitations for other DTAs, certain common stock investments, and MSRs[4][5] | | **325** | | — |
| **Total CET1 Capital (Standardized Approach and Advanced Approaches)** | $ | **148,930** | $ | 149,305 |
| **Additional Tier 1 Capital** | | | | |
| Qualifying noncumulative perpetual preferred stock[1] | $ | **18,864** | $ | 18,864 |
| Qualifying trust preferred securities[6] | | **1,406** | | 1,399 |
| Qualifying noncontrolling interests | | **30** | | 34 |
| **Regulatory capital deductions:** | | | | |
| Less: Other | | **85** | | 34 |
| **Total Additional Tier 1 Capital (Standardized Approach and Advanced Approaches)** | $ | **20,215** | $ | 20,263 |
| **Total Tier 1 Capital (CET1 Capital + Additional Tier 1 Capital) (Standardized Approach and Advanced Approaches)** | $ | **169,145** | $ | 169,568 |
| **Tier 2 Capital** | | | | |
| Qualifying subordinated debt | $ | **15,530** | $ | 20,064 |
| Qualifying trust preferred securities[7] | | **—** | | 248 |
| Qualifying noncontrolling interests | | **37** | | 42 |
| Eligible allowance for credit losses[2][8] | | **13,426** | | 14,209 |
| **Regulatory capital deduction:** | | | | |
| Less: Other | | **595** | | 293 |
| **Total Tier 2 Capital (Standardized Approach)** | $ | **28,398** | $ | 34,270 |
| **Total Capital (Tier 1 Capital + Tier 2 Capital) (Standardized Approach)** | $ | **197,543** | $ | 203,838 |
| Adjustment for excess of eligible credit reserves over expected credit losses[2][8] | $ | **(8,704)** | $ | (9,832) |
| **Total Tier 2 Capital (Advanced Approaches)** | $ | **19,694** | $ | 24,438 |
| **Total Capital (Tier 1 Capital + Tier 2 Capital) (Advanced Approaches)** | $ | **188,839** | $ | 194,006 |

Source: Citigroup 2022 10-K, p. 30

# Where Do I Look to Understand a Bank's Capital?

| *In millions of dollars* | Institutional Clients Group | Personal Banking and Wealth Management | Legacy Franchises | Corporate/Other and consolidating eliminations[2] | Citigroup parent company-issued long-term debt and stockholders' equity[3] | Total Citigroup consolidated |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Cash and deposits with banks, net of allowance | $ 108,289 | $ 6,411 | $ 3,251 | $ 224,074 | $ — | $ 342,025 |
| Securities borrowed and purchased under agreements to resell, net of allowance | 364,673 | 425 | 303 | — | — | 365,401 |
| Trading account assets | 319,376 | 2,250 | 639 | 11,849 | — | 334,114 |
| Investments, net of allowance | 140,613 | 73 | 1,516 | 384,380 | — | 526,582 |
| Loans, net of unearned income and allowance for credit losses on loans | 279,337 | 324,260 | 36,650 | — | — | 640,247 |
| Other assets, net of allowance | 111,477 | 25,559 | 27,764 | 43,507 | — | 208,307 |
| Net intersegment liquid assets[4] | 406,143 | 134,852 | 26,592 | (567,587) | — | — |
| **Total assets** | $ 1,729,908 | $ 493,830 | $ 96,715 | $ 96,223 | $ — | $ 2,416,676 |
| **Liabilities and equity** | | | | | | |
| Total deposits | $ 845,364 | $ 437,813 | $ 50,994 | $ 31,783 | $ — | $ 1,365,954 |
| Securities loaned and sold under agreements to repurchase | 199,895 | 80 | 2,469 | — | — | 202,444 |
| Trading account liabilities | 168,550 | 1,636 | 258 | 203 | — | 170,647 |
| Short-term borrowings | 34,785 | 2 | 4 | 12,305 | — | 47,096 |
| Long-term debt[3] | 93,219 | 189 | 75 | 11,866 | 166,257 | 271,606 |
| Other liabilities | 99,353 | 14,514 | 27,868 | 15,356 | — | 157,091 |
| Net intersegment funding (lending)[3] | 288,742 | 39,596 | 15,047 | 24,061 | (367,446) | — |
| **Total liabilities** | $ 1,729,908 | $ 493,830 | $ 96,715 | $ 95,574 | $ (201,189) | $ 2,214,838 |
| **Total stockholders' equity**[5] | — | — | — | 649 | 201,189 | 201,838 |
| **Total liabilities and equity** | $ 1,729,908 | $ 493,830 | $ 96,715 | $ 96,223 | $ — | $ 2,416,676 |

Source: Citigroup 2022 10-K, p. 11

# Where Do I Look to Understand a Bank's Capital?

| | | | | |
|---|---|---|---|---|
| **Stockholders' equity** | | | | |
| Preferred stock ($1.00 par value; authorized shares: 30 million), issued shares: **759,800 as of December 31, 2022** and 759,800 as of December 31, 2021, at aggregate liquidation value | **$** | **18,995** | $ | 18,995 |
| Common stock ($0.01 par value; authorized shares: 6 billion), issued shares: **3,099,669,424 as of December 31, 2022** and 3,099,651,835 as of December 31, 2021 | | **31** | | 31 |
| Additional paid-in capital | | **108,458** | | 108,003 |
| Retained earnings | | **194,734** | | 184,948 |
| Treasury stock, at cost: **1,162,682,999 shares as of December 31, 2022** and 1,115,296,641 shares as of December 31, 2021 | | **(73,967)** | | (71,240) |
| Accumulated other comprehensive income (loss) (*AOCI*) | | **(47,062)** | | (38,765) |
| **Total Citigroup stockholders' equity** | **$** | **201,189** | $ | 201,972 |
| Noncontrolling interests | | **649** | | 700 |
| **Total equity** | **$** | **201,838** | $ | 202,672 |

Source: Citigroup 2022 10-K, p. 141

# Where Do I Look to Understand a Bank's Capital?

***Components of Citigroup Capital***

| *In millions of dollars* | | December 31, 2022 | | December 31, 2021 |
|---|---|---|---|---|
| **CET1 Capital** | | | | |
| Citigroup common stockholders' equity[1] | $ | **182,325** | $ | 183,108 |
| Add: Qualifying noncontrolling interests | | **128** | | 143 |
| **Regulatory capital adjustments and deductions:** | | | | |
| Add: CECL transition provision[2] | | **2,271** | | 3,028 |
| Less: Accumulated net unrealized gains (losses) on cash flow hedges, net of tax | | **(2,522)** | | 101 |
| Less: Cumulative unrealized net gain (loss) related to changes in fair value of financial liabilities attributable to own creditworthiness, net of tax | | **1,441** | | (896) |
| Less: Intangible assets: | | | | |
| Goodwill, net of related DTLs[3] | | **19,007** | | 20,619 |
| Identifiable intangible assets other than MSRs, net of related DTLs | | **3,411** | | 3,800 |
| Less: Defined benefit pension plan net assets; other | | **1,935** | | 2,080 |
| Less: DTAs arising from net operating loss, foreign tax credit and general business credit carry-forwards[4] | | **12,197** | | 11,270 |
| Less: Excess over 10%/15% limitations for other DTAs, certain common stock investments, and MSRs[4][5] | | **325** | | — |
| **Total CET1 Capital (Standardized Approach and Advanced Approaches)** | $ | **148,930** | $ | 149,305 |
| **Additional Tier 1 Capital** | | | | |
| Qualifying noncumulative perpetual preferred stock[1] | $ | **18,864** | $ | 18,864 |
| Qualifying trust preferred securities[6] | | **1,406** | | 1,399 |
| Qualifying noncontrolling interests | | **30** | | 34 |
| **Regulatory capital deductions:** | | | | |
| Less: Other | | **85** | | 34 |
| **Total Additional Tier 1 Capital (Standardized Approach and Advanced Approaches)** | $ | **20,215** | $ | 20,263 |
| **Total Tier 1 Capital (CET1 Capital + Additional Tier 1 Capital) (Standardized Approach and Advanced Approaches)** | $ | **169,145** | $ | 169,568 |
| **Tier 2 Capital** | | | | |
| Qualifying subordinated debt | $ | **15,530** | $ | 20,064 |
| Qualifying trust preferred securities[7] | | **—** | | 248 |
| Qualifying noncontrolling interests | | **37** | | 42 |
| Eligible allowance for credit losses[2][8] | | **13,426** | | 14,209 |
| **Regulatory capital deduction:** | | | | |
| Less: Other | | **595** | | 293 |
| **Total Tier 2 Capital (Standardized Approach)** | $ | **28,398** | $ | 34,270 |
| **Total Capital (Tier 1 Capital + Tier 2 Capital) (Standardized Approach)** | $ | **197,543** | $ | 203,838 |
| Adjustment for excess of eligible credit reserves over expected credit losses[2][8] | $ | **(8,704)** | $ | (9,832) |
| **Total Tier 2 Capital (Advanced Approaches)** | $ | **19,694** | $ | 24,438 |
| **Total Capital (Tier 1 Capital + Tier 2 Capital) (Advanced Approaches)** | $ | **188,839** | $ | 194,006 |

Source: Citigroup 2022 10-K, p. 30

# Brief History of Capital Regulation



## Overview of Basel Committee and Basel Accords

- **Basel Committee on Banking Supervision** (BCBS or Basel Committee)
  - Organization of central bankers and regulators from around the world
  - Global standard-setter for the prudential regulation of banks
  - Provides a forum for cooperation and coordination on banking supervisory matters
  - Seeks to encourage financial stability and minimize regulatory arbitrage across nations
- Basel Accords are **not necessarily binding on the regulators** of Basel Committee member states
  - Accords represent international agreement, but are still required to be implemented/adopted through individual national means
- The U.S. bank regulators are tasked with implementing regulation of banks and bank holding companies in the U.S.
  - Federal Reserve – bank holding companies, state "member" banks
  - Office of the Comptroller of the Currency (OCC) – national banks, federal savings associations
  - Federal Deposit Insurance Corporation (FDIC) – state "non-member" banks and certain state savings associations
- U.S. bank regulators have a recent habit of "**gold-plating**" with "**super-equivalent**" requirements.

# History — Basel I and Basel II

**BASEL I**

– Accord reached in July 1988
– Focus on credit risk
– **Two key ratios** (compromise among nations)
  • 4% Tier 1 capital to risk-weighted assets
  • 8% total capital (Tier 1 "core" plus Tier 2 "supplementary") to risk-weighted assets
– Risk-weighted asset calculations based on **four "buckets" of potential risk**
  • 0% category – e.g., cash and U.S./OECD government securities; gold bullion
  • 20% category – e.g., claims on U.S./OECD banks, GSEs/agencies, municipal GO bonds
  • 50% category – e.g., mortgage on 1-4 family residential property, muni revenue bonds
  • 100% category – all other claims
– U.S. adopted in 1989; phased in through 1992

**BASEL II / II.5**

– Process began in 1998, released in June 2004
– Focus on denominator (calculation of risk weights) – encourage use of **models, rather than "buckets"**
– Finalized in mid-2006, also to **include market risk capital for the trading book (Basel II.5)**
– **Three pillars** of capital adequacy:
  • Pillar 1 – Minimum capital requirements for credit, market and (new) operational risk; use "internal ratings-based" (IRB) approaches ("models")
  • Pillar 2 – Supervisory review
  • Pillar 3 – Market discipline (disclosures)
– **Implementation in the United States**
  • Rule covered approx. 20 large and complex U.S. banks
    • $250 billion in consolidated assets, or $10 billion in foreign exposure
    • Other banks could opt-in
  • First U.S. banks began parallel runs in 2009
    • But, no banks were permitted to "exit" parallel run and use solely these "Advanced Approaches"
    • Skepticism of models and of lower RWA
    • Base capital requirements were still Basel I for U.S. banks up until effectiveness of Basel III



# History — Basel III

**2007-09 "Great Financial Crisis" revealed broader deficiencies in the management of bank capital**
• **Goals -- Increate quantity of capital, AND increase quality of capital**
• **December 2010: Basel III core capital modifications largely completed**

**Squeeze the numerator (increase quality of loss-absorbing capital)**
♦ New Common Equity Tier 1 requirement
♦ Tighter definitions of qualifying capital – Limiting the types of instruments that qualify as capital makes it more difficult to satisfy an existing ratio
♦ Phase out softer/hybrid forms of capital
♦ Elimination of certain balance sheet items from capital

**Expand the denominator (more detailed categories of risk-weighting)**
♦ Heavier risk-weighting of riskier, more opaque assets
♦ Heavier risk-weighting for trading assets
♦ Preferential risk weights for cleared vs. OTC derivatives

**Higher capital ratios** required:
♦ Capital conservation buffer
♦ Countercyclical buffer
♦ Higher requirements for most systemically important banks

# U.S. History — Dodd-Frank Act (2010)

| | |
|---|---|
| SECTION 616 | **Capital requirements**<br>— Federal Reserve required to establish capital requirements for BHCs/FHCs<br>— BHC/FHC required to be "source of strength" for its subsidiary banks |
| SECTION 171 | **"Collins Amendment"**<br>— General minimum risk-based capital guidelines serve as a floor for the Advanced Approaches<br>— Disqualifies certain securities, including trust preferred securities and cumulative perpetual preferred stock, from Tier 1 capital |
| SECTION 939A | **Removal of Reliance on Credit Ratings**<br>— Requires federal regulations to be stripped of all reliance on credit ratings<br>— Leads to divergence between Basel III implementation in the US and other countries (ratings are used to assign risk-weights) |
| SECTION 165 | **Enhanced Prudential Standards** (key final rules adopted Feb. 2014; updated "tailoring" finalized in 2019)<br>— Capital Plans - requires all BHCs with consolidated assets above $100 billion, all IHCs of foreign banks and nonbank SIFIs to comply with the Federal Reserve's capital plan rule<br>— Stress Tests - requirement to maintain minimum capital ratios under expected and stressed conditions |
| SECTION 606 | **Financial holding company (FHC) capital**<br>— FHCs required to maintain "well-capitalized" status at holding company level; not only at the depository institution subsidiary level |

15

# History — Economic Growth, Regulatory Relief and Consumer Protection Act (2018)

| | |
|---|---|
| STOP "ONE SIZE FITS ALL" REGULATION | Required the Federal Reserve to **tailor the application of the enhanced prudential standards**<br>— Tailoring Rules adopted in October 2019 assign each FBO, BHC and U.S. IHC with $50 billion or more in total U.S. assets into one of five classifications (Categories I through IV, and 'other firms').<br>• Based on size and four risk-based indicators: Weighted short-term wholesale funding ("STWF"), cross-jurisdictional activity ("CJA"), nonbank assets ("NBA") and off-balance sheet exposure ("OBE")<br>• Capital, stress testing and liquidity requirements generally increase in stringency as BHCs and IHCs ascend these categories |
| LOWER THE STRESS | **Modified capital stress testing processes**<br>— Raised asset thresholds for annual stress testing and eliminated one of the three stress scenarios |
| LEVERAGE RATIO MODS (FOR SOME BANKS) | **Revised the supplementary leverage ratio for custodian banks**<br>— Removes central bank deposits linked to custodial accounts from the supplementary leverage ratio denominator |
| HELP THE SMALL BANKS | Required the agencies to establish a **community bank leverage ratio** |

16

2019 FRB Projections

## List of Domestic Firms by Projected Category (based on estimated data) ǂ

| | Category I<br>U.S. GSIBs | Category II<br>≥ \$700b Total Assets or ≥ \$75b in Cross-Jurisdictional Activity | Category III<br>≥ \$250b Total Assets or ≥ \$75b in NBA, wSTWF, or Off-balance sheet exposure | Category IV<br>Other firms with \$100b to \$250b Total Assets | Other firms<br>\$50b to \$100b Total Assets |
|---|---|---|---|---|---|
| U.S. Domestic Banking Org. | Bank of America<br>Bank of New York Mellon<br>Citigroup<br>Goldman Sachs<br>JPMorgan Chase<br>Morgan Stanley<br>State Street<br>Wells Fargo | Northern Trust | Capital One<br>Charles Schwab<br>PNC Financial<br>U.S. Bancorp | Ally Financial<br>American Express<br>BB&T Corp.<br>Citizens Financial<br>Discover<br>Fifth Third<br>Huntington<br>KeyCorp<br>M&T Bank<br>Regions Financial<br>SunTrust Inc.<br>Synchrony Financial | Comerica Inc.<br>CIT Group Inc.<br>E*TRADE Financial<br>NY Community Bancorp<br>Silicon Valley Bank |

## List of Foreign Firms by Projected Category (standards vary by legal entity)

| | Category I<br>U.S. GSIBs | Category II<br>≥ \$700b Total Assets or ≥ \$75b in Cross-Jurisdictional Activity | Category III<br>≥ \$250b Total Assets or ≥ \$75b in NBA, wSTWF, or Off-balance sheet exposure | Category IV<br>Other firms with \$100b to \$250b Total Assets | Other firms<br>\$50b to \$100b Total Assets |
|---|---|---|---|---|---|
| Intermediate Holding Company | | | Barclays*<br>Credit Suisse<br>Deutsche Bank<br>HSBC<br>Toronto-Dominion<br>UBS | Bank of Montreal<br>BNP Paribas<br>MUFG<br>Royal Bank of Canada<br>Santander | BBVA |
| Combined U.S. Operations | | Barclays<br>Credit Suisse<br>Deutsche Bank<br>MUFG | HSBC<br>Mizuho<br>Royal Bank of Canada<br>Toronto-Dominion<br>UBS | Banco Santander<br>Bank of Nova Scotia<br>Bank of Montreal<br>BBVA<br>BNP Paribas<br>BPCE<br>Société Généralé<br>Sumitomo Mitsui | Canadian Imperial<br>Crédit Agricole<br>I & C bank of China<br>Norinchukin<br>Rabobank |

17

# Capital Planning and Stress Testing

18

# Capital Planning and Stress Testing

**CAPITAL PLANNING**

BHCs with **consolidated assets of $100 bn or more** are required to submit annual **capital plans** to the Federal Reserve for review

– Submit capital plan on April 5 each year, with summary results published in June each year

**Four mandatory elements:**

– Assess **expected uses and sources of capital over the 9-quarter planning horizon**, reflecting the BHC's size, complexity, risk profile, and scope of operations under both expected and stressed conditions
  - Planned capital actions (e.g., dividends, stock repurchases, etc.)
  - Maintain the minimum capital ratios

– Describe BHC's **processes** to assess capital adequacy

– BHC's capital **policies**

– Discuss baseline **changes to the BHC's business plan** that would likely have material impact

Federal Reserve evaluates as part of **Comprehensive Capital Analysis and Review ("CCAR")** exercise

– Quantitative assessment yields stress capital buffer

– Qualitative assessment focuses on ability to take the capital actions described and maintain its capital ratios above the minimum in stressed conditions

**STRESS TESTING**

**Supervisory Stress Testing / Stress Capital Buffer**

– The capital plans of BHCs and IHCs that are:
  - **Category I, II and III** firms are subject to an **annual** supervisory stress test, while
  - **Category IV** firms are subject to a supervisory stress test **every other year**, but may opt into test in an "off year" to reset stress capital buffer

– The Federal Reserve conducts its stress tests under **two economic scenarios** (using the standardized approach only):
  - ***Baseline*** – reflects normal economic conditions
  - ***Severely Adverse*** – reflects severe recession

– The Federal Reserve runs the test based on a set of **assumed capital actions** known as **Dodd-Frank Act stress testing ("DFAST") assumptions**

– The DFAST supervisory stress tests determine the main component of each CCAR firm's "**stress capital buffer**" (i.e., the projected stress test decline in capital)

**Company-Run Stress Testing**

– Category I and II firms – test annually

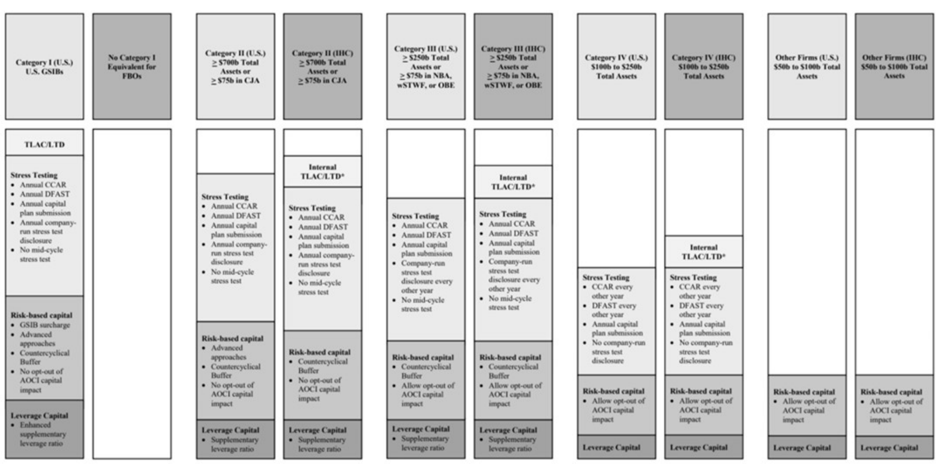
– Category III firms – test every other year

– Category IV firms – not required

– Same economic scenarios as supervisory stress test, just run on BHC's / IHC's own models



# Capital and Stress Testing Requirements for U.S. Banking Organizations and Intermediate Holding Companies



# Capital and Stress Testing Requirements for U.S. Banking Organizations and Intermediate Holding Companies

| Category I (U.S.) U.S. GSIBs | No Category I Equivalent for FBOs | Category II (U.S.) ≥ $700b Total Assets or ≥ $75b in CJA | Category II (IHC) ≥ $700b Total Assets or ≥ $75b in CJA | Category III (U.S.) ≥ $250b Total Assets or ≥ $75b in NBA, wSTWF, or OBE | Category III (IHC) ≥ $250b Total Assets or ≥ $75b in NBA, wSTWF, or OBE | Category IV (U.S.) $100b to $250b Total Assets | Category IV (IHC) $100b to $250b Total Assets | Other Firms (U.S.) $50b to $100b Total Assets | Other Firms (IHC) $50b to $100b Total Assets |
|---|---|---|---|---|---|---|---|---|---|
| **TLAC/LTD** | | | **Internal TLAC/LTD*** | | **Internal TLAC/LTD*** | | **Internal TLAC/LTD*** | | |
| **Stress Testing**<br>• Annual CCAR<br>• Annual DFAST<br>• Annual capital plan submission<br>• Annual company-run stress test disclosure<br>• No mid-cycle stress test | | **Stress Testing**<br>• Annual CCAR<br>• Annual DFAST<br>• Annual capital plan submission<br>• Annual company-run stress test disclosure<br>• No mid-cycle stress test | **Stress Testing**<br>• Annual CCAR<br>• Annual DFAST<br>• Annual capital plan submission<br>• Annual company-run stress test disclosure<br>• No mid-cycle stress test | **Stress Testing**<br>• Annual CCAR<br>• Annual DFAST<br>• Annual capital plan submission<br>• Company-run stress test disclosure every other year<br>• No mid-cycle stress test | **Stress Testing**<br>• Annual CCAR<br>• Annual DFAST<br>• Annual capital plan submission<br>• Company-run stress test disclosure every other year<br>• No mid-cycle stress test | **Stress Testing**<br>• CCAR every other year<br>• DFAST every other year<br>• Annual capital plan submission<br>• No company-run stress test disclosure | **Stress Testing**<br>• CCAR every other year<br>• DFAST every other year<br>• Annual capital plan submission<br>• No company-run stress test disclosure | | |
| **Risk-based capital**<br>• GSIB surcharge<br>• Advanced approaches<br>• Countercyclical Buffer<br>• No opt-out of AOCI capital impact | | **Risk-based capital**<br>• Advanced approaches<br>• Countercyclical Buffer<br>• No opt-out of AOCI capital impact | **Risk-based capital**<br>• Countercyclical Buffer<br>• No opt-out of AOCI capital impact | **Risk-based capital**<br>• Countercyclical Buffer<br>• Allow opt-out of AOCI capital impact | **Risk-based capital**<br>• Countercyclical Buffer<br>• Allow opt-out of AOCI capital impact | **Risk-based capital**<br>• Allow opt-out of AOCI capital impact | **Risk-based capital**<br>• Allow opt-out of AOCI capital impact | **Risk-based capital**<br>• Allow opt-out of AOCI capital impact | **Risk-based capital**<br>• Allow opt-out of AOCI capital impact |
| **Leverage Capital**<br>• Enhanced supplementary leverage ratio | | **Leverage Capital**<br>• Supplementary leverage ratio | **Leverage Capital**<br>• Supplementary leverage ratio | **Leverage Capital**<br>• Supplementary leverage ratio | **Leverage Capital**<br>• Supplementary leverage ratio | **Leverage Capital** | **Leverage Capital** | **Leverage Capital** | **Leverage Capital** |

# Current U.S. Capital Framework:

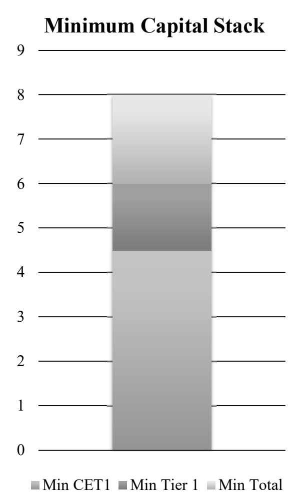
## Minimum Ratios and Numerator/Capital Components



# Minimum Capital Ratios

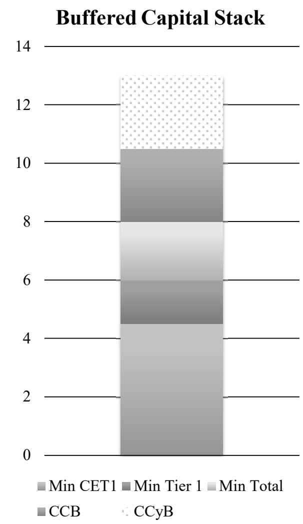
- **Common Equity Tier 1 (CET1) (4.5% minimum)**
  - Qualifying common stock instruments, related surplus and retained earnings; classified as GAAP equity
  - Most subordinated claim; perpetual instrument with no incentive or expectation to redeem
  - Dividends must be discretionary
- **Additional Tier 1 (AT1)**
  - Instruments satisfying 14 specific eligibility criteria – essentially non-cumulative perpetual preferred; classified as GAAP equity.
  - Can be called after five years (but must still be perpetual)
  - Dividends must be cancellable
- **CET1 + AT1 = Tier 1 Capital (6% minimum)**
  - "Going concern capital" – i.e., capital that can be depleted, likely without placing the bank into insolvency
- **Tier 2 Capital**
  - "Gone-concern capital" – i.e., capital that absorbs losses if shareholders' equity is wiped out (insolvency), and well prior to depositors losing any money
  - Subordinated debt instruments that meet specific eligibility criteria
  - Not secured or guaranteed; minimum original maturity of at least 5 years and not callable for 5 years
- **Tier 1 + Tier 2 Capital = Total Capital (8% minimum)**

- **Key Point** – These are *minima*; a bank can have greater than these amounts, and could meet the T1 and Total requirements with a combination (e.g., could fill its capital stack with all CET1 if it wanted to)



# Buffers

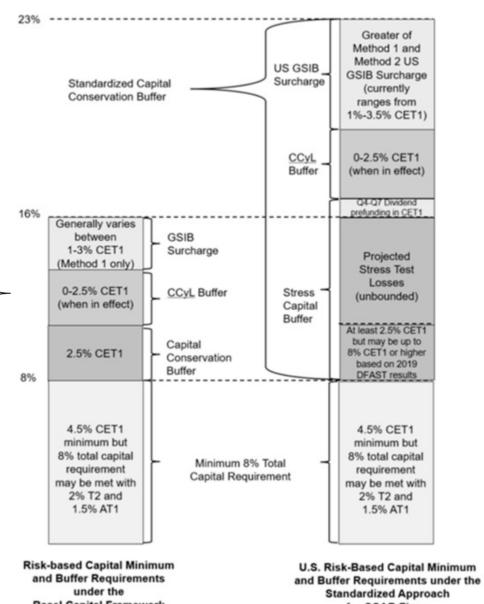
- **Capital Conservation Buffer (CCB)**
  - Applies to all banks / BHCs that are subject to the risk-based capital rules (i.e., not the CBLR)
    - For Category I, II, III and IV firms the "standardized capital conservation buffer" now includes the dynamic, firm-specific "stress capital buffer" for the standardized approach capital ratios with a floor of 2.5%
    - Category I and II firms are also subject to a static 2.5% "advanced capital conservation buffer"
  - In all circumstances, at least **2.5% composed of CET1**
  - Added to <u>each</u> of the minimum requirements
  - Intended to be available in times of stress
  - If any capital level falls below its "buffered" minimum, **constraints on ability to distribute earnings and make discretionary bonus payments** will be progressively applied
- **Countercyclical Buffer (CCyB)**
  - Applies only to Category I, II and III BHCs/IHCs and their bank subsidiaries
  - Between 0% and 2.5% – To be determined from time to time by regulator according to its **perception of the systemic risk that has built up in the banking system** as a result of excess credit growth
  - Works as an increased Capital Conservation Buffer (standardized and advanced), with same constraints on distributions and discretionary bonuses
  - September 2016 – Federal Reserve Board issued "policy statement" on framework it would follow, and factors it would consider, in setting a Countercyclical Buffer.





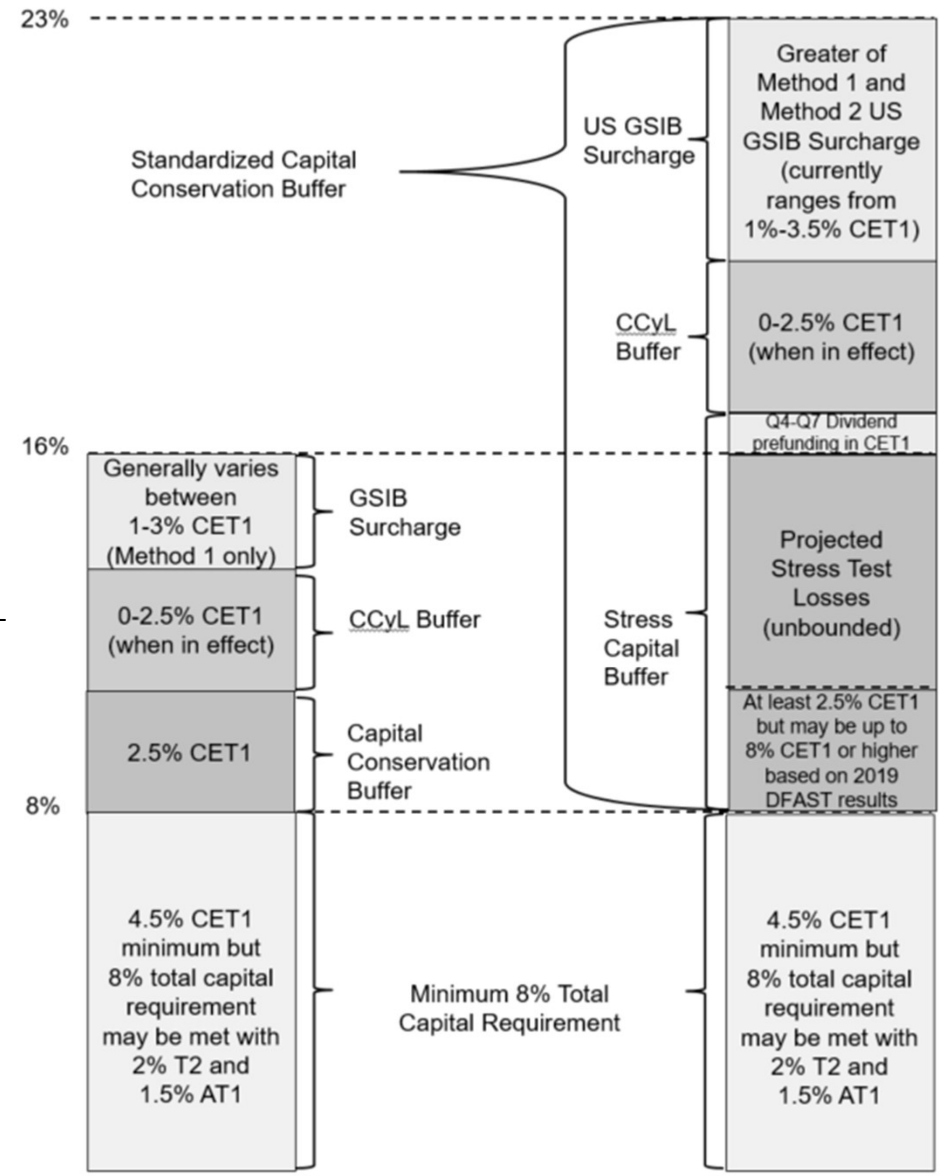

# Stress Capital Buffer

- March 2020 – Federal Reserve adopted a rule modifying the Capital Conservation Buffer for those firms that are subject to CCAR stress tests
- Creates a **"stress capital buffer"**
  - Applies only under the Standardized Approach
- The "stress capital buffer" consists of:
  - **Maximum projected decline** (peak-to-trough) in a firm's CET1 ratio during the 9-quarter stress horizon under the "severely adverse" stress test scenario, **<u>plus</u>**
  - The firm's **planned common stock dividends for Q4 through Q7** of the planning horizon
- But in no case less than 2.5% (floor)
- "Super-equivalent" to the Basel framework; no analog in other countries



# Stress Capital Buffer

- March 2020 – Federal Reserve adopted a rule modifying the Capital Conservation Buffer for those firms that are subject to CCAR stress tests
- Creates a **"stress capital buffer"**
  - Applies only under the Standardized Approach
- The "stress capital buffer" consists of:
  - **Maximum projected decline** (peak-to-trough) in a firm's CET1 ratio during the 9-quarter stress horizon under the "severely adverse" stress test scenario, **plus**
  - The firm's **planned common stock dividends for Q4 through Q7** of the planning horizon
- But in no case less than 2.5% (floor)
- "Super-equivalent" to the Basel framework; no analog in other countries




Risk-based Capital Minimum and Buffer Requirements under the Basel Capital Framework

U.S. Risk-Based Capital Minimum and Buffer Requirements under the Standardized Approach for CCAR Firms

# G-SIB Surcharge

**INTERNATIONAL CHARGE ON GLOBAL SYSTEMICALLY IMPORTANT BANKS (G-SIBS)**

Published by the international **Financial Stability Board (FSB)** in November 2011

- Identifies G-SIBs using an assessment methodology and framework developed by the Basel Committee
- FSB then proposed that **G-SIBs be subject to a "capital surcharge"**
- The scoring is based on 5 systemic risk indicators:
  - ***Size*** – total exposures
  - ***Interconnectedness*** – intra-financial system assets, intra-financial system liabilities, and securities outstanding
  - ***Substitutability*** – payments activity, assets under custody, and underwritten transactions in debt and equity markets
  - ***Complexity*** – notional amount of OTC derivatives, trading and available-for-sale securities, and level 3 assets
  - ***Cross-Border Activity*** – cross-border claims and cross-border liabilities
- Annual list places each G-SIB into a "bucket" corresponding to the proposed international surcharge for that G-SIB

**U.S. GOLD-PLATED IMPLEMENTATION**

Category I firms apply two methods to determine their surcharge

- **Method 1** – Basel Committee criteria
- **Method 2** – substitutability factor replaced with a score reflecting **dependence on short-term wholesale funding**
- G-SIB must apply higher of the two surcharges (Method 2 generally produces significantly higher scores)

Operationally, the surcharge is **added to the capital conservation buffer**

- Can only be satisfied with CET 1
- Increasingly more stringent restrictions on distributions and discretionary bonus payments the further below the capital conservation buffer + G-SIB surcharge
- In contrast to the eSLR buffer (which is also G-SIB-specific), the G-SIB surcharge does not apply to a G-SIB's insured depository institution (IDI) subsidiaries



| G-SIB SURCHARGE | |
|---|---|
| **Bucket** | **G-SIBs in alphabetical order within each bucket** |
| 3.5% | (Empty) |
| 2.5% | JP Morgan Chase |
| 2.0% | Bank of America<br>Citigroup<br>HSBC |
| 1.5% | Agricultural Bank of China<br>Bank of China<br>Barclays<br>BNP Paribas<br>China Construction Bank<br>Deutsche Bank<br>Goldman Sachs<br>Industrial and Commercial Bank of China<br>Mitsubishi UFJ FG<br>UBS |
| 1.0% | Bank of Communications (China)<br>Bank of New York Mellon<br>Group BPCE<br>Group Crédit Agricole<br>ING Bank<br>Mizuho FG<br>Morgan Stanley<br>Royal Bank of Canada<br>Santander<br>Société Générale<br>Standard Chartered<br>State Street<br>Sumitomo Mitsui FG<br>Toronto Dominion<br>Wells Fargo |

Source: FSB, *2022 List of Global Systemically Important Banks (G-SIBs), Nov. 27, 2023*

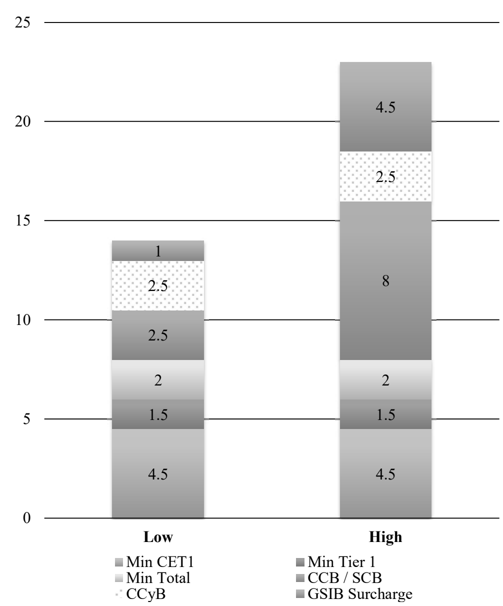
# U.S. G-SIB Surcharge Comparison

| GSIB | Score 1 | Score 2 | Capital Surcharge: Method 1 | Capital Surcharge: Method 2 | Binding Method | Effective Capital Surcharge |
|---|---|---|---|---|---|---|
| B of A | 311 | 559 | 1.5 | 3.0 | 2 | 3.0 |
| BoNY | 149 | 213 | 1.0 | 1.0 | Both | 1.0 |
| C | 409 | 714 | 2.0 | 3.5 | 2 | 3.5 |
| GS | 248 | 585 | 1.5 | 3.0 | 2 | 3.0 |
| JPM | 473 | 857 | 2.5 | 4.5 | 2 | 4.5 |
| MS | 224 | 545 | 1.0 | 3.0 | 2 | 3.0 |
| STT | 146 | 275 | 1.0 | 1.0 | Both | 1.0 |
| WFC | 197 | 352 | 1.0 | 2.0 | 2 | 2.0 |

Source: G-SIB Surcharge, Final Rule, 80 Fed. Reg. 49082 (2015).

27

# Hypothetical GSIB Capital Stack—Low vs. High




28

# Buffers - Payout Ratios

| Capital Buffer (combination of some or all of Capital Conservation Buffer, Countercyclical Buffer, Stress Capital Buffer and/or GSIB Surcharge) | Maximum Payout Ratio for dividends and discretionary bonuses (as a percentage of eligible retained income) |
|---|---|
| Greater than the Board-regulated institution's buffer requirement | No payout ratio limit |
| Less than or equal to 100%, and greater than 75% of the regulated institution's buffer requirement | 60% |
| Less than or equal to 75%, and greater than 50% of the regulated institution's buffer requirement | 40% |
| Less than or equal to 50%, and greater than 25% of the regulated institution's buffer requirement | 20% |
| Less than or equal to 25% of the regulated institution's buffer requirement | 0% |



# U.S. Leverage Ratio Implementation

**TIER 1 LEVERAGE RATIO AND COMMUNITY BANK LEVERAGE RATIO**

- In its simplest form = **Tier 1 capital amount / average balance sheet assets**
  - No inclusion of off-balance sheet assets
- Still applicable to all banks and bank holding companies in the U.S. (other than those opting into the CBLR)
  - 4% minimum; 5% for IDIs to be deemed well-capitalized
- Banking organizations with less than $10 billion in total assets may opt into the CBLR, an elevated Tier 1 leverage ratio set at 9%, compliance with which eliminates risk-based capital requirements

**SUPPLEMENTARY (INTERNATIONAL) LEVERAGE RATIO (SLR)**

- Basel Committee decided, at U.S. urging, to incorporate a leverage ratio requirement into Basel III
  - Balance sheet assets plus **measure of "total exposure" including off-balance sheet items**
  - Incorporates repos, securities loans/borrows, derivatives, credit derivatives, margin receipts, securities lending agency guarantees and other off-balance sheet exposures
  - Custodian banks (BNYM, STT, and NTRS) may eliminate central bank deposits from the denominator
- In U.S., applicable to Category I, II and III firms – maintain a **minimum of 3%**

**ENHANCED SUPPLEMENTARY LEVERAGE RATIO (ESLR)**

- Category I BHCs (U.S. GSIBs) – **8 largest, most systemically significant, U.S. banking organizations**
- Category I BHCs maintain buffer of at least 2% above the minimum SLR requirement of 3%, for a **total of 5%** – failure to maintain 5% ratio subjects Category I BHCs to restrictions on discretionary bonus payments and capital distributions
- IDI subsidiaries of Category I BHCs are required to meet a **6% SLR** to be considered "well-capitalized" for prompt corrective action purposes

# Sample Supplementary Leverage Ratio Disclosure

***Supplementary Leverage Ratio***
The following table presents Citi's Supplementary Leverage ratio and related components as of December 31, 2022, September 30, 2022 and December 31, 2021:

| *In millions of dollars, except ratios* | **December 31, 2022** | September 30, 2022 | December 31, 2021 |
|---|---|---|---|
| **Tier 1 Capital** | $ **169,145** | $ 164,830 | $ 169,568 |
| **Total Leverage Exposure** | | | |
| **On-balance sheet assets**[(1)(2)] | $ **2,432,823** | $ 2,401,767 | $ 2,389,237 |
| **Certain off-balance sheet exposures**[(3)] | | | |
| Potential future exposure on derivative contracts | **133,071** | 153,842 | 222,241 |
| Effective notional of sold credit derivatives, net[(4)] | **34,117** | 32,768 | 23,788 |
| Counterparty credit risk for repo-style transactions[(5)] | **17,169** | 16,997 | 25,775 |
| Other off-balance sheet exposures | **326,553** | 320,364 | 334,526 |
| **Total of certain off-balance sheet exposures** | $ **510,910** | $ 523,971 | $ 606,330 |
| Less: Tier 1 Capital deductions | **36,960** | 37,203 | 37,803 |
| **Total Leverage Exposure** | $ **2,906,773** | $ 2,888,535 | $ 2,957,764 |
| **Supplementary Leverage ratio** | **5.82 %** | 5.71 % | 5.73 % |

Source: Citigroup 2022 10-K, p. 35



# Prompt Corrective Action

- Introduced in **1991 through the Federal Deposit Insurance Corporation Improvement Act (FDICIA)**
  - Codified at 12 U.S.C. § 1831o
  - Links declines in capital strength to **intervention by bank regulators**
  - Applies **only to insured depository institutions** – not bank holding companies
- For smaller banks that make use of the **"community bank leverage ratio" (CBLR)**, agencies have similar "tiers" of the CBLR for treatment under the Prompt Corrective Action framework (with 9% established as the "well capitalized" tier).

| | Well-Capitalized | Adequately Capitalized | Undercapitalized | Significantly Undercapitalized | Critically Undercapitalized |
|---|---|---|---|---|---|
| **Total Capital Ratio** | ≥ 10 | ≥ 8 | < 8 | < 6 | Tangible equity (i.e., tier 1 capital plus non-tier 1 perpetual preferred stock) to total assets ratio ≤2 |
| **Tier 1 Ratio** | ≥ 8 | ≥ 6 | < 6 | < 4 | |
| **CET1 Ratio** | ≥ 6.5 | ≥ 4.5 | < 4.5 | < 3 | |
| **Leverage Ratio** | ≥ 5 | ≥ 4 | < 4 | < 3 | |
| **SLR** | - | ≥ 3 | < 3 | - | |
| **Effects / Actions Required** | | Negatively affects (i) ability to make use of certain permissions, and (ii) FHC status of holding company | File a capital restoration plan; no dividends; no payments of management fees; enhanced supervisory monitoring; restricted growth; restrictions on acquisitions and expansion | All requirements / effects to the left, plus restrict compensation of executive officers; regulator may require additional restrictions such as recapitalization, restricting transactions with affiliates, restricting interest rates paid, restricting activities, improving management, dismissing officers, requiring divestitures. | All of the requirements / effects to the left, plus mandatory restrictions on activities, mandatory restrictions on payments on sub debt; could appoint a conservator or receiver unless another course of action is determined to be appropriate |

# Example of Banking Institution Disclosure of All Ratios

| *In millions of dollars, except ratios* | Stated minimum | Citigroup Well-capitalized minimum | Citigroup December 31, 2022 | Citigroup December 31, 2021 | Citibank Well-capitalized minimum | Citibank December 31, 2022 | Citibank December 31, 2021 |
|---|---|---|---|---|---|---|---|
| CET1 Capital | | | $ 148,930 | $ 149,305 | | $ 149,593 | $ 148,548 |
| Tier 1 Capital | | | 169,145 | 169,568 | | 151,720 | 150,679 |
| Total Capital (Tier 1 Capital + Tier 2 Capital)—Standardized Approach | | | 197,543 | 203,838 | | 172,647 | 175,427 |
| Total Capital (Tier 1 Capital + Tier 2 Capital)—Advanced Approaches | | | 188,839 | 194,006 | | 165,131 | 166,921 |
| Total risk-weighted assets—Standardized Approach | | | 1,142,985 | 1,219,175 | | 982,914 | 1,066,015 |
| Total risk-weighted assets—Advanced Approaches | | | 1,221,538 | 1,209,374 | | 1,003,747 | 1,017,774 |
| Quarterly adjusted average total assets[1] | | | 2,395,863 | 2,351,434 | | 1,738,744 | 1,716,596 |
| Total Leverage Exposure[2] | | | 2,906,773 | 2,957,764 | | 2,189,541 | 2,236,839 |
| CET1 Capital ratio[3] | 4.5 % | N/A | 13.03 % | 12.25 % | 6.5 % | 14.90 % | 13.93 % |
| Tier 1 Capital ratio[3] | 6.0 | 6.0 % | 14.80 | 13.91 | 8.0 | 15.12 | 14.13 |
| Total Capital ratio[3] | 8.0 | 10.0 | 15.46 | 16.04 | 10.0 | 16.45 | 16.40 |
| Tier 1 Leverage ratio | 4.0 | N/A | 7.06 | 7.21 | 5.0 | 8.73 | 8.78 |
| Supplementary Leverage ratio | 3.0 | N/A | 5.82 | 5.73 | 6.0 | 6.93 | 6.74 |

(1) Tier 1 Leverage ratio denominator.
(2) Supplementary Leverage ratio denominator.
(3) Citi's binding CET1 Capital and Tier 1 Capital ratios were derived under the Basel III Standardized Approach as of December 31, 2022 and 2021, whereas Citi's binding Total Capital ratio was derived under the Basel III Advanced Approaches framework for both periods presented. Citibank's binding CET1 Capital and Tier 1 Capital ratios were derived under the Basel III Advanced Approaches framework as of December 31, 2022, and were derived under the Basel III Standardized Approach as of December 31, 2021. Citibank's binding Total Capital ratio was derived under the Basel III Advanced Approaches framework for both periods presented.

N/A Not applicable

Source: Citigroup 2022 10-K, p. 233



# Current U.S. Capital Framework:

# Risk Weighting and Denominator Calculations

# Standardized Approach

- **Standardized Approach** became effective January 1, 2015
  - A **non-models-based** approach for determining risk-weighted assets for banking organizations that are not mandatorily subject to the Advanced Approaches and have not opted into the CBLR
    - Applies to **all banking organizations** currently subject to minimum capital requirements, other than
      - (i) BHCs with less than $3 bn in total assets subject to the FRB's Small BHC Policy Statement, and
      - (ii) institutions with less than $10 billion total assets that choose to apply the CBLR
    - Is the "generally applicable" capital requirement for purposes of determining compliance with the Collins Amendment's risk-based **capital "floor"**

- Generally, the methodology for calculating risk-weighted assets is:
  - For **on-balance-sheet exposures** – multiplying the exposure by a provided risk weight or by a risk weight determined by using a simplified formula
  - For **off-balance-sheet exposures** – multiplying the off-balance sheet component first by a **"credit conversion factor,"** to get the applicable exposure, and then by the risk weight for the exposure
  - Most risk weights are provided directly in the regulation

35

# Standardized Approach – Risk-Weight Examples

| Sovereign Risk Weights | |
|---|---|
| Country Risk Classification (CRC) | Risk Weight |
| 0-1 | 0 |
| 2 | 20 |
| 3 | 50 |
| 4-6 | 100 |
| 7 | 150 |
| OECD Member with no CRC | 0 |
| Non-OECD Member with no CRC | 100 |
| Sovereign Default | 150 |

| Foreign Bank Risk Weights | |
|---|---|
| Country Risk Classification (CRC) | Risk Weight |
| 0-1 | 20 |
| 2 | 50 |
| 3 | 100 |
| 4-7 | 150 |
| OECD Member with no CRC | 20 |
| Non-OECD Member with no CRC | 100 |
| Sovereign Default | 150 |

36

# Standardized Approach – Risk-Weight Examples

| Equity Risk Weights | |
|---|---|
| **Equity Exposure** | **Risk Weight** |
| Sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, and any other entity whose credit exposures receive a zero percent risk weight under section 32 of the final rule. | 0 |
| An equity exposure to a PSE, Federal Home Loan Bank or Farmer Mac. | 20 |
| • Community development equity exposures.<br>• The effective portion of a hedge pair.<br>• Non-significant equity exposures to the extent that the aggregate adjusted carrying value of the exposures does not exceed 10 percent of tier 1 capital plus tier 2 capital | 100 |
| A significant investment in the capital of an unconsolidated financial institution in the form of common stock that is not deducted under section 22 of the final rule. | 250 |
| A publicly-traded equity exposure (other than an equity exposure that receives a 600 percent risk weight and including the ineffective portion of a hedge pair). | 300 |
| An equity exposure that is not publicly-traded (other than an equity exposure that receives a 600 percent risk weight). | 400 |
| An equity exposure to an investment firm that (i) would meet the definition of a traditional securitization were it not for the primary Federal supervisor's application of paragraph (8) of that definition and (ii) has greater than immaterial leverage. | 600 |

37

# Advanced Approaches

- Applies to **largest, internationally active U.S. BHCs and their IDI subsidiaries**
  - **Category I and II firms only** (9 firms)
  - Prior to Tailoring Rules, applied to all banking organizations over $250 billion total assets or over $10 billion in foreign exposure (approx. 12-15 institutions), and included their IDI subsidiaries
- Incorporates more **sophisticated models**
  - BUT Section 171 of the Dodd-Frank Act (the "**Collins Amendment**") requires that even Advanced Approaches banks **calculate capital based on a "floor" of the Standardized Approach**
  - Internal ratings-based (IRB) approach / other models to calculate risk-based capital requirements for credit risk
  - Advanced measurement approaches (AMA) to calculate capital requirements for **operational risk**.

38

# Market Risk and Operational Risk

- **Market risk**
  - Based on **Basel II.5**; U.S. revised version effective January 1, 2013
  - Applies to all depository institutions and BHCs with combined "**trading assets and liabilities**" equal to:
    - At least $1 billion, or
    - 10% of its total assets
  - Calculation of market risk equivalent risk-weighted assets – "extract" those trading assets from denominator, run market risk calculations (in contrast to credit risk) and replace
  - Use in both Advanced Approach and Standardized Approach
    - Category I and II banking organizations that meet the criteria for use of market risk rules must use the market risk rules in calculating both their Advanced Approaches and their standardized "floor" risk-weighted asset amounts
  - Revisions and increased capital requirements proposed under "Fundamental Review of the Trading Book" / Basel III Endgame

- **Operational Risk**
  - Operational risk – potential that inadequate information systems, operational problems, internal control breaches, fraud, or unforeseen catastrophes result in unexpected losses.
  - Category I and II firms must use advanced measurement approaches (AMA) to calculate their capital requirement for operational risk.
  - Estimate operational risk exposure – based on potential aggregate operational losses over a one-year horizon, using several data elements.
  - Significant revisions to eliminate all use of internal models proposed under Basel III Endgame

39

# Sample Disclosure of RWAs Across Credit, Market and Op Risk

| | | Advanced Approaches | | | Standardized Approach | | |
|---|---|---|---|---|---|---|---|
| *In millions of dollars, except ratios* | Required Capital Ratios[1] | **December 31, 2022** | September 30, 2022 | December 31, 2021 | **December 31, 2022** | September 30, 2022 | December 31, 2021 |
| CET1 Capital[2] | | **$ 149,593** | $ 147,938 | $ 148,548 | **$ 149,593** | $ 147,938 | $ 148,548 |
| Tier 1 Capital[2] | | **151,720** | 150,062 | 150,679 | **151,720** | 150,062 | 150,679 |
| Total Capital (Tier 1 Capital + Tier 2 Capital)[2][3] | | **165,131** | 165,171 | 166,921 | **172,647** | 172,916 | 175,427 |
| Total Risk-Weighted Assets | | **1,003,747** | 1,046,884 | 1,017,774 | **982,914** | 1,024,923 | 1,066,015 |
| Credit Risk[2] | | **$ 728,082** | $ 762,660 | $ 737,802 | **$ 948,150** | $ 983,949 | $ 1,016,293 |
| Market Risk | | **34,403** | 40,676 | 48,089 | **34,764** | 40,974 | 49,722 |
| Operational Risk | | **241,262** | 243,548 | 231,883 | — | — | — |
| CET1 Capital ratio[4][5] | **7.0 %** | **14.90 %** | 14.13 % | 14.60 % | **15.22 %** | 14.43 % | 13.93 % |
| Tier 1 Capital ratio[4][5] | **8.5** | **15.12** | 14.33 | 14.80 | **15.44** | 14.64 | 14.13 |
| Total Capital ratio[4][5] | **10.5** | **16.45** | 15.78 | 16.40 | **17.56** | 16.87 | 16.46 |

| *In millions of dollars, except ratios* | Required Capital Ratios | December 31, 2022 | September 30, 2022 | December 31, 2021 |
|---|---|---|---|---|
| Quarterly Adjusted Average Total Assets[2][6] | | **$ 1,738,744** | $ 1,694,381 | $ 1,716,596 |
| Total Leverage Exposure[2][7] | | **2,189,541** | 2,147,923 | 2,236,839 |
| Tier 1 Leverage ratio[5] | **5.0 %** | **8.73 %** | 8.86 % | 8.78 % |
| Supplementary Leverage ratio[5] | **6.0** | **6.93** | 6.99 | 6.74 |

Source: Citigroup 2022 10-K, p. 28

40

# Summer 2023 Proposals – Basel III "Endgame"

| Element of Rules | Current Capital Rules | | Proposed Capital Rules |
|---|---|---|---|
| Advanced Approaches / Models | Category I (GSIBs) and Category II | ⇒ | Eliminated |
| Credit Risk RWAs | (1) Category I and II can use models<br>(2) Others use Standardized Approach | ⇒ | (1) All institutions above $100bn (Categories I-IV) use new "enhanced risk-based approach" (ERBA)<br>(2) Under $100bn, continue to use existing Standardized Approach |
| Market Risk RWAs | (1) Apply if aggregate trading assets and trading liabilities equal to: (a) 10 % or more of total assets; or (b) $1 billion or more<br>(2) Category I and II could use models, if approved | ⇒ | (1) All institutions above $100bn (Categories I-IV), plus any other institution with aggregate trading assets and trading liabilities equal to: (a) 10 % or more of total assets; or (b) $5 billion or more<br>(2) Any market risk organization can apply to have a model approved for a desk |
| Operational Risk RWAs | (1) Category I and II applied as part of the Advanced Approaches<br>(2) Use Advanced Measurement Approach (model) | ⇒ | (1) All institutions above $100bn (Categories I-IV)<br>(2) Use more standardized business indicator approach |
| Supplementary Leverage Ratio | Categories I-III | ⇒ | Expand to Category IV |
| CCyB | Categories I-III | ⇒ | Expand to Category IV |
| Long-Term (Bail-in) Debt (LTD) Requirements | (1) Category I (GSIBs) only, as part of total loss-absorbing capacity (TLAC)<br>(2) Does not apply to IDI subsidiaries of GSIBs | ⇒ | (1) All institutions above $100bn (Categories I-IV), unless already apply TLAC (US GSIBs, GSIB IHCs)<br>(2) Categories II-IV apply LTD only, not TLAC, and apply at a lower amount than GSIBs.<br>(3) IDI subsidiaries of Category II-IV must also undertake internal LTD, but IDI subs of US GSIBs not required |
| Collins Floor | Applies only to Advanced Approaches (Category I and II) | ⇒ | Applies in more complex way:<br>(1) Standardized Approach serves as floor to the ERBA overall (for Categories I-IV)<br>(2) Standardized market risk approach serves as floor for desks that are permitted to use models |



# Liquidity Requirements

# Basel Liquidity Framework

**NEED FOR LIQUIDITY MEASURES**

- Early stages of the 2007-2009 financial crisis – institutions experienced **liquidity squeeze <u>despite</u> having adequate capital levels**
  - See also – Silicon Valley Bank
- Crisis theme: "Before Asia opens"

**LIQUIDITY COVERAGE RATIO (LCR)**

- Promotes short-term resilience by requiring that an institution maintain high-quality liquid assets ("HQLA") to withstand a stress scenario lasting for 30 days
- Finalized by Basel Committee in January 2014, and adopted in the U.S. in October 2014

**NET STABLE FUNDING RATIO (NSFR)**

- Promotes longer-term resilience by requiring that the institution maintain sufficiently stable amounts of longer-term funding matched to assets
- Finalized by Basel Committee in October 2014, and adopted in the U.S. in October 2020

43

# Key Liquidity Considerations

Under LCR and NSFR
Institutions must evaluate the effect of their transactions and products on liquidity

**<u>Key LCR questions:</u>**

Does the transaction cause a **liquidity drain** under the regulators' outflow assumptions?

Does the transaction serve as a **liquidity source** or inflow?

Can the instrument serve as a **liquidity store**, or "HQLA"?

**<u>Key NSFR questions:</u>**

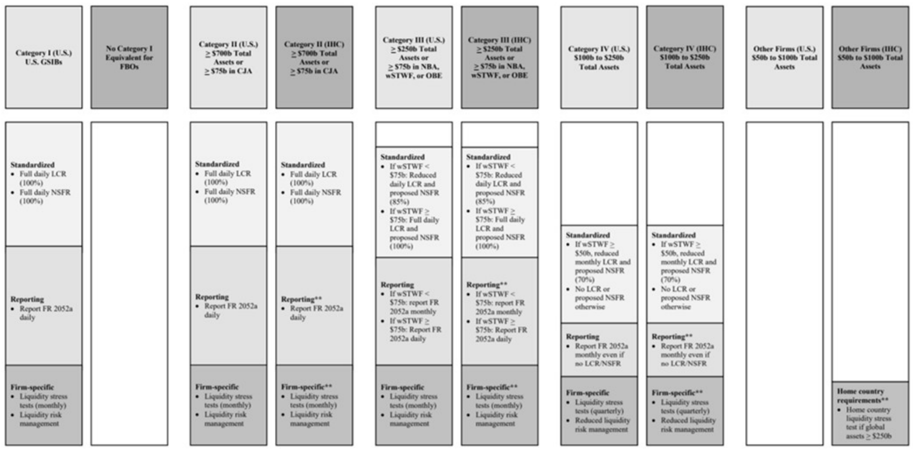
Are liabilities and capital sufficiently **long-term and stable** as to support assets?

Are assets **liquid enough** to not require long-term funding, or might their liquidity need to be supported with long-term funding?

Has the institution **"matched" funding** with assets?

44

## Liquidity Requirements Applicable to U.S. Banking Organizations and Intermediate Holding Companies






# U.S. Liquidity Coverage Ratio

- **Institutions subject to the full LCR (100%)**
  - **Category I and II** firms and their IDI subsidiaries with $10 bn or more in assets
  - **Category III** firms with wSTWF of $75 billion or greater and their IDI subsidiaries with $10 bn or more in assets
- **Institutions subject to <u>reduced</u> LCR requirements**:
  - **Category III** firms with wSTWF of $75 billion or less (and their >$10 bn IDI subsidiaries) are subject to an 85% LCR
  - **Category IV** firms with wSTWF of $50 billion or greater (but **not** their IDI subsidiaries) are subject to a 70% LCR
- **LCR Calculation**
  - **Daily** calculation required for firms subject to the full LCR; **monthly** for firms subject to reduced LCR

$$\text{LCR} = \frac{\text{HQLA amount as of the calculation date}}{\text{Total } \underline{\text{net}} \text{ cash outflow amount as of the calculation date}} \geq 100\%$$

  - The **Reduced LCR** is operationalized by multiplying the denominator by the applicable percentage (i.e. 70% or 85%)

# Liquidity Requirements Applicable to U.S. Banking Organizations and Intermediate Holding Companies

| Category I (U.S.) U.S. GSIBs | No Category I Equivalent for FBOs | Category II (U.S.) ≥ \$700b Total Assets or ≥ \$75b in CJA | Category II (IHC) ≥ \$700b Total Assets or ≥ \$75b in CJA | Category III (U.S.) ≥ \$250b Total Assets or ≥ \$75b in NBA, wSTWF, or OBE | Category III (IHC) ≥ \$250b Total Assets or ≥ \$75b in NBA, wSTWF, or OBE | Category IV (U.S.) \$100b to \$250b Total Assets | Category IV (IHC) \$100b to \$250b Total Assets | Other Firms (U.S.) \$50b to \$100b Total Assets | Other Firms (IHC) \$50b to \$100b Total Assets |
|---|---|---|---|---|---|---|---|---|---|
| **Standardized**<br>• Full daily LCR (100%)<br>• Full daily NSFR (100%) | | **Standardized**<br>• Full daily LCR (100%)<br>• Full daily NSFR (100%) | **Standardized**<br>• Full daily LCR (100%)<br>• Full daily NSFR (100%) | **Standardized**<br>• If wSTWF < \$75b: Reduced daily LCR and proposed NSFR (85%)<br>• If wSTWF ≥ \$75b: Full daily LCR and proposed NSFR (100%) | **Standardized**<br>• If wSTWF < \$75b: Reduced daily LCR and proposed NSFR (85%)<br>• If wSTWF ≥ \$75b: Full daily LCR and proposed NSFR (100%) | **Standardized**<br>• If wSTWF ≥ \$50b, reduced monthly LCR and proposed NSFR (70%)<br>• No LCR or proposed NSFR otherwise | **Standardized**<br>• If wSTWF ≥ \$50b, reduced monthly LCR and proposed NSFR (70%)<br>• No LCR or proposed NSFR otherwise | | |
| **Reporting**<br>• Report FR 2052a daily | | **Reporting**<br>• Report FR 2052a daily | **Reporting****<br>• Report FR 2052a daily | **Reporting**<br>• If wSTWF < \$75b: report FR 2052a monthly<br>• If wSTWF ≥ \$75b: Report FR 2052a daily | **Reporting****<br>• If wSTWF < \$75b: report FR 2052a monthly<br>• If wSTWF ≥ \$75b: Report FR 2052a daily | **Reporting**<br>• Report FR 2052a monthly even if no LCR/NSFR | **Reporting****<br>• Report FR 2052a monthly even if no LCR/NSFR | | |
| **Firm-specific**<br>• Liquidity stress tests (monthly)<br>• Liquidity risk management | | **Firm-specific**<br>• Liquidity stress tests (monthly)<br>• Liquidity risk management | **Firm-specific****<br>• Liquidity stress tests (monthly)<br>• Liquidity risk management | **Firm-specific**<br>• Liquidity stress tests (monthly)<br>• Liquidity risk management | **Firm-specific****<br>• Liquidity stress tests (monthly)<br>• Liquidity risk management | **Firm-specific**<br>• Liquidity stress tests (quarterly)<br>• Reduced liquidity risk management | **Firm-specific****<br>• Liquidity stress tests (quarterly)<br>• Reduced liquidity risk management | | **Home country requirements****<br>• Home country liquidity stress test if global assets ≥ \$250b |

## How the LCR Works

**OUTFLOWS**

Maturing within the 30-day stress period, or
"Assumed", by regulation, to flow out during the 30 days

- Assumed outflow rates range from 0%-100%.
- Examples include:
  - 3% outflow – stable retail deposits fully covered by FDIC
  - 10% outflow – brokered deposits that mature outside 30-days
  - 100% outflow – undrawn liquidity facility commitments to financial institutions

**MINUS**

**INFLOWS**

Maturing within the 30-day stress period.
However, because of stress, some are not counted as full inflows

- Cash inflows without stated maturities and contingent cash flows (e.g., credit and liquidity facilities) are excluded from calculation

Regulation-determined inflow rates range from 0%-100%

- 0% inflow – credit / liquidity facilities to the institution
- 50% inflow – retail loan payments
- 0% inflow – secured lending transactions on Level 1 HQLA
- 15% inflow – secured lending transactions on Level 2A HQLA

**ADJUSTMENTS**

Inflows capped at 75% of outflows to ensure that there will always be a positive requirement to maintain HQLA

"Maturity mismatch add-on": This does not appear in Basel LCR, but reflects the U.S. regulators' views that later inflows should not offset earlier outflows

**HQLA DEFINITION**

— **Level 1 assets** (most liquid) = reserves (but not just cash); U.S. government debt; certain higher quality sovereign, development bank, central bank debt
— **Level 2A assets** = Government Sponsored Entity (GSE) debt; agency mortgage-backed securities (MBS); certain sovereign, development bank debt (15% haircut)
— **Level 2B assets** = certain investment-grade corporate debt; Russell 1000 equities; certain foreign equities; certain investment-grade state/muni (50% haircut)

- Max 40% of HQLA buffer may be Level 2 (i.e., 2A + 2B) assets
- Max 15% of HQLA buffer may be Level 2B assets

— **HQLA exclude** all financial institution securities (wrong-way risk), residential mortgage-backed securities, covered bonds, non-investment grade corporate bonds and certain municipal bonds
— Also need to meet a number of **operational and other requirements** to become **eligible HQLA**. Some of these include:

- Unencumbered
- Capable of being monetized
- In control of business unit in charge of liquidity risk

47

## Net Stable Funding Ratio

- In October 2020, the U.S. Agencies adopted rules to implement the Net Stable Funding Ratio (NSFR) element of the Basel liquidity framework.
- **Applicability** – same as LCR.
  - **"Full" NSFR**: all Category I and II firms, Category III firms with wSTWF of $75 billion or greater, and these firms' IDI subs with $10 bn or more in assets
  - **Reduced NSFR**:
    - Category III firms with wSTWF of $75 billion or less (and their >$10 bn IDI subsidiaries) are subject to an 85% NSFR
    - Category IV firms with wSTWF of $50 billion or greater (but not their IDI subsidiaries) are subject to a 70% NSFR
- **Formula** –

$$\text{Full NSFR} = \frac{\text{Available Stable Funding (ASF)}}{\text{Required Stable Funding (RSF)}} \geq 100\%$$

  - The Reduced NSFR is operationalized by multiplying the denominator by the applicable percentage (i.e. 70% or 85%)
- **ASF** = the sum of all regulatory capital elements and liabilities, each multiplied by an ASF factor from 0 ~ 100% assigned based on stability of the funding source over a one-year horizon
- **RSF** = the sum of all assets and certain off-balance sheet and derivative charges, each multiplied by an RSF factor from 0 ~ 100% assigned based on the relative liquidity of the asset over a one-year horizon

48

# How the LCR Works

## OUTFLOWS

Maturing within the 30-day stress period, or
"Assumed", by regulation, to flow out during the 30 days

- Assumed outflow rates range from 0%-100%.
- Examples include:
  - 3% outflow – stable retail deposits fully covered by FDIC
  - 10% outflow – brokered deposits that mature outside 30-days
  - 100% outflow – undrawn liquidity facility commitments to financial institutions

**MINUS**

## INFLOWS

Maturing within the 30-day stress period.
However, because of stress, some are not counted as full inflows

- Cash inflows without stated maturities and contingent cash flows (e.g., credit and liquidity facilities) are excluded from calculation

Regulation-determined inflow rates range from 0%-100%

- 0% inflow – credit / liquidity facilities to the institution
- 50% inflow – retail loan payments
- 0% inflow – secured lending transactions on Level 1 HQLA
- 15% inflow – secured lending transactions on Level 2A HQLA

## ADJUSTMENTS

Inflows capped at 75% of outflows to ensure that there will always be a positive requirement to maintain HQLA

"Maturity mismatch add-on": This does not appear in Basel LCR, but reflects the U.S. regulators' views that later inflows should not offset earlier outflows

## HQLA DEFINITION

— **Level 1 assets** (most liquid) = reserves (but not just cash); U.S. government debt; certain higher quality sovereign, development bank, central bank debt

— **Level 2A assets** = Government Sponsored Entity (GSE) debt; agency mortgage-backed securities (MBS); certain sovereign, development bank debt (15% haircut)

— **Level 2B assets** = certain investment-grade corporate debt; Russell 1000 equities; certain foreign equities; certain investment-grade state/muni (50% haircut)

- Max 40% of HQLA buffer may be Level 2 (i.e., 2A + 2B) assets
- Max 15% of HQLA buffer may be Level 2B assets

— **HQLA exclude** all financial institution securities (wrong-way risk), residential mortgage-backed securities, covered bonds, non-investment grade corporate bonds and certain municipal bonds

— Also need to meet a number of **operational and other requirements** to become **eligible HQLA**. Some of these include:

- Unencumbered
- Capable of being monetized
- In control of business unit in charge of liquidity risk

# Resolution-Related Requirements



# Total Loss-Absorbing Capacity (TLAC) and Long-Term Debt (LTD) Requirements

- The Financial Stability Board's TLAC standard establishes a minimum requirement for the instruments and liabilities that should be readily **available to "bail in"** as part of the resolution of a G-SIB.
- The TLAC Rules apply to:
  - Top-tier U.S. bank holding companies identified by the Federal Reserve as G-SIBs; and
  - U.S. intermediate holding companies (IHCs) of G-SIB foreign banking organizations with at least $50 billion in U.S. non-branch assets.
- U.S. G-SIB BHC Requirements:
  - **External TLAC** greater or equal to 18% of its total RWA and 9.5% of its total leverage exposure
    - Plus an external TLAC buffer composed solely of CET1 equal to:
      - 2.5% of total RWA plus
      - the countercyclical buffer (when in effect) plus
      - the G-SIB BHC's Method 1 G-SIB surcharge
  - The Federal Reserve went beyond the international agreement, requiring **External LTD** equal to at least 6% of total risk weighted assets and 4.5% of its total leverage exposure
    - **Eligible LTD debt securities** generally must, among other requirements, have a maturity of at least 1 year from the date of issuance and may not provide the holder with acceleration rights outside of insolvency or payment default.
- Lower percentages apply to the U.S. **intermediate holding companies of foreign banks**, which issue **"internal" TLAC and LTD** to their foreign bank parents.

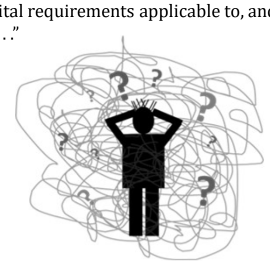
# Clean Holding Company Requirements

- "Clean holding company" framework imposes certain restrictions on the types of liabilities that may be held at the level of the G-SIB BHC and Covered IHCs.
  - Purpose is to be able to "bail in" the issued TLAC/LTD and not have to cover all of the holding companies liabilities, but be able to cover the operating subsidiaries (bank, broker-dealer, etc.)
- G-SIB BHCs are prohibited from:
  - issuing short-term debt (including commercial paper and short-term deposits);
  - creating setoff rights against subsidiaries;
  - entering qualified financial contracts with third parties; and
  - issuing guarantees with certain prohibited cross-defaults or benefiting from upstream guarantees.
- The TLAC Rules also impose a 5% cap on the aggregate amount of certain non-contingent liabilities (including structured notes and operating liabilities such as rent and employee obligations) owed to third parties, subject to certain exceptions.

51

# Reactions

- **Thomas Hoenig (former FDIC Director):**
  - "The poor record of Basel I, II and II.5 is that of a system fundamentally flawed. Basel III is a continuation of these efforts, but with more complexity"
  - "If you add 400 more rules, or 400 equations, that is 400 more ways to game the system."
- **Andrew Haldane (former BoE Executive Director for Financial Stability):**
  - "Modern finance is complex, perhaps too complex . . . As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity. Less may be more . . ."
  - "To ask today's regulators to save us from tomorrow's crisis using yesterday's toolbox is to ask a border collie to catch a Frisbee by first applying Newton's law of gravity."
- **Citigroup 2014 10-K, Risk Factors, page 54:**
  - "Despite the adoption of the final U.S. Basel III rules, there continue to be changes and uncertainties regarding the regulatory capital requirements applicable to, and, as a result, the ultimate impact of these requirements on, Citi. . . ."



52

# Fundamentals of Banking Law

## Tab I: Restraints on Lending

John A. Buchman
June 25, 2024

## Discussion Agenda

- Threshold lending considerations – permissible forms of lending and statutory, regulatory, and supervisory limits on lending
- National banks' ability to export interest rates under 12 U.S.C. § 85 and Marquette U.S. Supreme Court decision
- Loans to one borrower limitations under 12 U.S.C. § 84 and 12 C.F.R. Part 32
- Loans to insiders limitations under 12 U.S.C. §§ 375a and 375b and 12 C.F.R. Part 215.
- Other kinds of statutes and regulations impacting lending



Classification: Schwab Internal

# Threshold Lending Considerations

## Threshold Lending Considerations

1. What **types of activities** constitute permissible forms of lending?
2. Are there any **statutory or regulatory limitations** that would generally apply or apply to specific types of lending?
3. Is there **supervisory guidance** that would also impose limits on a bank's ability to make certain types of loans?

3

Classification: Schwab Internal

# Permissible Forms of Lending

- 12 U.S.C. § 24(Seventh), which references "loaning money on personal security", read generally as providing NBs with broad authority to make secured and unsecured loans or other extensions credit.
- 12 U.S.C. § 371 authorizes NBs to make real estate loans.
- OCC and courts have long held that the economic substance of the transaction, rather than its form, guides the analysis of whether the transaction is a permissible lending activity.
  - 9th Circuit 1977 decision in M&M Leasing Corp. held personal property leases structured to be the functional equivalent of loans are within a NB's lending powers – codified at 12 C.F.R. § 23
  - In Interp. Ltr. No. 1139 (Nov. 2013), OCC permitted NB to provide financing to a solar project through an investment in the project's owner based on finding that financing is substantially identical to a loan transaction.



Classification: Schwab Internal

# Permissible Forms of Lending

- Other types of quasi-lending activities are treated as permissible loans and extensions of credit by the OCC, including:
  - Contractual commitments to advance funds such as commercial lines of credit and HELOCs
  - Standby and commercial letters of credit
  - Repurchase agreements
  - Bankers' acceptances
  - Sales of Fed funds
  - Certain kinds of guarantees and acting as surety
  - Any other similar transaction as a result of which a person becomes obligated to pay money to the bank
  - Credit exposure from derivatives transactions



Classification: Schwab Internal

# Statutory/Regulatory Limits on Lending

- *Limit by Entity Powers:* Choice of charter type can affect scope of lending powers.
  - Federal savings associations are limited in the amount of commercial loans they may hold, – up to 10/20% of assets and 400% of capital for commercial real estate loans. They must also satisfy the HOLA or IRS domestic building and loan association (DBLA) qualified thrift lender tests.
    - HOLA QTL test – must hold qualified thrift investments (QTIs) equal to at least 65% of thrift's portfolio assets; QTIs include mortgage loans, HELOC, education, small business and credit card loans, and MBS.
    - DBLA tests – general public holds more than 75% of thrift's deposits, 75% of income derived from interest on loans and government obligations, 60% of thrift's assets invested in residential mortgage loans, government securities, REMICs.
  - Credit card banks, trust banks, and industrial loan companies are limited purpose entities with only powers granted in their charters.



Classification: Schwab Internal

# Statutory/Regulatory Limits on Lending

- *Limit by Statute/Regulation:*
  - NBs are limited in their ability to own real estate under 12 U.S.C. 12 U.S.C. §29 and 12 C.F.R. § 7.1000 and thus may only lease out real property under limited circumstances (e.g., in their own office buildings); whereas NBs are able to engage in leasing transactions involving <u>personal property</u> that are the functional equivalents of loans under 12 C.F.R. Part 23.
    - Leasing of personal property as equivalent of a loan: OCC may require payment of the full value of a leased auto through an extended term of lease payments and a full residual payment at the end of the lease that functions like a down payment.
  - NBs are limited in their ability to hold equity securities; however, they may, as consideration for a loan, share in the profit, income, or earnings from a business. OCC also allows taking of a warrant or option on stock as acceptable "interest" on a loan rather than prohibited equity ownership. Warrant may not be exercised by the bank. 12 C.F.R. § 7.1006.
  - Similarly, NBs may also make shared appreciation mortgage loans to real estate developers. OCC Interp. Ltr. No. 244.



Classification: Schwab Internal

# Statutory/Regulatory Limits on Lending

- *Limit by Statute/Regulation:*
  - NBs are prohibited from making loans secured by the bank's own stock under 12 U.S.C. § 83.
  - NBs may hold a security interest in other types of collateral that they may not own: they may take real estate collateral for mortgage loans or make loans with equities as collateral and may take such collateral on foreclosure under "debts previously contracted (DPC)" exception. 12 U.S.C. § 29; 12 CFR Part 221 (Regulation U)
  - Historically, NBs have generally been prohibited from making guarantees, but they may do so now if they have a substantial (financial) interest in the transaction, i.e., if the guarantee is incidental to another of their authorized activities. 12 C.F.R. § 7.017
  - Letters of credit and surety bonds as equivalents of guarantees are also permitted under 12 C.F.R. § 7.017.

8

Classification: Schwab Internal

# Supervisory Limits on Lending

- Concentration limits for a particular type of lending activity: traditionally regulators concerned about credit concentrations relating only to geography or borrower sector; now limits could be imposed for any concentration of risks, e.g., pools of transactions that have common sensitivity to economic, financial, or business developments.
  - See OCC Handbook on Concentrations of Credit, December 2020.
- CRE lending: OCC requires bank limits imposed by board of directors based on internal considerations such as the size and sophistication of the bank and external considerations, including market conditions, vacancy rates, zoning issues, and valuation trends; higher capital requirements for high volatility commercial real estate (HVCRE) loans - loans that primarily finance acquisition, construction and development loans for commercial projects
  - See OCC Handbook on Commercial Real Estate Lending, March 2022; 12 C.F.R. Part 208, Appendix C – Interagency Guidelines for Real Estate Lending Policies.
- Generally, NBs in good standing do not require prior approval for new lending activities permitted by the OCC; however, regulators may require approval for new banks and banks subject to enforcement actions.

9

Classification: Schwab Internal

# Marquette and Exportation of Interest Rates

## Marquette and Exportation of Interest Rates

- Under 12 U.S.C. 85, enacted as section 30 of the National Bank Act of 1864, national banks may charge interest:
  - At the rate allowed by the laws of the state. . . where the bank is located
  - At a rate 1% in excess of the discount rate on 90-day commercial paper, or
  - When there is no state usury rate, up to 7%.
- *Tiffany v. National Bank of Missouri*, 85 U.S. 409 (1873) – NB may use highest rate allowed for any state lender even if it is higher than rate allowed for state banks. – “national banks are national favorites”



Classification: Schwab Internal

# Marquette and Exportation of Interest Rates

- *Marquette National Bank v. First of Omaha Service Corporation*, 439 U.S. 299 (1978)
  - Case involved NB in Nebraska issuing credit cards to customers in Minnesota.
  - Decision permits NB to charge interest on its credit card loans at the rate permitted by Nebraska, where the bank is located, not where customer is located or where transaction takes place.
  - By allowing NB to charge Minnesota customers Nebraska interest rates, Section 85 pre-empted Minnesota's usury statute.
- Section 521 of Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) gave state-chartered institutions the same ability to export their home state interest rates. But Iowa, Colorado, and Puerto Rico have opted out of Section 521. The opt out does not apply to loans made by national banks.
- Marquette was key to the development of the credit card industry and explains why so many banks are located in states with no usury limits





# Marquette and Exportation of Interest Rates

- Are fees or charges included in the concept of an interest rate and protected from state limits on rates by preemption?
  - *Smiley v. Citibank*, 517 US 735 (1996) – NB's late fees treated as interest and subject to exportation; transactional costs are included as "interest" but one-time costs, e.g., the card's annual fee, are not.
  - *Greenwood Trust Co. v. Massachusetts, 971 F.2d 818 (1st Cir.1992)* - same holding as Smiley but for state-chartered banks under § 521 of DIDMCA.
- OCC Interpretive Ltr. 822, February 17, 1988, addressed situation where NB has interstate branches; letter permitted national banks to charge the rate of the home state or any other state in which the bank had a branch as long as the loans in question were made in branch office state. Loans were made where:
  - Loan decision was made (where loan is approved),
  - Loan was made (where loan approval is communicated to the borrower), and
  - Loan funds were distributed (usually, where loan closing takes place)

# Marquette and Exportation of Interest Rates

- In National Ass'n of Industrial Bankers et al v. Weiser et al, a lawsuit brought in the U.S. District Court for Colorado in March 2024, plaintiffs allege, among other things, that the opt out law violates the US Constitution's Supremacy and Commerce Clauses and Sections 521 and 525 of DIDMCA, and that the National Bank Act preempts the law.
- The opt out language in Section 525 of DIDMCA provides that Section 521 will not apply "to loans made in a state" if the state adopts a law or voters vote for a provision opting out of Section 521.
- A key issue in the case is whether a loan made to a Colorado resident by an out-of-state state-chartered bank is made in the bank's state or in Colorado.
- The FDIC has filed an amicus brief supporting Colorado's position. The American Bankers Association filed an amicus brief supporting plaintiffs' position and taking issue with the FDIC's arguments.
- The Colorado opt out law is scheduled to go into effect on July 1, 2024 unless the law is blocked by the court. So far (as of 6/10/24), the court has not rendered a verdict in the case.



# Marquette and Exportation of Interest Rates

- In Madden v. Midland Funding LLC, 786 F.3d 246 (2nd Cir. 2015), a national bank charged Madden's credit card account as uncollectible and sold the debt to a debt collector, Midland Funding; the credit card debt carried a 27% interest rate and NY's usury law imposed a maximum rate of 25%.
  - 2nd Circuit held that NY's usury law was not pre-empted by the National Bank Act b/c application of the law to Midland would not significantly interfere with the NB's ability to exercise its powers.
- In May 2020, the OCC and FDIC adopted "Madden fix" rules to clarify that the "valid when made" doctrine applies - when a bank sells, assigns or otherwise transfers a loan, the interest permissible before the transfer continues to be permissible after the transfer. See 12 C.F.R. § 7.4001(e) and 12 C.F.R. § 331.4(e).
- In February 2022, the rules were both upheld by the U.S. District Court for Northern California in California v. OCC and California v. FDIC.

# Loans to One Borrower

## Loans to One Borrower

- Loans to one borrower lending limits, 12 U.S.C. § 84, 12 C.F.R. § 32, along with loans to insiders limits, 12 U.S.C. §§ 375a and 375b, and Regulation O, 12 C.F.R. § 215, and transactions with affiliates requirements, FRA Sections 23A & 23B, and Regulation W, 12 C.F.R. § 223 (discussed separately in Affiliate Transactions session):
  - All designed to preserve integrity of bank's credit decisions
  - All are concerned with the possible harm to a bank from lending where a powerful constituency (large borrower, affiliate, management) threatens the impartiality of the bank's credit-making function or the quantity of such loans on the books of the bank
- Regulation O objective: To prevent excessive loans to one person, or to related persons that are financially dependent, and to promote diversification of loans and equitable access to banking services



Classification: Schwab Internal

# Loans to One Borrower

- Part 32 Combined general limit - A national bank's total outstanding loans and extensions of credit to one borrower may not exceed:
  - 15% of the bank's capital and surplus,
  - plus an additional 10% of the bank's capital and surplus, ***if*** the amount that exceeds the bank's 15 percent general limit is fully secured by readily marketable collateral (e.g. publicly-traded securities)
  - The bank must have a perfected security interest in the collateral, and the collateral must have a current market value at all times of at least 100% of the amount of the loan in excess of the 15% general limit.
  - A bank's "capital and surplus" equals its total capital plus the amount of its loan loss reserves not included in its Tier 2 capital.
- The phrase "loans and extensions of credit" is broadly defined to include actual loans, contractual commitments to advance funds, overdrafts, securities repurchase agreements, sales of Federal funds, banker's acceptances, discounting of consumer and commercial paper, and credit exposure arising from derivative transactions.





# Loans to One Borrower

- Under Part 32, a number of lending-type transactions are treated either as (1) not being loans subject to the regulation, i.e., "non-loans" or (2) loans that a bank can make without limit.
  - Non-loans include additional funds advanced to protect a bank's security interest in a property, bank-financed sales of REO, sold loan participations, amounts paid in the normal course of collection, accrued interest.
  - Loans that can be made without limit include discounts of commercial paper, bankers' acceptances eligible for rediscount, loans secured by U.S. obligations, loans secured by segregated deposit accounts, and intra-day credit exposures.
  - Rationales for non-loan and loan without limit treatment – (1) very low risk to the bank, (2) public policy purpose to promote commerce, and (3) to benefit the bank.

## Loans to One Borrower

- Qualifying commitment to lend (QCL) – a commitment that, when combined with all other loans and commitments to a borrower, was within a bank's lending limit
  - A QCL is treated as a loan for loans to one borrower purposes.
  - If a different loan is subsequently made to the borrower that, if combined with all other loans and commitments, would exceed the bank's lending limit, QCLs are disqualified in last-to-first order.
  - A disqualified commitment to lend is no longer treated as a loan and therefore is no longer counted for LTOB lending limits; only actual advances are counted as loans.
  - OCC's reason for treating commitments to lend this way was apparently to give NBs flexibility to make loans to borrowers that had large undrawn upon lines of credit, thus promoting lending.



Classification: Schwab Internal

## Loans to One Borrower

- Supplemental Lending Limit Program in 12 C.F.R. § 32.7 – NBs that are well capitalized and have "1" or "2" CAMELS ratings (with at least a "2" rating in asset quality and management) may exceed the Combined General Limit by applying to the OCC.
- Under the program, the total of all loans to one borrower cannot exceed 25% of the bank's capital and surplus and all loans made under the rule cannot exceed 100% of capital and surplus.
- The three types of loans that are eligible for the program are:
  - 1-4 family residential real estate loans
  - Small business loans, and
  - Small farm loans.



Classification: Schwab Internal

## Loans to One Borrower

- Combination Rule in 12 C.F.R. § 32.5 – Loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed the same borrower—
  - When proceeds of a loan or extension of credit are to be used for the **direct benefit** of the other person, to the extent of the proceeds so used; or
  - When a **common enterprise** is deemed to exist between the persons.
- Direct benefit test. When loan proceeds are transferred to another borrower, both loans will be attributed to the other borrower.
  - Exception where funds are transferred in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services

22

Classification: Schwab Internal

## Loans to One Borrower

- Common enterprise test. A common enterprise will be deemed to exist and loans to separate borrowers will be aggregated when:
  - **The expected source of repayment** for each loan is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid. ( There is a general exception for loans to employers and employees;
  - Loans are made (i) to borrowers that are affiliated ("common control") and (ii) **substantial financial interdependence** exists between or among the borrowers (50% or more test); or
  - Separate persons borrow from a bank to acquire a business enterprise and thereafter the borrowers will own more than 50 percent of the company.

23

Classification: Schwab Internal

# Loans to Insiders – Regulation O

## Loans to Insiders - Regulation O

Policy Background

- Transactions between a bank and its insiders can address legitimate banking needs and serve the interests of both parties. The challenge is to separate legitimate insider financial relationships from those that are, or could become, abusive, imprudent, or preferential.
- While most risks can be measured and quantified, insider abuse can damage a bank's reputation beyond the dollar amount of any credit loss. Improper insider activities can undermine public confidence in the institution. Market perception of the integrity of a bank's insiders is fundamental to the bank's financial health and ongoing viability.
- Managing reputation risk: To maintain this public confidence, a bank must have a reputation for honesty and integrity in all of its activities, especially in its transactions with insiders.



Classification: Schwab Internal

## Loans to Insiders - Regulation O

- Regulation O imposes general prohibitions on loans made to a bank's insiders, including executive officers, directors, principal shareholders, and their related interests, as well as additional prohibitions applicable to the bank's executive officers.
  - Executive officers, directors, principal shareholders (owners of 10% or more of a bank's or its holding company's stock), and their related interests are all defined in Section 215.2 of Regulation O as insiders.
- General prohibitions applicable to all insiders:
  - Loans must be made on same terms as available to third parties and may not involve more than normal risk of repayment or present other unfavorable features;
    - (Exception for extensions of credit on terms that are widely available to employees)
  - Prior board approval is required for extensions of credit exceeding certain thresholds (lesser of $25k or 5% of bank's capital; $500k aggregate);
  - Total extensions of credit to any one insider may not exceed 12 C.F.R. Part 32 single borrower lending limits;



Classification: Schwab Internal

## Loans to Insiders - Regulation O

- Limits on aggregate extensions of credit to all insiders (generally, 100% of bank's capital); and
- Prohibition on overdrafts by executive officers and directors unless pursuant to a pre-authorized plan.
  - (Exception for overdrafts of up to $1,000 repaid within 5 business days where insider pays same fees as customer would)
- Scope of general prohibition and supplemental requirements:
  - Treats loans to an insider's own ventures ("related interests") as loans to the insider
  - In most cases, treats insiders of a bank's affiliates as insiders of the bank
  - Prohibits knowing receipt of an improper extension of credit by an insider, and
  - Prohibits preferential lending to a correspondent bank's insider.
  - Reg O does not apply to advances against accrued salary or for authorized travel, certain credit card debt up to $15K, or overdraft programs with lines below $5K.



Classification: Schwab Internal

## Loans to Insiders – Regulation O

- Additional restrictions applicable to a bank's executive directors
  - Loans to finance education of executive officer's children – unlimited;
  - First mortgage loans to finance or refinance the purchase, construction, maintenance, or improvement of an executive officer's residence – unlimited:
  - Loans secured by U.S. government securities or guaranteed by U.S. government and segregated deposit accounts – unlimited; and
  - Loans for all other purposes – $100,000 limit.
- Reg O effectively requires extensive internal recordkeeping and information gathering, and adoption of Reg O policies, to prevent inadvertent violations.
- Regulators treat violations of Reg O very seriously.

28

Classification: Schwab Internal

# Additional Lending Rules

## Additional Lending Rules

- Debts previously contracted (DPC) – banks may take stock or real estate or other assets otherwise impermissible for it (or its BHC) to own in satisfaction of a debt
- Key limitations for NBs:
  - May hold for a maximum of 10 years;
  - Must obtain extension annually after 5 years (2 years if held by BHC); some states do not have a limited holding period;
  - Can exercise control of the foreclosed property;
  - Must show efforts to dispose;
  - Additional funds may be spent with notification to the OCC if funds are needed to enable bank to recover its total investment;
  - Must value asset appropriately/write off loan amount exceeding asset's value.
- Other real estate rules
  - Appraisal required
  - Flood insurance



Classification: Schwab Internal

## Additional Lending Rules

- Anti-tying rule – Section 106 of the BHCA, 12 U.S.C. 1972, requires that a bank shall not extend credit to a borrower on the condition that the customer obtain another (non-traditional) product or service.
  - Cannot condition the product on purchase of another product from, or providing something of value to, the bank or an affiliate, the refusal to take a product from competitor or the varying of the cost of the bank or affiliate product or service
  - E.g., cannot require a borrower to obtain title insurance from an affiliate in order to obtain a mortgage loan and cannot offer the customer a higher interest rates on a deposit account if they open a brokerage account with your affiliate
  - Concept of credit being scarce and the lender having great leverage to compete unfairly
  - Banks may tie "traditional bank products", which include loan, deposit or trust products
  - Fed allows "combined balance discounts" as long as deposit balances and other banking products are treated equally with other non-bank financial products.



Classification: Schwab Internal

## Additional Lending Rules

- Community Reinvestment Act (CRA) and implementing agency regulations are designed to require banks to help meet the credit needs of low-to- moderate-income communities in their assessment areas
  - Banks are assessed by their regulators on their CRA performance and are assigned one of four ratings – Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance
  - Negative bank CRA ratings can have a negative impact on the bank's ability to expand geographically, make acquisitions, or provide new products and services
  - New interagency CRA regulations are expected to be issued this fall.
- Home Mortgage Disclosure Act: HMDA data is designed to collect lending data to detect and prevent discrimination against minority groups

32

Classification: Schwab Internal

## Questions?

# SECTION 23A AND 23B OF THE FEDERAL RESERVE ACT – AFFILIATE TRANSACTIONS

BANKING LAW FUNDAMENTALS

JUNE 25, 2024

**JOSEPH E. SILVIA**
312.377.7870
jsilvia@dickinsonwright.com

## Welcome & Introduction

- Welcome
- Introductions
- Goals

# Why focus on transactions by an insured depository institution with its affiliates?

- **Insured Depository Institutions ("banks") have special advantages**:
  - **Subsidy**. Banks fund their activities more cheaply and with less capital than other firms because only banks may collect deposits backed by the FDIC and the US taxpayer—people deposit funds with banks and lend funds to banks at low rates because they believe the deposits and funds are safe and will be returned
  - **Risk passed to taxpayer**. FDIC and US taxpayers take on some risk of failure of a bank at the same time that bank investors reap all the profits from the activities of the bank

- **Sharing these benefits**.
  - **Passing on the Subsidy**. Banks can share this special funding advantage with nonbank affiliates by lending funds and/or purchasing assets from affiliates. Affiliates can then use funding from the bank to conduct a broader range of activities than the bank may be permitted to conduct itself and conduct those activities without the limits that apply to banks (for example, without limits on loans-to-one-borrower).
  - **Increased risk to the IDI**. A bank that lends funds to an affiliate also takes on the risks of failure of the affiliate, which may therefore increase the potential losses to the bank and the FDIC. Because nonbank affiliates are resolved in bankruptcy, the FDIC may not be able to recover funds lent by the bank to the affiliate.

# Sections 23A & 23B

**Congress enacted Sections 23A & 23B of the Federal Reserve Act**
- originally applied only to national banks and state chartered banks that were members of the Federal Reserve System (so-called "member banks")
- Over time have been extended to all state chartered banks and all savings associations

- **Section 23A**. Section 23A imposes special quantitative, qualitative and collateral restrictions on transactions between a bank and its affiliates

- **Section 23B**. Section 23B requires that transactions between a bank and its affiliates be on market terms

- **Regulation W**. Reg W implements Sections 23A and 23B of the Federal Reserve Act

# What is an Affiliate under 23A?

- **<u>Parent company</u>**. Any company that controls the bank
- **<u>Companies under common control by a parent company</u>**. Any company, including any subsidiary of a company, that is controlled by a company that controls the bank (i.e., a holding company and any company directly or indirectly controlled by the holding company)
- **<u>Companies under other common control by individuals</u>**. Any company that is controlled, directly or indirectly by or for the benefit of shareholders (including individuals) who control the bank or any company that controls the bank
- **<u>Companies with interlocking directors</u>**. Any company in which a majority of directors, trustees, or general partners (or individuals exercising similar functions) constitute a majority of the persons holding any such office with the bank or any company that controls the bank
- **<u>Sponsored and/or advised companies</u>**. Any company that is sponsored and advised on a contractual basis by the bank or an affiliate of the bank, and any investment company for which the bank or any affiliate of the bank serves as an investment adviser or owns 5%
- **<u>Companies held under merchant banking authority</u>**. Any company in which a holding company of the bank owns or controls 15% or more of the equity capital under the merchant banking authority provided to FHCs
- **<u>Other companies</u>**. Any other company that the FRB (or OCC/FDIC as applicable) determines by regulation or order, to have a relationship with the bank such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank

# What is NOT an Affiliate under 23A?

- **The following are <u>NOT</u> Affiliates under 23A:**
  - Any natural person, estate or personal trust
  - Operating subsidiaries of the bank itself, <u>but not</u>:
    - "Financial subsidiaries"
    - "Joint venture" subsidiaries
  - Any company engaged solely in holding bank (but not BHC) premises
  - Any company held in satisfaction of a debt previously contracted (DPC)
  - Shares of a company held in a fiduciary capacity
- **What about two banks that are affiliates, OR transactions between a bank and its own subsidiaries?**
  - Between and among a bank and its own subsidiaries (other than financial subsidiaries, subsidiaries that are banks and certain joint venture subsidiaries) – not subject to Sections 23A/23B
  - Between "<u>sister banks</u>" (if at least 80% commonly owned) -- not subject to 23A/23B, but (1) cannot transfer "low quality" assets; and (2) must engage in safe and sound transactions

# Covered Transactions

**Covered Transactions** for Section 23A purposes include:

- **Credit Transactions:**
  - A loan or extension of credit, including, among others:
    - Purchase of assets subject to an agreement to repurchase
    - Advance, overdraft, cash item or otherwise
    - Lease that is the functional equivalent of an extension of credit
    - Acquisition of a debt security, note or other obligation
    - Transactions as a result of which an affiliate becomes obligated to pay money or its equivalent
  - Issuance of a guarantee, acceptance, letter of credit, including endorsement/standby letter of credit, on behalf of an affiliate
  - Confirmation of a letter of credit issued by an affiliate
  - A "cross-affiliate netting arrangement"
  - Credit exposure to an affiliate arising from securities borrowing/lending or derivative transactions

# Covered Transactions

- **Other Covered Transactions:**
  - A purchase of or an investment in securities issued by an affiliate
  - A purchase of assets from an affiliate; however, a purchase of assets by a bank subject to a repurchase agreement (a "reverse repo") *is* an extension of credit
  - An acceptance of a security or other debt obligation of an affiliate as collateral for a loan or extension of credit to any person or company

- **Transactions that are not Covered Transactions:**
  - Dividends or management fees paid by a bank to its holding company
  - Sales of assets by a bank to an affiliate
  - Most service contracts between a bank and an affiliate

# Limits and Restrictions

- **Quantitative Limits**
  - Total of all Covered Transactions with any one affiliate cannot be greater than 10% of the bank's capital and surplus
  - Total of all Covered Transactions with all affiliates cannot be greater than 20% of bank's capital and surplus
  - Capital & Surplus = The bank's Tier 1 Capital, plus Tier 2 Capital, *plus* any Allowance for Loan and Lease Losses ("ALLL") not counted in Tier 2 capital
- **Collateral Requirements**
- **Low-Quality Asset Prohibition**

# Collateral Requirements for Loans

- **Collateral Rule**. An extension of credit by a bank to an affiliate must be collateralized.
  - *includes* any loan by the bank to an affiliate, a standby letter of credit or guarantee issued by a bank on behalf of an affiliate, and a bank's exposure on a cross-affiliate netting agreement
- **Amount of Collateral**. The amount of collateral required depends on the type of collateral pledged.
  - At all times, the value of the collateral must be at least:
  - **100%** of the amount of the transaction, if the collateral is:
    - Obligations of the United States or its agencies;
    - Obligations fully guaranteed by the United States or its agencies as to principal and interest;
    - Notes, drafts, bills, or bankers' acceptances eligible for rediscount or purchase by a Federal Reserve Bank; or
    - A segregated, earmarked deposit account with the bank that is for the sole purpose of securing the credit transaction;
  - **110% -** If the collateral is obligations of any State or municipality
  - **120%** - If the collateral is debt instruments, including loans or receivables
  - **130% -** If the collateral is stock, leases, or other real or personal property

# Collateral Matters

- **<u>What types of assets are NOT eligible to meet collateral requirements</u>?**
  - Low quality assets
  - Securities or obligations of an affiliate
  - Equity or debt securities of the bank
- **<u>Can multiple types of collateral be posted</u>?**
  - Yes, but consider the different collateral valuation requirements
  - For example, an affiliate might post $500 of US Government securities, $480 of MBS and $130 of real estate to cover a $1000 loan from an affiliated bank. In this case, $500 of the loan would be collateralized by US Government securities at 100%; $400 would be collateralized by the MBS (the value of the MBS must equal 120% of the loan amount); and the remaining $100 of the credit would be collateralized by the real estate (the value of real estate must equal 130% of the loan amount)
- **<u>Must the interest in collateral be perfected</u>? <u>And must the bank have a first lien on the collateral</u>?**
  - The bank must perfect its security interest in the collateral, but it need not have a first lien. The value of collateral must be reduced by the amount of all liens senior to the lien granted to the bank
- **<u>What happens if the collateral value declines after credit is extended</u>?**
  - The value of the collateral must be sufficient <u>at all times</u> (not just at the time of the transaction, as was the case before Dodd-Frank), AND, any collateral that is retired must be replaced up to the full collateral valuation requirement.
  - Section 23A requires that collateral be replaced if it loses value in the marketplace, and Section 23B requires that all credit transactions with an affiliate be conducted in a safe and sound manner and be on market terms

# Limits and Restrictions

- **Low-Quality Asset Prohibition:**
  - Bank purchases of “low-quality” assets from an affiliate are prohibited (limited exceptions)
    - Classified or special mention assets (whether classified by examiners or in the bank’s internal loan rating system)
    - Most non-investment grade securities
    - Any asset in non-accrual status
    - Any asset on which principal or interest payments are more than 30 days past due
    - Any asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor
    - An asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted (DPC)
- **Safety and Soundness Requirement**:
  - Engaging in unsafe/unsound inter-affiliate transactions is prohibited
- **Reporting**:
  - Banks (but not FBO branches and agencies) are required to report covered transactions quarterly on the Federal Reserve’s Form FR Y-8

# Attribution Rule

- **Attribution rule**: a bank must treat a transaction with any person as a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate of the bank
  - **Examples**:
    - Loan from a bank to a client where the client purchases securities from a broker-dealer affiliate
    - Loan from a bank to a client where the client pays off a prior loan made by an affiliate
    - Prepaid swap with counterparty where counterparty uses proceeds to purchase a bond from an affiliate
    - Loan to a buyer in an M&A deal where the buyer uses loan proceeds to pay an affiliate's advisory fees
  - **Primary Exceptions:**
    - Affiliate acts exclusively as agent/broker for a borrower; asset purchased by borrower is not sold, issued or underwritten by an affiliate; and fee/commission is on market terms
    - Riskless principal transactions in which an affiliate buys/sells a security upon the order of a customer; security is not issued, underwritten or sold by an affiliate (other than as riskless principal); and fee/commission is on market terms
    - Pre-existing line of credit not established in contemplation of the purchase of securities through or from an affiliate
    - General purpose credit cards – bank credit card used to purchase a product from an affiliate

# Exempt Transactions

**Transactions that are NOT covered:**

- Dividend payments by a bank (these are restricted under other provisions of law)
- Extensions of credit by an affiliate to the bank (direction matters)
- Certain transactions exempt by statute or regulation:
  - Sister bank exception. Transactions between banks that are under common corporate control; the control threshold to qualify for this exception is a minimum of 80% ownership of each bank
  - Credit 100% secured by Cash/US Government securities. Extensions of credit fully secured by US government or agency securities, or by segregated, earmarked deposit accounts at the lending bank (securities/deposit accounts may be established by the parent BHC for repayment of credit extended to affiliates)
  - Purchasing liquid assets. Purchases of an asset from an affiliate with a readily identifiable and publicly available market price (i.e., a price quoted routinely in a widely disseminated publication readily available to the public)
  - Asset purchases by a newly formed member bank. The purchase of an asset from an affiliate by a newly formed DI, if the appropriate Federal banking agency approves the asset purchase in connection with its review of the formation of the DI
  - Intraday extensions of credit. An intraday extension of credit to an affiliate if the bank has policies to manage these intraday credit exposures, the bank has no reason to believe that the affiliate will not repay the credit in accordance with its terms, and the bank ceases to rely on the exemption for intraday credit at the end of the business day

# Derivative Transactions

**Evolution of Derivative Coverage under Sections 23A/23B and Regulation W**

- Under Regulation W, derivatives were historically deemed **not** to be "covered transactions" for purposes of Section 23A, but were subject to Section 23B
- Even during this period (prior to Dodd-Frank), there were **derivative "red flags"** to watch for:
  - Reg. W provision: Credit default swaps or total return swaps where the reference asset is an obligation of a bank affiliate is a guaranty of a bank affiliate
  - Certain transactions may be "re-characterized" into covered transactions:
    - Certain derivatives may look like an extension of credit to an affiliate – e.g., deep-in-the money option, zero-strike call, prepaid swap
    - Certain derivatives may look like a purchase of an asset from an affiliate – e.g., forward sale
  - Novations of derivatives from within the corporate structure to a bank in the corporate structure covered transactions (purchase of assets/potential attribution rule issue)

# Derivatives Transactions

**Evolution of Derivative Coverage under Sections 23A/23B and Regulation W**

- Under the Dodd-Frank Act, the **"credit exposure"** created by derivatives between the bank and an affiliate is deemed a covered transaction
  - FRB still has not incorporated 2010 Dodd-Frank provisions into Regulation W
    - Need to define "credit exposure"
    - "credit exposure" could be exempted by posting of cash/US government securities, but how much will the affiliate have to post
- How may FRB choose to calculate "credit exposure"?
  - OCC Legal Lending Limits included the ability to use the following when calculating derivative exposure:
    - Internal models or "current exposure method" under the capital rules
    - A purely bespoke method called the "conversion matrix method" (look up on a table)
    - The new "Standardized Approach to Counterparty Credit Risk" or SA-CCR
  - Other rules, such as swap margin rules, also have methods for determining the variation margin exposure and the "
  - potential future exposure" for initial margin purposes
- Derivatives must still comply with Section 23B

# How are transactions valued?

- **Extensions of credit**.
  - An extension of credit is valued at:
    - The higher of the principal amount of the credit or the amount owed on the credit,
    - Plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction
  - value reduced as the credit is repaid.
- **Purchases of assets**.
  - valued at the amount paid in consideration for the asset (special rules if the asset is a security issued by an affiliate)
  - value post-purchase may be reduced to reflect amortization or depreciation of the asset, to the extent the reductions are consistent with GAAP
- **Filling up the bucket**:
  - A covered transaction applies against the 10% and 20% limit as long as it is outstanding (for an extension of credit) or until it is sold or fully amortized according to GAAP (for the purchase of an asset)

# Internal Corporate Reorganizations

**Examples**

- **Purchase of stock** - Bank purchases the stock of an affiliated mortgage company for $100,000 = covered transaction (bank has paid $100,000 to purchase an asset (the stock of the mortgage company) from its affiliate (the parent BHC))

- **Capital "donation"** - BHC donates all the stock of its mortgage subsidiary to the bank, without any consideration paid by the bank to the BHC? Is that still considered an asset purchase under section 23A?
  - Yes, the transaction is still covered under section 23A. Even without consideration the bank is assuming an obligation to repay the liabilities of the mortgage company in exchange for the assets of the mortgage company - considered a purchase of assets by the bank valued at the amount of any liabilities held by the donated company

- **NOTE**: Because both the sale and donation of stock of an affiliate to an IDI are covered by section 23A, the value of the transaction is subject to the 10% quantitative limit in section 23A and helps fill up the IDI's section 23A bucket

## Special Rules for certain Internal Corporate Reorganizations

- **Special exemption for internal reorganizations with a Holding Company guarantee**. Because the 10% and 20% quantitative limits in section 23A could effectively prohibit any internal reorganizations by a BHC, the FRB has exempted the purchase of assets by a bank from an affiliate as part of an internal corporate reorganization (including a donation of securities of an affiliate to a bank), if:
  - Prior notice is provided to the FRB and the bank's appropriate Federal banking agency;
  - Top-tier BHC protects the bank against losses on the transferred assets for two years;
  - A majority of the bank's directors approve the transaction;
  - The value of the transaction represents less than 25% of capital stock and surplus of the bank (must aggregate with any other transactions relying on this exemption during the preceding 12 months); and
  - BHC and all its subsidiary banks are well capitalized and well managed, both before and after the transaction
- **Special exemption for a servicing affiliate**.
  - The FRB has, by rule, exempted the purchase by a bank of shares of a so-called "Bank Service Company" (i.e., a company that engages solely in providing services to its parent bank and affiliates, such as a data processing service provider)

## Section 23B

- **Market terms requirement**. Section 23B requires that transactions between a bank and its affiliates be on terms and under circumstances, including credit standards, that:
  - Are substantially the same, or at least as favorable, as those prevailing at the time for comparable transactions with or involving non-affiliates; or
  - If no comparable transactions, then on terms and under circumstances that in good faith would be offered to, or would apply to, non-affiliates
- **Prohibited fiduciary and underwriting transactions**. Section 23B prohibits a bank from:
  - Purchasing as fiduciary any security or other asset from any affiliate unless permitted by the fiduciary instrument, court order, or the law of the jurisdiction governing the fiduciary relationship
  - Purchasing, as principal or fiduciary, any security during an underwriting if a principal underwriter of the security is an affiliate of the bank, unless the purchase has been approved, before the security is initially offered for sale to the public, by a majority of the directors of the bank
- **Why require market terms and prohibit certain transactions?**
  - Requiring market terms prevents the bank from transferring its taxpayer-supported subsidy to its non-bank affiliates through more lenient or cheaper terms, and protects the bank from greater losses or higher expenses on transactions with affiliates
  - Requiring market terms prevents an affiliate of a bank from gaining an advantage over its competitors through cheaper funding or better credit and other support
  - Prohibiting fiduciary and underwriting transactions protects customers of the bank from poor decisions by affiliates of the bank

# Transactions under 23B

- **Scope of 23B is broader than 23A**. 23B "market terms" requirements apply to:
  - Any covered transaction under 23A (transactions that are exempt by statute from 23A are also exempt from 23B);
  - The sale of a security or other asset by the bank to an affiliate, including an asset subject to an agreement to repurchase;
  - The payment of money (including payment for a service from the affiliate) or the furnishing of a service by the bank to an affiliate under contract, lease, or otherwise;
  - Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; and
  - Any transaction or series of transactions with a non-affiliate, if an affiliate has a financial interest in the non-affiliate, or is a participant in the transaction or series of transactions
- **Attribution rule**. For purposes of Section 23B, any transaction by an IDI with any person is deemed a transaction with an affiliate of the IDI *if* any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate

# Foreign Banks Operating in the US

- **Branches, Agencies and Commercial lending companies in the US**. 23A and 23B apply to each U.S. branch, agency, or commercial lending company of a foreign bank *as if* the branch, agency, or commercial lending company were a bank
- **Certain US Affiliates Only**. The term "affiliate" for purposes of 23A and 23B is *limited* in the case of FBOs to:
  - A company that would be an affiliate that is directly engaged in the US in:
    - Insurance underwriting activities;
    - Securities underwriting, dealing, or market making activities;
    - Merchant banking activities (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities); or
    - Any other activity designated by the FRB
  - A subsidiary of a company engaged in one of the activities listed above; or
  - A portfolio company held under the merchant banking authority that would be an affiliate for a US bank
- **Capital stock and surplus**. Capital stock and surplus of a U.S. branch, agency, or commercial lending company is the capital of the foreign bank as calculated under its home country capital standards
  - Makes the quantitative limits quite high and seldom binding
  - collateral and market terms requirements would apply equally to US banks and FBOs

# Exemptive Authority

- Federal Reserve previously had broad authority to grant exemptions to 23A
  - Significant number of pre-Dodd-Frank precedents/interpretations related to internal reorganizations, certain securities borrowing/lending arrangements, etc.

- Dodd-Frank Act established new procedures for 23A exemptions:
  - FRB can issue regulations or orders to define terms in 23A or as may be necessary to administer and carry out the purposes of 23A and prevent evasion
  - FRB may issue a regulation exempting certain transactions or relationships, but only if:
    - FRB finds the exemption to be in the public interest and consistent with the purposes of 23A, and notifies the FDIC; and
    - FDIC analyzes whether it is an unacceptable risk to the Deposit Insurance Fund and issues a written non-objection.
  - For banks within their respective jurisdictions, the OCC, FRB or the FDIC may issue an order granting an exemption, provided that:
    - FRB and the applicable additional agency find the exemption to be in the public interest and consistent with purpose of 23A;
    - Notification is made to the FDIC; and
    - FDIC analyzes whether it is an unacceptable risk to the Deposit Insurance Fund and issues a written non-objection.

# Thank You

**Joseph E. Silvia**
Member
**Dickinson Wright PLLC**
312.377.7870
jsilvia@dickinsonwright.com

Joe provides guidance on a variety of matters including mergers & acquisitions, strategic transactions, governance, international banking, payments systems, anti-money laundering and sanctions, and private equity and venture capital investments. He advises financial institutions, fintech companies, and corporations regarding risk and compliance, third party vendor management, consumer protection, digital currencies, affiliate transactions, privacy, and retail and commercial banking, including handling significant drafting and negotiation of vendor agreements and bank agreements between financial institutions and their clients.

Joe handles matters for his clients concerning banking and financial services regulation, including state and federal regulation with respect to licensing, retail banking, consumer credit, cannabis, anti-money laundering and OFAC compliance, and more. Having previously served as counsel to the Federal Reserve Bank of Chicago, where he focused on the supervision and regulation of banks, bank holding companies, and savings and loan holding companies as well as consumer finance and compliance matters, Joseph has a unique perspective on all aspects of the banking system.

Joe is an adjunct professor at Chicago-Kent College of Law, where he teaches Consumer Banking Law.

Banking Law Fundamentals

# Deposit Products and Issues

**Session K:** ***See, Chapter 5, The Keys to Banking Law, 3rd Edition, Karol K. Sparks***

**Sara A. Kelsey**

© June 2024

## STATEMENT OF CONDITION

| **Assets** | **Liabilities & Capital** |
|---|---|
| Cash & Due from Banks | Deposits |
| Investments | Demand Deposits |
| Loans | NOW Accounts |
| Gross | Money Market Accounts |
| (ALLL) | Savings & Time Deposits |
| Net Loans | Total Deposits |
| Premises, Equipment & Other Assets | Other Borrowing |
| Total Assets | Total Liabilities |
| | |
| | Capital |
| | Total Liabilities & Capital |

2

## FOCUS ON THE DEPOSIT SIDE

- Only chartered depository institutions ("IDIs") may take deposits
- The vast majority of a bank's liabilities are deposits, which are borrowings from customers
- Deposits are a bank's principal source of funds
- Different types of deposits have different maturities and other terms, may pay different interest rates and may require different reserves
- If a bank fails and is resolved, deposits have priority over other unsecured liabilities – insured deposits are paid first, up to the insured amount

3

## OVERVIEW OF DEPOSIT REGULATION

- Federal Reserve Board
- CFPB
- FDIC
- State Law and UCC (discussed in Chapter 5 of Keys)

Rules that pertain to deposits are written and interpreted by all of the above authorities. The primary Federal, and, where applicable, State regulators examine for and enforce these laws for the banks under their supervision. The CFPB examines banks $ 10 Billion or more in assets.

4

# SOURCES OF FEDERAL LAW

**FEDERAL RESERVE SYSTEM**

- Reserve Requirements – Regulation D
- Expedited Funds Availability – Regulation CC
- Unlawful Internet Gambling – Regulation GG

**CFPB**

- Electronic Funds Transfer Act – Regulation E
- Truth in Savings – Regulation DD
- Unfair, Deceptive or Abusive Acts or Practices, 12 USC 5531-5536

**FDIC**

- Deposit Insurance/Insurance Premiums/Assessments
- Receiverships
- Brokered Deposits/Core Deposit Classifications & Consequences

5

# WHERE TO FIND THE LAW?

**FEDERAL RESERVE SYSTEM**

Regulations: 12 CFR Part 200 – letters of the alphabet based on alphabet order – Regulation D is 12 CFR 204

**CFPB**

Codified former FRS regulations the same way, only in the 1,000's – Regulation E is now 12 CFR 1005

**FDIC**

Regulations: 12 CFR Part 300 – deposit insurance rules: 12 CFR 330

6

# FEDERAL RESERVE: TYPES OF DEPOSITS

**Regulation D** –12 CFR 204 defines the various types of deposits

- Demand Deposits. Demand deposits (regular checking accounts) are corporate and individual transaction accounts. They permit immediate withdrawal and are used for payments.
- NOW (Negotiable Order of Withdrawal) Accounts. A NOW account is a special type of transaction account. Like a savings account it pays interest, and like a checking account it can be used for payments. It is not available to businesses.
- Money Market Accounts. A special type of savings account permitting a limited number of transactions and originally intended, when interest rates were controlled, to permit the payment of a rate competitive with the return on money market mutual funds.
- Savings & Time Deposits. Includes deposits that permit withdrawal but not checking, and deposits that have fixed maturities.

7

# TYPES OF DEPOSITS: APPLICABLE LAW

**Regulation D -12 CFR § 204 -**defines the various types of accounts:

- *(d) (1)Savings deposit* means a deposit or account with respect to which the depositor is not required by the deposit contract but may at any time be required by the depository institution to give written notice of an intended withdrawal not less than seven days before withdrawal is made, and that is not payable on a specified date or at the expiration of a specified time after the date of deposit.
- The term "savings deposit" also means: … a passbook savings account, a statement savings account, or a money market deposit account (MMDA), that otherwise meets the requirements of § 204.2(d)(1) and from which, under the terms of the deposit contract or by practice of the depository institution, the depositor is permitted or authorized to make no more than six transfers and withdrawals (later modified by FRB), or a combination of such transfers and withdrawals, per calendar month or statement cycle (or similar period) of at least four weeks, to another account (including a transaction account) of the depositor at the same institution or to a third party by means of a preauthorized or automatic transfer, or telephonic (including data transmission) agreement, order or instruction, or by check, draft, debit card, or similar order made by the depositor and payable to third parties.

8

# TYPES OF DEPOSITS: RESERVES

**Regulation D -12 CFR § 204**

Sets uniform requirements for all depository institutions to maintain reserve balances either with their Federal Reserve Bank or as cash.

Must be maintained against transaction accounts (primarily NOW and regular checking accounts).

**Was used as one of two tools of monetary policy, the other being the discount rate**

Since 2008, the Federal Reserve has paid interest on reserves, as permitted by Congress. Formerly, reserves received no interest

Reserve requirements were modified in 2014:

- the first $13.3 million of otherwise reserveable balances are exempt from the reserve requirements;
- for transaction accounts aggregating more than $13.3 million to $89.0 million, the reserve requirement is 3% of total transaction accounts; and
- for net transaction accounts in excess of $89.0 million, the reserve requirement is $2,271,000 plus 10% of the aggregate amount of total transaction accounts in excess of $89.0 million.

**Effective March 26, 2020** the Federal Reserve reduced the reserve requirement ratio to **ZERO,** effectively eliminating reserve requirements, leaving the discount rate as the only remaining monetary policy tool wielded by the Federal Reserve. **NOTE**: the reserve requirement is still on the law books and could be reinstated by the Federal Reserve.

9

# INTEREST ON DDA'S

- **Regulation Q -12 CFR 217**
- **Historically the payment of interest on demand deposit accounts was restricted.**
- **CHANGE:**
  - **Interest rate limits and thrift/bank differentials were eliminated by the Depository Institutions Deregulation and Monetary Control Act of 1980 – some say igniting the Thrift Crisis**
  - **The payment of interest on business transaction accounts was prohibited**
  - **Repealed** by Section 637 of Dodd-Frank effective 7-21-2011
  - Federal Reserve rulemaking repealed the old Reg Q requirements, removing all references from other regulations
  - **Reg Q is now the Board's capital regulation**

10

# DEPOSIT PRODUCT: SWEEPS

- **Reasons for Sweeps:**
  - Bank internal reserve purposes
  - Rate chasing by customer
  - Protection above FDIC insurance
- **Types of Sweeps:**
  - Internal sweeps
  - Sweeps into money market mutual funds
  - Sweep repurchase agreements
- **Treatment on Bank Closing:**
  - See 12 CFR 360.8 – Method for Determining Deposit and Other Liability Account Balances at a Failed Depository Institution - also an excellent guide to how to maintain deposit accounts within a bank.

11

# CFPB: RETAIL DEPOSIT PRODUCTS

- Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection of 2010, consumer rules that formerly were the province of the Federal Reserve were transferred to the CFPB.
- The CFPB now writes, interprets, and enforces the rules for these provisions. Bank regulators also are empowered to enforce these rules. The CFPB has the authority to examine banks with consolidated assets over $100 million for these issues.
- Two of the rules transferred to the CFPB pertain to deposits:
  - Electronic Funds Transfer Act, Regulation E
  - Truth in Savings Act, Regulation DD.
- In addition, the CFPB was given rulemaking and enforcement authority to prohibit Unfair, Deceptive, or Abusive Acts or Practices, which also may pertain to deposits.

12

# CFPB: RETAIL DEPOSIT PRODUCTS

Deposit account access devices: Regulation E – 12 CFR Part 205

- Online banking
- Mobile banking
- Debit cards
- ACH credits and debits
- Wire transfers

- Prepaid cards
- Overdraft protection
- Online account-opening

13

# CFPB: ENFORCEMENT ACTIONS

Some examples:

Regions Bank – 4/28/15 – $49 million customer restitution, $7.5 million Civil Money Penalty. Violations: Regulation E and unfair, deceptive and abusive acts or practices

– 9/28/22 – $141 million customer restitution, $50 million Civil Money Penalty – for authorized-positive overdraft fees

Wells Fargo – 9/8/16 – $100 million Civil Money Penalty. Violations include opening approximately 1.5 million deposit accounts and transferring funds without authorization – bank also charged fees for insufficient funds or overdraft fees because money was not in original accounts.

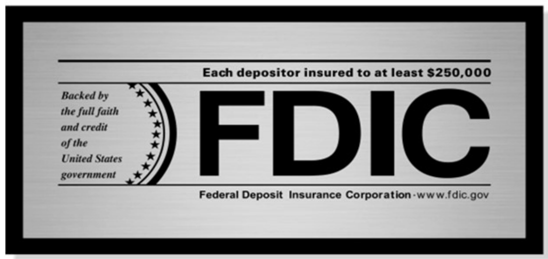
– 12/20/22 – $2 billion in consumer restitution and $1.7 billion Civil Money Penalty. "Surprise" overdraft fees on debit cards and ATM withdrawals (authorized-positive overdraft fees)

Bank of America– 5/4/22 – Civil Money Penalty $10 million and $592,000 customer restitution for violation of consumer garnishment-related protections – customer accounts were frozen and the bank improperly turned over customer funds

– 7/14/22 – Civil Money Penalties – CFPB – $100 million; OCC – $ 125 million & customer restitution TBD. Violations of Regulation E and unfair acts or practices with respect to prepaid debit card used for unemployment insurance and other benefit payments, pursuant to contracts with 12 States, with bank freezing/blocking customer accounts & denying notices of error.

14

# FDIC INSURANCE COVERAGE/PREMIUMS




15

# FDIC INSURANCE DISCLOSURE

- Banks must disclose whether accounts are FDIC insured
- If funds are not FDIC insured, bank must disclose if the customer would be a secured or unsecured creditor of receivership

16

President Franklin D. Roosevelt Signs Banking Act of 1933, Creating FDIC Insurance
June 16, 1933

17

# FDIC INSURANCE COVERAGE

Standard Maximum Deposit Insurance Amount ("SMDIA") (originally set at $2,500 per depositor in 1933):

Most recently:

- October 03, 2008 – Extended on May 20, 2009 – Temporary increase of the SMDIA from $100,000 to $250,000 through December 31, 2013.
- July 22, 2010 – Permanent increase of the SMDIA to $250,000 with a retroactive effective date of January 1, 2008.
- Individual insurance coverage can be calculated using a tool available on the FDIC website: **https://www.fdic.gov/edie/fdic_info.html.**

18

# FDIC INSURANCE COVERAGE LIMIT

Recent bank failures involving large amounts of uninsured deposits (above the SMDIA), have prompted a discussion concerning whether FDIC insurance coverage should be changed. The FDIC has proposed three options:

- **Limited Coverage**: Maintaining the current deposit insurance framework, which provides insurance to depositors up to a specified limit (possibly higher than the current $250,000 limit) by ownership rights and capacities.
- **Unlimited Coverage**: Extending unlimited deposit insurance coverage to all depositors.
- **Targeted Coverage**: Offering different deposit insurance limits across account types, where business payment accounts receive significantly higher coverage than other accounts.

*See,* https://www.fdic.gov/news/press-releases/2023/pr23035.html

19

# FDIC INSURANCE COVERAGE

- **Pass-Through Coverage** (agent or custodial accounts):
- Funds must be owned by the beneficial owners not the agent/custodian.
- Bank's account records must have a signpost indicating the agency nature of the account (XYZ Company as Custodian).
- Bank's records or accountholder's records must indicate both the identities of the beneficial owners as well as the ownership interest in the deposit.
- Deposit terms (i.e., the interest rate and maturity date) for accounts opened at the bank must match the terms the third party agent promised the customer.

20

# FDIC INSURANCE COVERAGE

**Deposits in Foreign Branches:**

- Historically, not "deposits" for deposit preference purposes in bank receivership unless expressly "dually payable" in US and foreign country. Depositors were general creditors (paid after all expenses and all deposits).
- Banks have not expressly provided for dual payment but U.K had concerns about U.K. depositors.
- 12 CFR § 330.3(e) revised 9-10-13: deposits in foreign branches of U.S. banks are not FDIC-insured, even though they can be deposits for purposes of the national depositor preference statute as long as "dually payable" in the US. This must be disclosed in customer account documentation.

21

# FDIC INSURANCE COVERAGE

**Brokered Deposits -- what is the issue?**

- Not core or stable funding, so present a liquidity issue. Result: potential for bank run-contagion; and higher cost of FDIC insurance premiums, due to risk of potential greater cost to DIF.
- **Question**: does a high percentage of uninsured deposits present a similar lack of stability? Consider the correlation between recent bank failures and a high ratio of uninsured deposits.
- A deposit broker is:
  - any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and
  - an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

22

# FDIC INSURANCE COVERAGE

**Brokered Deposits, cont.**

December 24, 2014 FDIC FAQ – Guidance on Identifying, Accepting and Reporting Brokered Deposits:

- Compilation of prior interpretations in the form of FAQs.
- Basically creates a presumption that any deposit placed (i.e., funds delivered) by a third person is brokered unless an exemption applies.
- Includes: affiliate bank deposits, most prepaid card deposits, referred and advertised deposits (where volume based fees are paid), insurance agent, lawyer and accountant referred deposits, bank network placed deposits, some listing services …

23

# FDIC INSURANCE COVERAGE

Brokered Deposits:

- **BANK MAY NOT ACCEPT, ROLL-OVER OR RENEW BROKERED DEPOSITS UNLESS WELL-CAPITALIZED!**

- No waivers were granted by FDIC during Global Financial Crisis, but now are being granted again.

24

# FDIC INSURANCE PREMIUMS

- The FDIC has the authority to establish by regulation risk-based deposit insurance premiums.
- Statutory and regulatory evolution of this process: https://www.fdic.gov/analysis/cfr/staff-studies/2020-01.pdf.
- Risk-based assessments were initiated in 1993, utilizing a 9-cell pricing matrix based upon a bank's capital (vertical) and exam ratings (horizontal).
- Due to statutory constraints that prohibited the FDIC from collecting insurance premiums after the insurance fund ratio reached a pre-determined rate, the FDIC was not able to impose a risk-based premium in a robust, sustained way until legislation permitted it in 2006.

25

# FDIC INSURANCE PREMIUMS, cont.

- The FDIC introduced three new possible adjustments to a bank's assessment rate: the unsecured debt adjustment, the secured liability adjustment, and the brokered deposit adjustment. These adjustments were intended to account for liabilities that either would reduce the loss to the fund when a bank failed (unsecured debt) or increase the loss to the fund when a bank failed (secured liabilities (eliminated in 2011) and brokered deposits). The unsecured debt adjustment and the secured liability adjustment applied to institutions in all risk categories, while the brokered deposit adjustment applied to institutions in Risk Categories II, III, or IV.

26

## FDIC INSURANCE PREMIUMS, cont.

- For the first time, the FDIC utilized separate methods for calculating premiums for small banks (generally those with less than $10 billion in total assets) and large banks (generally those with $10 billion or more in total assets) to differentiate risk among institutions in Risk Category I and determine their assessment rates.
- In 2011, the FDIC introduced new scorecards for large banks to determine risk-based assessment rates derived from new data, including information on how large banks fared during the crisis. In 2016, the agency updated risk-based pricing for established small banks, using data obtained from the failure of hundreds of small banks during and in the aftermath of the crisis and failures from the previous crisis.



## FDIC INSURANCE PREMIUMS, cont.

- Finally, the FDIC incorporated financial ratios in the pricing method for all large institutions in Risk Category I.
- Importantly, following the 2008 Financial Crisis, pursuant to the Dodd-Frank Act, the FDIC amended its regulations in 2011 to redefine the assessment base by broadening it from domestic deposits to average consolidated total assets minus average tangible equity.
- The revised assessment base and accompanying change in rates shifted more of the total burden of assessments to the largest banks from the rest of the industry. The largest banks rely to a greater extent than smaller banks on funding sources other than domestic deposits.

# FDIC INSURANCE PREMIUMS, cont.

- In sum, the changes made to risk-based pricing over time (e.g., separate pricing methods for small, large, and highly complex banks; introduction of numerous financial risk measures; and various pricing adjustments) made the system more complex but also, in the FDIC's view, more effective in differentiating risk. Statistical analyses indicate that the current system prices risk more accurately than earlier systems and appropriately places a greater assessment burden on banks with higher risk profiles.
- The regulatory proposal by the FDIC to adjust the risk-based assessment became effective as of January 1, 2023.https://www.fdic.gov/deposit/insurance/assessments/risk.html
- FDIC Deposit Insurance FAQs (updated as of April 1, 2024): https://search.app/?link=https%3A%2F%2Fwww%2Efdic%2Egov%2Fresources%2Fdeposit%2Dinsurance%2Ffaq%2Findex%2Ehtml&utm_source=igadl%2Cigatpdl%2Csh%2Fx%2Fgs%2Fm2%2F5

29

# FDIC SYSTEMIC RISK SPECIAL ASSESSMENT

- In connection with the failures of SVB and Signature Bank in March 2023, the FDIC made a Systemic Risk Determination. By statute, the FDIC is required to recover through special assessments the losses to the DIF incurred as a result of the actions taken pursuant to the determination of systemic risk. The FDIC estimates the cost to the DIF for these failures to be $16.1 billion and $2.4 billion, respectively. Of that estimated total cost of $18.5 billion, the FDIC estimates that approximately $15.8 billion was attributable to the cost of covering uninsured deposits pursuant to the systemic risk determination made on March 12, 2023. However, as with all failed bank receiverships, this estimate will be periodically adjusted as assets are sold, liabilities are satisfied, and receivership expenses are incurred. The exact amount of losses incurred will be determined when the FDIC terminates the receiverships.

30

# FDIC SYSTEMIC RISK SPECIAL ASSESSMENT

- On May 11, 2023, the FDIC Board of Directors approved a notice of proposed rulemaking with a 60-day comment period to impose a special assessment to recover the loss to the DIF arising from the protection of uninsured depositors in connection with the systemic risk determination announced on March 12, 2023, following the closures of SVB and Signature Bank, as required by the FDI Act. Under the proposal, the FDIC would apply an annual special assessment rate of approximately 12.5 basis points to an assessment base that would equal an insured depository institution's (IDI) estimated uninsured deposits reported as of December 31, 2022. For IDIs that are not part of a holding company, the first $5 billion in estimated uninsured deposits would be excluded from the assessment base. For IDIs that are part of a holding company, the first $5 billion of the combined banking organization's estimated uninsured deposits would be excluded.

31

# FDIC SYSTEMIC RISK SPECIAL ASSESSMENT

- Defining the assessment base in this way would effectively exclude most small banks from the special assessment. In implementing the special assessment, the law requires the FDIC to consider the types of entities that benefit from any action taken or assistance provided as well as economic conditions, the effects on the industry, and other factors deemed appropriate and relevant. In general, large banks with large amounts of uninsured deposits benefitted the most from the systemic risk determination. Under the proposal, no banking organizations with total assets under $5 billion would pay the special assessment.
- Based on data reported as of December 31, 2022, the FDIC estimates that 113 banking organizations, which include IDIs that are not subsidiaries of a holding company and holding companies with one or more subsidiary IDIs, would be subject to the special assessment. Banking organizations with total assets over $50 billion would pay over 95 percent of the special assessment.

32

## FDIC EFFECT OF SPECIAL ASSESSMENT ON LARGE BANK EXPENSES

- Net income for the 4,587 FDIC-insured commercial banks and savings institutions declined $30 billion (43.9 percent) from one quarter ago to $38.4 billion in fourth quarter 2023. Higher noninterest expense (up $26.6 billion, or 18.9 percent), lower noninterest income (down $6.5 billion, or 8.8 percent), and higher provision expense (up $5.2 billion, or 26.5 percent) drove the decline in net income in the fourth quarter. **However, it is estimated that 70 percent of the decrease in net income was caused by specific, non-recurring, noninterest expenses at large banks. These expenses include the special assessment,** goodwill impairment, and legal, reorganization, **and other one-time costs at large banks.** Higher provision expense occurred as the industry built reserves, primarily for credit card and commercial real estate loans. The banking industry reported a quarterly ROA of 0.65 percent in the fourth quarter, down from 1.17 percent in the previous quarter and 1.16 percent in the year-ago quarter.

33

## FDIC INSURANCE CONCLUSION

**CONCLUSION**: How do deposit issues show up in a bank's CAMELS rating?

Most obvious:

L – Liquidity (ability to maintain deposits; sell assets);

S – Sensitivity to Market Risk (includes interest rate risk); and

E – Earnings (affected by net marginal cost of funding assets).

Perhaps less obvious:

C – Capital Adequacy (need to manage the relationship between assets & liabilities (ALCO Committee function) – failure to do so may cause losses that will adversely impact capital, and adversely affect depositor and/or market confidence, which may make it difficult to raise needed capital); and

M – Management (if a bank is not successfully managing any or all of the above factors, its management rating may be downgraded).

34

# Banking Law Fundamentals

## Privacy, Cyber and Data Security

Jay Johnson
June 25, 2024

Classification: Schwab Internal

## Presentation Agenda

**Privacy and Security Fundamentals**

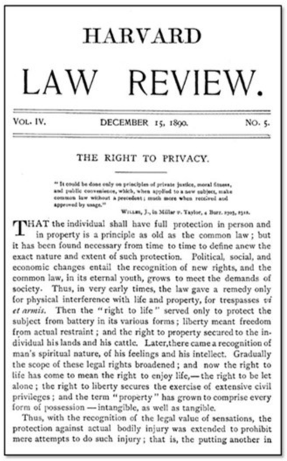
**Key Statutes / Regulations**

**Status of Recent SEC Proposals**

**Incident Notification Requirements**

**Grab Bag!**

Classification: Schwab Internal



HARVARD

LAW REVIEW.

VOL. IV. DECEMBER 15, 1890. NO. 5.

THE RIGHT TO PRIVACY.

"It could be done only on principles of private justice, moral fitness, and public convenience, which, when applied to a new subject, make common law without a precedent; much more when received and approved by usage."

WILLES, J., in Millar v. Taylor, 4 Burr. 2303, 2312.

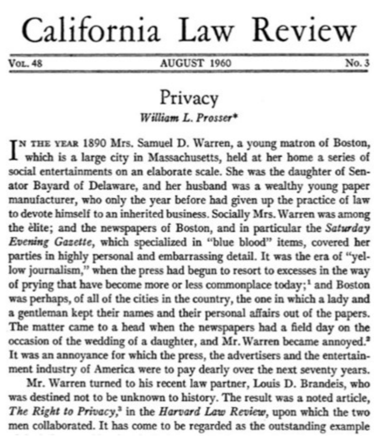
THAT the individual shall have full protection in person and in property is a principle as old as the common law; but it has been found necessary from time to time to define anew the exact nature and extent of such protection. Political, social, and economic changes entail the recognition of new rights, and the common law, in its eternal youth, grows to meet the demands of society. Thus, in very early times, the law gave a remedy only for physical interference with life and property, for trespasses *vi et armis*. Then the "right to life" served only to protect the subject from battery in its various forms; liberty meant freedom from actual restraint; and the right to property secured to the individual his lands and his cattle. Later, there came a recognition of man's spiritual nature, of his feelings and his intellect. Gradually the scope of these legal rights broadened; and now the right to life has come to mean the right to enjoy life,—the right to be let alone; the right to liberty secures the exercise of extensive civil privileges; and the term "property" has grown to comprise every form of possession—intangible, as well as tangible.

Thus, with the recognition of the legal value of sensations, the protection against actual bodily injury was extended to prohibit mere attempts to do such injury; that is, the putting another in

The intensity and complexity of life, attendant upon advancing civilization, have rendered necessary some retreat from the world, and man, under the refining influence of culture, has become more sensitive to publicity, so that solitude and privacy have become more essential to the individual; but modern enterprise and invention have, through invasions upon his privacy, subjected him to mental pain and distress, far greater than could be inflicted by mere bodily injury.

**To Be Let Alone**





California Law Review

VOL. 48 AUGUST 1960 No. 3

Privacy

*William L. Prosser**

IN THE YEAR 1890 Mrs. Samuel D. Warren, a young matron of Boston, which is a large city in Massachusetts, held at her home a series of social entertainments on an elaborate scale. She was the daughter of Senator Bayard of Delaware, and her husband was a wealthy young paper manufacturer, who only the year before had given up the practice of law to devote himself to an inherited business. Socially Mrs. Warren was among the èlite; and the newspapers of Boston, and in particular the *Saturday Evening Gazette*, which specialized in "blue blood" items, covered her parties in highly personal and embarrassing detail. It was the era of "yellow journalism," when the press had begun to resort to excesses in the way of prying that have become more or less commonplace today;[1] and Boston was perhaps, of all of the cities in the country, the one in which a lady and a gentleman kept their names and their personal affairs out of the papers. The matter came to a head when the newspapers had a field day on the occasion of the wedding of a daughter, and Mr. Warren became annoyed.[2] It was an annoyance for which the press, the advertisers and the entertainment industry of America were to pay dearly over the next seventy years.

Mr. Warren turned to his recent law partner, Louis D. Brandeis, who was destined not to be unknown to history. The result was a noted article, *The Right to Privacy*,[3] in the *Harvard Law Review*, upon which the two men collaborated. It has come to be regarded as the outstanding example

**Intrusion upon a person's seclusion**

**Public disclosure of embarrassing private facts**

**Publicity which places a person in a false light**

**Appropriation of a person's name or likeness**

| Code of Fair Information Practices (1973 HEW Report) |
|---|
| There must be no personal-data record-keeping systems whose very existence is secret. |
| There must be a way for an individual to find out what information about him is in a record and how it is used. |
| There must be a way for an individual to prevent information about him obtained for one purpose from being used or made available for other purposes without his consent. |
| There must be a way for an individual to correct or amend a record of identifiable information about him. |
| Any organization creating, maintaining, using, or disseminating records of identifiable personal data must ensure the reliability of the data for their intended use and must take reasonable precautions to prevent misuse of the data. |

Classification: Schwab Internal

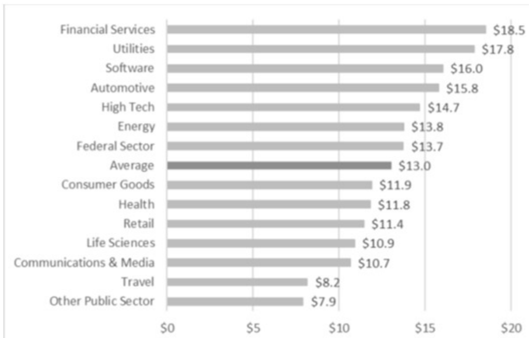
# OECD'S FAIR INFORMATION PRACTICES

(OECD GUIDELINES ON THE PROTECTION OF PRIVACY AND TRANSBORDER FLOWS OF PERSONAL DATA, 1980)

| | | | |
|---|---|---|---|
| Collection Limitation | Data Quality | Purpose Specification | Use Limitation |
| Security Safeguards | Openness | Individual Participation | Accountability |

Classification: Schwab Internal

# CYBER IMPACT ON FINANCIAL INSTITUTIONS




Source: Introduction to Financial Services: Financial Cybersecurity, Congressional Research Service (Jan 5, 2023)

**Threats**
**Social Engineering**
**Ransomware**
**Supply Chain**
**Vulnerabilities**
**AI / Deep Fakes**
**Insider Threats**

**Risks**
**Financial**
**Operational**
**Reputational**
**Systemic**

Classification: Schwab Internal

**BAD**

**Loss of Confidentiality: Information is read or copied by someone not authorized to do so.**

**Loss of Integrity: Information is modified in unexpected ways.**

**Loss of Availability: Information is erased or otherwise inaccessible.**

**GOOD**

**Authentication: Proving that a user is the person he claims to be.**

**Authorization: Determining whether a user has the right to carry out a certain activity.**

Classification: Schwab Internal

# Presentation Agenda

**Privacy and Security Fundamentals**

**Key Statutes / Regulations**

**Status of Recent SEC Proposals**

**Incident Notification Requirements**

**Grab Bag!**

Classification: Schwab Internal

# GRAMM-LEACH-BLILEY ACT

(AKA: FINANCIAL SERVICES MODERNIZATION ACT OF 1999, 15 U.S.C. 6801-6809, 6821-6827)

**Nonpublic Personal Information**

- Personally identifiable financial information (i) provided by a consumer to a financial institution; (ii) resulting from any transaction with the consumer or any service performed for the consumer; or (iii) otherwise obtained by the financial institution.
- Does not include publicly available information.
- Includes any list, description, or other grouping of consumers (and publicly available information pertaining to them) that is derived using any nonpublic personal information other than publicly available information.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# GRAMM-LEACH-BLILEY ACT

(AKA: FINANCIAL SERVICES MODERNIZATION ACT OF 1999, 15 U.S.C. 6801-6809, 6821-6827)

**Financial Privacy Rule**

- Provide a privacy notice at the time the consumer relationship is established and annually.
- Explain how information collected about the consumer is collected, shared, used, and protected.
- Identify the consumer's right to opt out of information sharing with unaffiliated parties pursuant to the provisions of the Fair Credit Reporting Act.

**Safeguards Rule**

- Develop, implement, and maintain an information security program.
- Program should include administrative, technical, and physical safeguards designed to protect customer information.

**Pretexting**

- Implement safeguards against pretexting.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# GRAMM-LEACH-BLILEY ACT

(AKA: FINANCIAL SERVICES MODERNIZATION ACT OF 1999, 15 U.S.C. 6801-6809, 6821-6827)

**Information Sharing**

- Can share with affiliates. Consumer must be notified.
- Can share with non-affiliates after providing consumers ability to opt out of disclosure.
- Consumers cannot opt-out if third party performs "services for or functions on behalf of the financial institution, including marketing of the financial institution's own products and services, or financial products or services offered pursuant to joint agreements between two or more financial institutions."

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# GRAMM-LEACH-BLILEY ACT

(AKA: FINANCIAL SERVICES MODERNIZATION ACT OF 1999, 15 U.S.C. 6801-6809, 6821-6827)

**Safeguards Rule -- Interagency Guidelines Establishing Information Security Standards**

- Qualified Individual to implement and supervise information security program.
- Risk assessment.
- Safeguards to control risks identified in risk assessment: (i) access controls; (ii) data inventory; (iii) encryption in transit; (iv) app security; (v) multi-factor authentication; (vi) data disposal; (vii) change management; (viii) access logs.
- Monitor and test effectiveness of safeguards.
- Staff training.
- Monitor service providers.
- Update information security program.
- Incident response plan.
- BoD reports.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# OTHER FEDERAL FINANCIAL LAWS

- **Sarbanes-Oxley Act of 2002 (P.L. 107-204).** Annual reports with SEC that identify internal/external risks and how the company addresses those risks.
- **Fair and Accurate Credit Transactions Act (P.L. 108-159).** Identity theft guidelines that outline patterns, practices, and other indicators of identity theft.
- **Bank Protection Act (P.L. 90-389).** Establish security standards to discourage robberies, burglaries, and larcenies.
- **CFTC System Safeguards Rule (86 Fed. Reg. 70272).** Conduct vulnerability testing, penetration testing, controls testing, security incident response plan testing, enterprise technology risk assessments.
- **Bank Secrecy Act (31 U.S.C. 5311).** Adopt a customer identification program and file Suspicious Activity Reports when detecting known/suspected violations of federal law or suspicious transactions. Federal Financial Institutions Examination Council.
- **Regulators.** Prudential regulators (FDIC, OCC, FRB), FTC, CFPB, CFTC.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

## NYDFS CYBERSECURITY REGULATION
(23 NYCRR 500)

Applies to entities operating under DFS licensure, registration, or charter, or which are otherwise DFS-regulated (e.g., state-chartered banks, licensed lenders, private bankers, mortgage companies, insurance companies, service providers, etc.).

**Requires:**
- Risk assessments
- Audit trail
- Limitations on data retention
- Limited access privileges
- Incident response plan
- Notices to Superintendent

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

## NYDFS CYBERSECURITY REGULATION
(23 NYCRR 500)

**"[Risk] assessment should result in thoughtful cybersecurity programs specifically tailored to safeguard the confidentiality of company and consumer data."**

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# NYDFS CYBERSECURITY REGULATION

(23 NYCRR 500)

**Cybersecurity Governance (Section 500.4).**

(c) The CISO shall timely report to the senior governing body or senior officer(s) on material cybersecurity issues, such as significant cybersecurity events and significant changes to the covered entity's cybersecurity program.

(d) The senior governing body of the covered entity shall exercise oversight of the covered entity's cybersecurity risk management, including by:

(1) having sufficient understanding of cybersecurity-related matters to exercise such oversight, which may include the use of advisors;

(2) requiring the covered entity's executive management or its designees to develop, implement and maintain the covered entity's cybersecurity program;

(3) regularly receiving and reviewing management reports about cybersecurity matters; and

(4) confirming that the covered entity's management has allocated sufficient resources to implement and maintain an effective cybersecurity program.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# NYDFS CYBERSECURITY REGULATION

(23 NYCRR 500)

**Multi-Factor Authentication (Section 500.12).**

(a) [Multi-factor authentication. Based on its risk assessment, each covered entity shall use effective controls, which may include multi-factor authentication or risk-based authentication, to protect against unauthorized access to nonpublic information or information systems.] Multi-factor authentication shall be utilized for any individual accessing any information systems of a covered entity, unless the covered entity qualifies for a limited exemption pursuant to section 500.19(a) of this Part in which case multi-factor authentication shall be utilized for:

(1) remote access to the covered entity's information systems;

(2) remote access to third-party applications, including but not limited to those that are cloud based, from which nonpublic information is accessible; and

(3) all privileged accounts other than service accounts that prohibit interactive login.

(b) [Multi-factor authentication shall be utilized for any individual accessing the covered entity's internal networks from an external network, unless the covered entity's CISO has approved in writing the use of reasonably equivalent or more secure access controls.] If the covered entity has a CISO, the CISO may approve in writing the use of reasonably equivalent or more secure compensating controls. Such controls shall be reviewed periodically, but at a minimum annually.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# NYDFS CYBERSECURITY REGULATION

(23 NYCRR 500)

**Notices to Superintendent (Section 500.17).**

(c) Notice and explanation of extortion payment. Each covered entity, in the event of an extortion payment made in connection with a cybersecurity event involving the covered entity, shall provide the superintendent electronically, in the form set forth on the department's website, with the following:

(1) within 24 hours of the extortion payment, notice of the payment; and

(2) within 30 days of the extortion payment, a written description of the reasons payment was necessary, a description of alternatives to payment considered, all diligence performed to find alternatives to payment and all diligence performed to ensure compliance with applicable rules and regulations including those of the Office of Foreign Assets Control.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# MASSACHUSETTS WISP REQUIREMENT

(201 CMR 17.00 ET SEQ.)

- One or more employees designated to maintain the program.
- Identification and assessment of reasonably foreseeable internal and external risks to the security, confidentiality, and/or integrity of any record containing personal information.
- Security policies for employees relating to the storage, access and transportation of records containing personal information.
- Disciplinary measures for violations of the comprehensive information security program rules.
- Prevention of terminated employees from accessing records containing personal information.
- Service provider oversight that includes reasonable steps to select and retain third-party service providers that are capable of maintaining appropriate security measures, and contractual requirements forcing such third-party service providers to implement and maintain such appropriate security measures for personal information.
- Regular monitoring to ensure that the comprehensive information security program is operating in a manner reasonably calculated to prevent unauthorized access to or unauthorized use of personal information.
- Documenting responsive actions taken in connection with any breach.

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

| Issue | SEC | FTC | FFIEC | GLBA Safe. R. | MA |
|---|---|---|---|---|---|
| Governance & Risk Assessment | ✓ | ✓ | ✓ | ✓ | ✓ |
| Access Rights and Authentication Measures | ✓ | ✓ | ✓ | ✓ | ✓ |
| Data Loss Prevention (DLP) | ✓ | ✓ | ✓ | ✓ | ✓ |
| Vendor Management | ✓ | ✓ | ✓ | ✓ | ✓ |
| Training | ✓ | ✓ | ✓ | ✓ | ✓ |
| Incident Response | ✓ | ✓ | ✓ | ✓ | ✓ |

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# CALIFORNIA CONSUMER PRIVACY ACT

(CAL. CIV CODE 1798.100 ET SEQ.)

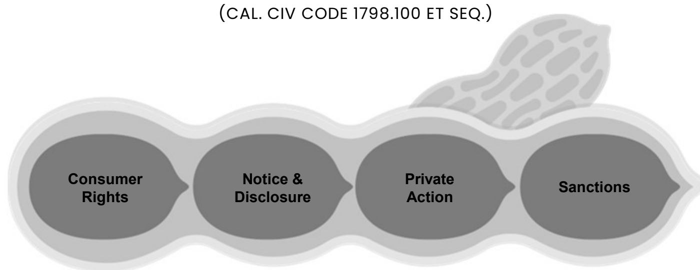
| | |
|---|---|
| **CCPA**<br>Cal Civ § 1798.145(e) | This title shall not apply to personal information collected, processed, sold, or disclosed subject to the federal Gramm-Leach-Bliley Act (Public Law 106-102), and implementing regulations . . . . |
| **GLBA**<br>15 U.S.C. § 6809(4)(A) | (A) The term "nonpublic personal information" means personally identifiable financial information— (i) provided by a consumer to a financial institution; (ii) resulting from any transaction with the consumer or any service performed for the consumer; or (iii) otherwise obtained by the financial institution. |

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

# CALIFORNIA CONSUMER PRIVACY ACT

(CAL. CIV CODE 1798.100 ET SEQ.)




| Consumer Rights | Notice & Disclosure | Private Action | Sanctions |
|---|---|---|---|
| Access<br>Correct<br>Know<br>Opt-out<br>Others | Categories Collected<br>Use Purposes<br>Sharing Recipients<br>Consumer Rights | Right to sue for data breach<br>+<br>statutory penalties | Civil action by California regulators<br>+<br>statutory penalties |

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

## CCPA Definition of "Sale"

**[S]elling, renting, releasing, disclosing, disseminating, making available, transferring, or otherwise communicating orally, in writing, or by electronic or other means a consumer's personal information for monetary or other valuable consideration.**

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

**CPRA Definition of "Share"**

[S]haring, renting, releasing, disclosing, disseminating, making available, transferring, or otherwise communicating orally, in writing, or by electronic or other means, a consumer's personal information by the business to a third party for cross-context behavioral advertising, whether or not for monetary or other valuable consideration, including transactions between a business and a third party for cross-context behavioral advertising for the benefit of a business in which no money is exchanged.



Classification: Schwab Internal

**CPRA Definition of "Cross-Context Behavioral Advertising"**

[T]he targeting of advertising to a consumer based on the consumer's personal information obtained from the consumer's activity across businesses, distinctly-branded websites, applications, or services, other than the business, distinctly-branded website, application, or service with which the consumer intentionally interacts.



Classification: Schwab Internal

**But what about Service Providers that, pursuant to a written contract, are prohibited from retaining, using, or disclosing the personal information for any purpose other than performing the services specified in the contract?**

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal

| | | |
|---|---|---|
| Categories of personal information collected | Purposes for which personal information is used | Specific pieces of information collected |
| A description of consumers rights and how to exercise them | Categories of personal information collected within past 12 months | Categories of personal information sold or disclosed within past 12 months |

**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

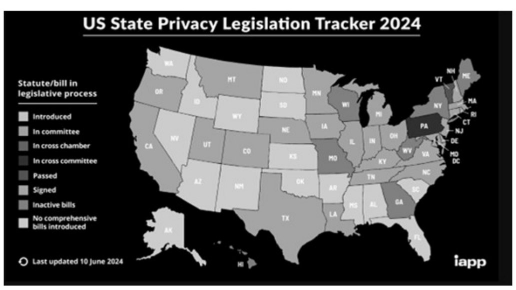
Classification: Schwab Internal

# CCPA Actions

| | |
|---|---|
| ✔ | Confirm that CCPA applies. |
| ✔ | Draft privacy notice that includes required disclosures. |
| ✔ | Provide requisite consumer rights (access, delete, opt-out of sale, etc.). |
| ✔ | Identify data sharing use cases that fall within definition of "sale." |
| ✔ | Update vendor contracts as needed. |
| ✔ | Develop infrastructure for facilitating exercise of consumer rights (opt-out of share). |

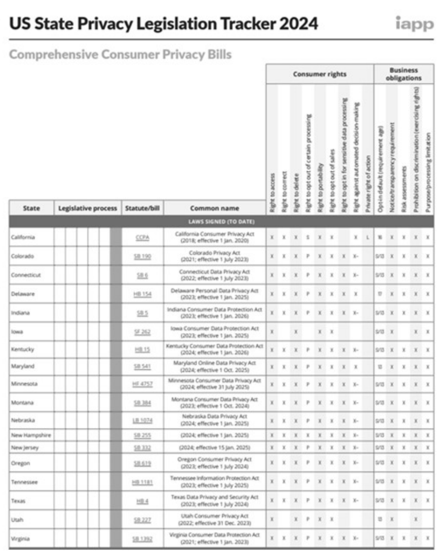
**Federal Financial Laws – State Financial Laws – State Data Protection Laws – State Privacy Laws**

Classification: Schwab Internal




ALL - the opt-in requirement age covers all individuals
IN - opt-in consent requirement
L - private right of action limited to certain violations only
P - right to opt-out of processing for profiling/targeted advertising purposes
S - sensitive data
X - right or obligation exists
~ - right to opt out of certain automated decision making
(C) - companion bills in the House and Senate of the state legislature

Source : https://iapp.org/resources/article/us-state-privacy-legislation-tracker/



## US State Privacy Legislation Tracker 2024

iapp

Comprehensive Consumer Privacy Bills

| State | Legislative process | Statute/bill | Common name | Consumer rights: Right to access | Right to correct | Right to delete | Right to opt out of certain processing | Right to portability | Right to opt out of sales | Right to opt in for sensitive data processing | Right against automated decision-making | Private right of action | Business obligations: Opt-in default (requirement age) | Notice/transparency requirement | Risk assessments | Prohibition on discrimination (exercising rights) | Purpose/processing limitation |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| LAWS SIGNED (TO DATE) | | | | | | | | | | | | | | | | | |
| California | | CCPA | California Consumer Privacy Act (2018; effective 1 Jan. 2020) | X | X | X | S | X | X | | X | L | 16 | X | X | X | X |
| Colorado | | SB 190 | Colorado Privacy Act (2021; effective 1 July 2023) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Connecticut | | SB 6 | Connecticut Data Privacy Act (2022; effective 1 July 2023) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Delaware | | HB 154 | Delaware Personal Data Privacy Act (2023; effective 1 Jan. 2025) | X | X | X | P | X | X | X | X | | 17 | X | X | X | X |
| Indiana | | SB 5 | Indiana Consumer Data Protection Act (2023; effective 1 Jan. 2026) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Iowa | | SF 262 | Iowa Consumer Data Protection Act (2023; effective 1 Jan. 2025) | X | | X | | X | X | | | | S/13 | X | | X | X |
| Kentucky | | HB 15 | Kentucky Consumer Data Protection Act (2024; effective 1 Jan. 2026) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Maryland | | SB 541 | Maryland Online Data Privacy Act (2024; effective 1 Oct. 2025) | X | X | X | P | X | X | X | X | | 13 | X | X | X | X |
| Minnesota | | HF 4757 | Minnesota Consumer Data Privacy Act (2024; effective 31 July 2025) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Montana | | SB 384 | Montana Consumer Data Privacy Act (2023; effective 1 Oct. 2024) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Nebraska | | LB 1074 | Nebraska Data Privacy Act (2024; effective 1 Jan. 2025) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| New Hampshire | | SB 255 | (2024; effective 1 Jan. 2025) | X | X | X | X | X | X | X | X~ | | S/13 | X | X | X | X |
| New Jersey | | SB 332 | (2024; effective 15 Jan. 2025) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Oregon | | SB 619 | Oregon Consumer Privacy Act (2023; effective 1 July 2024) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Tennessee | | HB 1181 | Tennessee Information Protection Act (2023; effective 1 July 2025) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Texas | | HB 4 | Texas Data Privacy and Security Act (2023; effective 1 July 2024) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |
| Utah | | SB 227 | Utah Consumer Privacy Act (2022; effective 31 Dec. 2023) | X | | X | P | X | X | | | | 13 | X | | X | |
| Virginia | | SB 1392 | Virginia Consumer Data Protection Act (2021; effective 1 Jan. 2023) | X | X | X | P | X | X | X | X~ | | S/13 | X | X | X | X |

Classification: Schwab Internal

## GDPR Actions

| | |
|---|---|
| ✔ | Confirm that GDPR applies, and that organization has appropriate governance mechanisms in place (DPO, record keeping, policies and procedures, employee training) |
| ✔ | Draft privacy notice that includes required disclosures (purpose, duration, consent). |
| ✔ | Confirm basis for processing (e.g., consent). |
| ✔ | Provide requisite consumer rights (access, rectify, delete, portability). |
| ✔ | Privacy by design and by default. |
| ✔ | Mechanism for transferring data internationally (standard contractual clauses, consent, etc.). |

Classification: Schwab Internal

## Presentation Agenda

**Privacy and Security Fundamentals**

**Key Statutes / Regulations**

**Status of Recent SEC Proposals**

**Incident Notification Requirements**

**Grab Bag!**

Classification: Schwab Internal

## CYBERSECURITY RISK MANAGEMENT, STRATEGY, GOVERNANCE, AND INCIDENT DISCLOSURE

- Disclose in Form 8-K of material cybersecurity incidents within four business days of determination that cybersecurity incident is material.
- Annual disclosures in Form 10-K regarding cybersecurity risk management and strategy.

**17 CFR Parts 229, 232, 239, 240, and 249**

**[Release Nos. 33-11216; 34-97989; File No. S7-09-22]**

**RIN 3235-AM89**

**Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is adopting new rules to enhance and standardize disclosures regarding cybersecurity risk management, strategy, governance, and incidents by public companies that are subject to the reporting requirements of the Securities Exchange Act of 1934. Specifically, we are adopting amendments to require current disclosure about material cybersecurity incidents. We are also adopting rules requiring periodic disclosures about a registrant's processes to assess, identify, and manage material cybersecurity risks, management's role in assessing and managing material cybersecurity risks, and the board of directors' oversight of cybersecurity risks. Lastly, the final rules require the cybersecurity disclosures to be presented in Inline eXtensible Business Reporting Language ("Inline XBRL").

**DATES:** *Effective date*: The amendments are effective September 5, 2023.

*Compliance dates*: See Section II.I (Compliance Dates).

Classification: Schwab Internal

## REGULATION S-P

## PRIVACY OF CONSUMER FINANCIAL INFORMATION AND SAFEGUARDING CUSTOMER INFORMATION

- Incident response policies and procedures "reasonably designed to detect, respond to, and recover from unauthorized access to or use of customer information."
- Service provider contracts that require 72-hour incident notification.
- Customer incident notification within 30 days.
- Safeguards/Disposal/Recordkeeping.

**17 CFR Parts 240, 248, 270, and 275**

**[Release Nos. 34-100155; IA-6604; IC-35193; File No. S7-05-23]**

**RIN 3235-AN26**

**Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is adopting rule amendments that will require brokers and dealers (or "broker-dealers"), investment companies, investment advisers registered with the Commission ("registered investment advisers"), funding portals, and transfer agents registered with the Commission or another appropriate regulatory agency ("ARA") as defined in the Securities Exchange Act of 1934 ("transfer agents") to adopt written policies and procedures for incident response programs to address unauthorized access to or use of customer information, including procedures for providing timely notification to individuals affected by an incident involving sensitive customer information with details about the incident and information designed to help affected individuals respond appropriately. In addition, the amendments extend the application of requirements to safeguard customer records and information to transfer agents; broaden the scope of information covered by the requirements for safeguarding customer records and information and for properly disposing of consumer report information; impose requirements to maintain written records documenting compliance with the amended rules; and conform annual privacy notice delivery

Classification: Schwab Internal

## CYBERSECURITY RISK MANAGEMENT RULE FOR BROKER-DEALERS, CLEARING AGENCIES, MAJOR SECURITY-BASED SWAP PARTICIPANTS

- Cybersecurity risk management policies and procedures "reasonably designed to detect, respond to, and recover from unauthorized access to or use of customer information."
- Notification to SEC of significant cybersecurity incident.
- Public disclosure of cybersecurity risks and incidents.

**17 CFR Parts 232, 240, 242 and 249**

**[Release No. 34-97142; File No. S7-06-23]**

**RIN 3235-AN15**

**Cybersecurity Risk Management Rule for Broker-Dealers, Clearing Agencies, Major Security-Based Swap Participants, the Municipal Securities Rulemaking Board, National Securities Associations, National Securities Exchanges, Security-Based Swap Data Repositories, Security-Based Swap Dealers, and Transfer Agents**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission") is proposing a new rule and form and amendments to existing recordkeeping rules to require broker-dealers, clearing agencies, major security-based swap participants, the Municipal Securities Rulemaking Board, national securities associations, national securities exchanges, security-based swap data repositories, security-based swap dealers, and transfer agents to address cybersecurity risks through policies and procedures, immediate notification to the Commission of the occurrence of a significant cybersecurity incident and, as applicable, reporting detailed information to the Commission about a significant cybersecurity incident, and public disclosures that would improve transparency with respect to cybersecurity risks and significant cybersecurity incidents. In addition, the Commission is proposing amendments to existing clearing agency exemption orders to require the retention of records that would need to be made under the proposed cybersecurity requirements. Finally, the Commission is proposing amendments to address the potential availability to security-based swap dealers and major security-based swap participants of substituted compliance in connection with those requirements.

Classification: Schwab Internal

## REGULATION SYSTEMS COMPLIANCE AND INTEGRITY

- Expanded definition of "SCI entity."
- Inventory, classification, lifecycle management program for SCI systems.
- Management of third parties.
- BCDR plans.
- Program to prevent unauthorized access to SCI systems.
- Identification of current SCI industry standards.

**17 CFR Parts 242 and 249**

**[Release No. 34-97143; File No. S7-07-23]**

**RIN 3235-AN25**

**Regulation Systems Compliance and Integrity**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is proposing amendments to Regulation Systems Compliance and Integrity ("Regulation SCI") under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed amendments would expand the definition of "SCI entity" to include a broader range of key market participants in the U.S. securities market infrastructure, and update certain provisions of Regulation SCI to take account of developments in the technology landscape of the markets since the adoption of Regulation SCI in 2014. The proposed expansion would add the following entities to the definition of "SCI entity": registered security-based swap data repositories ("SBSDRs"); registered broker-dealers exceeding an asset or transaction activity threshold; and additional clearing agencies exempted from registration. The proposed updates would amend provisions of Regulation SCI relating to systems classification and lifecycle management; third party/vendor management; cybersecurity; the SCI review; the role of current SCI industry standards; and recordkeeping and related matters. Further, the Commission is requesting comment on whether significant-volume alternative trading systems (ATSs) and/or broker-dealers using electronic or automated systems for trading of corporate debt securities or municipal securities should be subject to Regulation SCI.

Classification: Schwab Internal

**CONFLICTS OF INTEREST ASSOCIATED WITH THE USE OF PREDICTIVE DATA ANALYTICS BY BROKER-DEALERS AND INVESTMENT ADVISERS**

- Evaluate use of "covered technology."
- Identify conflicts of interest that elevate firm's interests over investor interests.
- Eliminate/neutralize effects of conflicts.
- Policies to prevent violations of proposed rule.

**17 CFR Parts 240 and 275**

**[Release Nos. 34-97990; IA-6353; File No. S7-12-23]**

**RIN 3235-AN00; 3235-AN14**

**Conflicts of Interest Associated with the Use of Predictive Data Analytics by Broker-Dealers and Investment Advisers**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is proposing new rules ("proposed conflicts rules") under the Securities Exchange Act of 1934 ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act") to eliminate, or neutralize the effect of, certain conflicts of interest associated with broker-dealers' or investment advisers' interactions with investors through these firms' use of technologies that optimize for, predict, guide, forecast, or direct investment-related behaviors or outcomes. The Commission is also proposing amendments to rules under the Exchange Act and Advisers Act that would require firms to make and maintain certain records in accordance with the proposed conflicts rules.

Classification: Schwab Internal

## <u>Presentation Agenda</u>

**Privacy and Security Fundamentals**

**Key Statutes / Regulations**

**Status of Recent SEC Proposals**

**Incident Notification Requirements**

**Grab Bag!**

Classification: Schwab Internal

- Computer-Security Incident Notification Requirements for Banking Organizations and Their Bank Service Providers (2022)
- State Banking Commission Requirements
- NYDFS Cybersecurity Regulation (2017) (2022)
- Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies (2022)
- Cyber Incident Reporting for Critical Infrastructure Act (2022)
- Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure (2022)
- National Association of Insurance Commissioners (NAIC) Model Law
- EU General Data Protection Regulation (2018)
- UK General Data Protection Regulation (2022)
- Gramm-Leach-Bliley Act (1999)
- U.S. State/Territory Data Breach Notification Laws
- Other International Notification Laws
- Customer Agreements
- Suspicious Activity Reports (SARs)

Classification: Schwab Internal

**This gets tricky…**

- State notification triggers range from "without unreasonable delay" to no later than 60 days after discovery. Federal range from "immediately" and "promptly" to 72 hours and "without delay."
- Some states require AG/admin notices, some don't. And triggers vary.
- NJ requires notification to State Police prior to notifying consumers; VA requires simultaneous notification to the state AG and consumers.
- Notification triggers: "substantial loss," "disruption," "serious impact," "reasonably likely to jeopardize," "potentially adverse effect," etc.

Classification: Schwab Internal

**Computer-Security Incident Notification Requirements for Banking Organizations and Their Bank Service Providers**

- Applicable to Banking Organizations
- Notification to primary federal regulator (Fed, OCC, FDIC)
- Requirement: 36 hours after determining a notification incident has occurred
- Key Definitions
  - Computer-Security Incident: "[A]n occurrence that results in actual harm to the confidentiality, integrity, or availability of an information system or the information that the system processes, stores, or transmits."
  - Notification Incident: "[A] computer-security incident that has materially disrupted or degraded, or is reasonably likely to materially disrupt or degrade, a banking organization's— (i) Ability to carry out banking operations, activities, or processes, or deliver banking products and services to a material portion of its customer base, in the ordinary course of business; (ii) Business line(s), including associated operations, services, functions, and support, that upon failure would result in a material loss of revenue, profit, or franchise value; or (iii) Operations, including associated services, functions and support, as applicable, the failure or discontinuance of which would pose a threat to the financial stability of the United States."

Classification: Schwab Internal

**Cyber Incident Reporting for Critical Infrastructure Act**

- Applicable to entities that Operate in a "Critical Infrastructure Sector" (including entities that own or operate financial services sector infrastructure)
- Notification to CISA
- Requirement: 72 hours after entity reasonably believes a significant cyber incident has occurred and 24 hours after ransom payment has been made
- Substantial Cyber Incident is one that leads to any of the following:
  (a) a substantial loss of confidentiality, integrity, or availability of a covered entity's information system or network;
  (b) a serious impact on the safety and resiliency of a covered entity's operational systems and processes;
  (c) a disruption of a covered entity's ability to engage in business or industrial operations, or deliver goods or services; or
  (d) unauthorized access to a covered entity's information system or network, or any nonpublic information contained therein, that is facilitated through or caused by either a compromise of a cloud service provider, managed service provider, other third-party data hosting provider, or a supply chain compromise.

Classification: Schwab Internal

**NYDFS Cybersecurity Regulation**

- Applicable to Covered Entities
- Notification of a Cybersecurity Event that (1) has a reasonable likelihood of materially harming any material part of the covered entity; or (2) triggers a separate obligation of the company to report to a government body, self-regulatory agency, or any other supervisory body
- Notification to NYDFS
- Requirement: 72 hours after determining a cyber event has occurred + 24 hours of extorsion payment
- Key Definitions
  - Covered Entity: "[A]ny Person operating under or required to operate under a license, registration, charter, certificate, permit, accreditation or similar authorization under the Banking Law, the Insurance Law or the Financial Services Law."
  - Cybersecurity Event: "Any act or attempt, successful or unsuccessful, to gain unauthorized access to, disrupt or misuse an Information System or information stored on such Information System."

Classification: Schwab Internal

**Massachusetts Data Breach Notification Law — Consumers**

- Notification Obligation. An Entity to which the statute applies shall provide notice to the affected residents, as soon as practicable and without unreasonable delay, when the Entity knows or has reason to know of a breach of security, or when the Entity knows or has reason to know that the PI of such resident was acquired or used by an unauthorized person or used for an unauthorized purpose.
- Timing of Notification. The notification shall be given as soon as practicable and without unreasonable delay following discovery of the breach. Entities cannot delay notification "on the grounds that the total number of residents affected is not yet ascertained."

Classification: Schwab Internal

**Massachusetts Data Breach Notification Law — AG/Agency**

- Attorney General/State Agency Notification. Notice must be provided to the state Attorney General and the director of consumer affairs and business regulation.
- The notice shall include, but not be limited to:
  - the nature of the breach of security or unauthorized acquisition or use;
  - the number of residents of MA affected by such incident at the time of notification;
  - the name and address of the person or agency that experienced the breach of security;
  - the type of person or agency reporting the breach of security;
  - the person responsible for the breach of security, if known;
  - the type of personal information compromised, including, but not limited to, social security number, driver's license number, financial account number, credit or debit card number or other data;
  - whether the person or agency maintains a written information security program; and
  - any steps the person or agency has taken or plans to take relating to the incident, including updating the written information security program….



**There are others.**

**How do we address the web of notification obligations?**

## Presentation Agenda

**Privacy and Security Fundamentals**

**Key Statutes / Regulations**

**Status of Recent SEC Proposals**

**Incident Notification Requirements**

**Grab Bag!**

Classification: Schwab Internal

# What Haven't We Covered That We Probably Should Have?

Classification: Schwab Internal

FUNDAMENTALS OF BANKING LAW:

**REGULATION OF FINTECH**

Fintech ecosystem
Operating authority
Operating obligations

**June 2024**

FINTECH ECOSYSTEM

2

## What Is "Fintech"? A Few Categorizations…

Customer

- Consumers
- Small Business
- Large Business
- Government

Product/Service

- Payments
- Credit (cards, loans)
- Deposits
- Savings
- Operations
- Compliance
- Infrastructure

Function

- B2C (Business to Consumer/Customer)
- B2B (Business to Business)
- B2B2C (Business to Business to Consumer/Customer)
- BaaS (Banking as a Service)
- SaaS (Software as a Service)

3

## OPERATING AUTHORITY

4

## How Do Fintechs Operate?

- First things first: You must be authorized to operate if you offer banking products or services directly to individuals
  - How do fintechs offer banking products and services without a bank charter?
- Authorization is through state licensure and bank partnerships
  - Fintechs must choose their path, similar to banks choosing their path

⇨ There is no such thing as a federal license to operate in the US.



## State Licensure

- License types
  - Money transmitter licenses (requires federal MSB registration) – payments, crypto
  - Lending – brokering, origination (cards, small dollar loans, installment loans), servicing
  - Other – debt collection, credit repair
- Requirements
  - Background checks
  - Capital and bonds
  - Compliance program
  - Examinations
  - Reporting

*State Licensure Overview*

- *50 states + DC*
- *100s of licenses*
- *State law (most rigorous state is floor) + CFPB*
- *States, CFPB, DOJ, FTC*

## Bank Partnerships

- Partnership types by product / service
  - Payments, credit cards, loans, deposits, savings
- Requirements
  - Appropriate leadership
  - Capital
  - Compliance program
  - Information security
  - Audits

*Bank Partnerships Overview*

- *Bank (one or more)*
- *For each bank: OCC, or state/FDIC v state/FRB*
- *State law (preemption sometimes) + CFPB*
- *Banks, states, CFPB, DOJ*

⇨ While fintechs may choose to contract with banks to operate, legally they are service providers to banks.



## Bank Partnership Agreements

Legal

- Ownership of
  - Customers
  - Deposits
  - Data
- Privacy, data protection
- Liability, indemnification
- Right to audit

Compliance

- Underwriting models
- BSA/AML/OFAC
- Monitoring and testing
- Regulatory reporting

⇨ If a bank's oversight of its fintech clients' activities is insufficient, the bank risks enforcement action.

Operations

- Access to payments systems
- Issuance of
  - Routing numbers
  - Cards (debit, credit)
- Fraud management
- Customer support
- Tech stack

# OPERATING OBLIGATIONS



## Obligations in Bank Partnerships

- A bank's obligations (compliance, operations, reporting, financial, etc.) expand when it agrees to a fintech partnership or engages in or with "Banking as a Service" (BaaS)
  - Not only is it responsible for itself in those areas, but it is responsible for each fintech it engages with
- This set of obligations is generally referred to as "third-party risk management" (TPRM)
- A bank's TPRM obligations become more challenging as the number and complexity of fintechs involved in a singular offering increases
- Not only is it difficult to execute on the obligations, but it is often even difficult to understand who provides what and is responsible to do what

## Third-Party Risk Management – Requirements

Regulators recently published their TPRM expectations in the form of comprehensive interagency guidance that contemplates such partnerships

- *Interagency Guidance on Third-Party Relationships: Risk Management* (June 2023)
  - Rescinds previous guidance from the Federal Reserve, OCC, and FDIC
  - Intended "to promote consistency in their [TPRM] guidance and to clearly articulate risk-based principles for [TPRM]"
  - Aims to help banks identify and manage risks in third-party relationships, which the agencies observe have increased in number and type, and comply with applicable laws and regulations
  - Principles-based, without imposing new requirements
- *Third-Party Risk Management: A Guide for Community Banks* (May 2024)
  - ***"*Engaging a third party does not diminish or remove a bank's responsibility to operate in a safe and sound manner and to comply with applicable legal and regulatory requirements, including consumer protection laws and regulations, just as if the bank were to perform the service or activity itself"** (statement published with emphasis)

11

## Third-Party Risk Management – Concepts

Longstanding concepts in TPRM – "Third-Party Relationship Lifecycle"

- Planning
- Due Diligence and Third-Party Selection
  - *Strategies and Goals; Legal and Regulatory Guidance; Financial Condition; Business Experience; Qualifications and Backgrounds of Key Personnel and Other Human Resources Considerations; Risk Management; Information Security; Management of Information Systems; Operational Resilience; Incident Reporting and Management Processes; Physical Security; Reliance on Subcontractors; Insurance Coverage; Contractual Arrangements with Other Parties*
- Contract Negotiation
  - *Nature and Scope of Arrangement; Performance Measures or Benchmarks; Responsibilities for Providing, Receiving, and Retaining Information; The Right to Audit and Require Remediation; Responsibility for Compliance with Laws and Regulations; Costs and Compensation; Ownership and License; Confidentiality and Integrity; Operational Resilience and Business Continuity; Indemnification and Limits on Liability; Insurance; Dispute Resolution; Customer Complaints; Subcontracting; Foreign-Based Third Parties; Default and Termination; Regulatory Supervision*
- Ongoing Monitoring
- Termination

12

## Third-Party Risk Management – Concepts

Longstanding concepts in TPRM – "Governance"

- Oversight and Accountability
  - Guidance sets forth responsibilities specific to Board and management
- Independent Review
  - Guidance lists factors that help assess the adequacy of third-party risk management processes
- Documentation and Reporting
  - Guidance provides examples of processes that support effective documentation and internal reporting

13

## Additional Regulatory Guidance

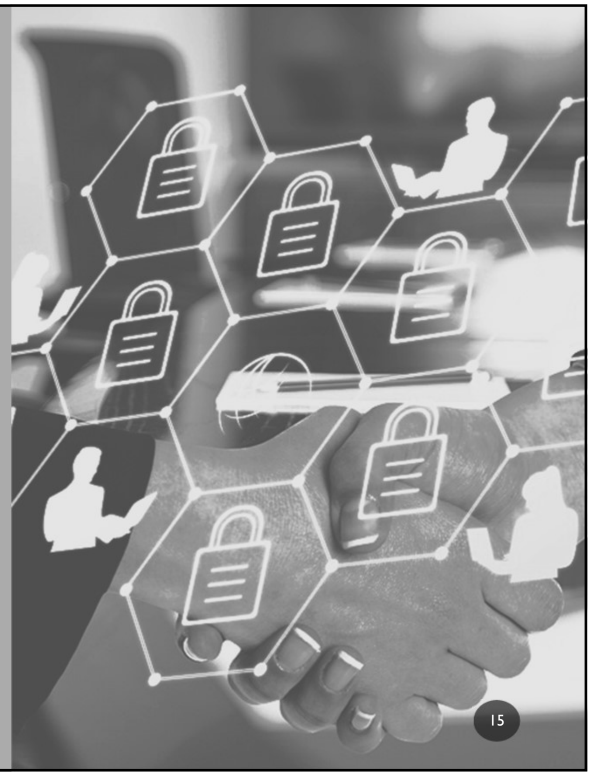
Selected other fintech and risk management guidance

- "Banking with Third-Party Apps" (May 2024) – issued by FDIC for consumers
- *Compliance Bulletin and Policy Guidance, Service Providers* (Oct 2016) – *CFPB Bulletin 2016-02*
- *Interagency Guidelines Establishing Information Security Standards* (July 2014)
- *Interagency Guidelines Establishing Standards for Safety and Soundness* (Jan 2010)
- *Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance* (May 2002) – OCC Bulletin 2002-16

14

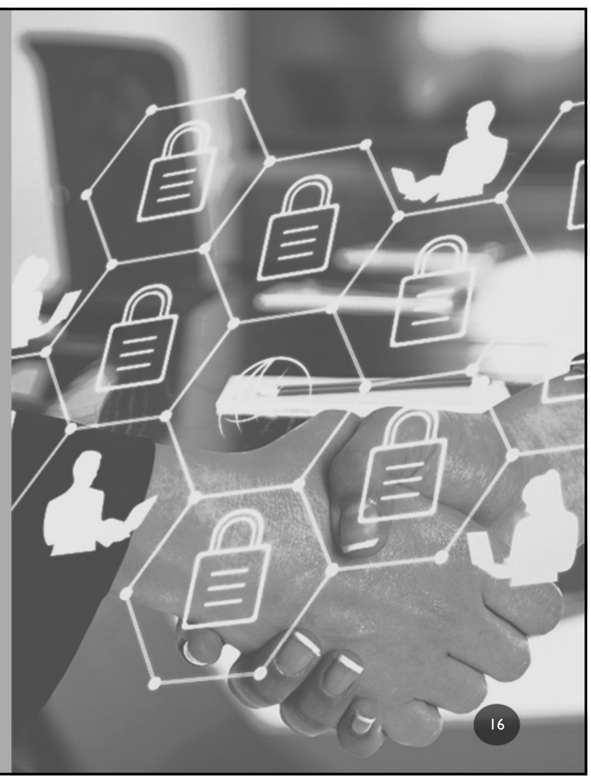
## Obligations – Consumer Protection

- FCRA + Reg V
- UDA(A)P
- GLBA + Reg P
- FDCPA + Reg F
- TISA + Reg DD
- EFTA + Reg E
- TILA + Reg Z
- ECOA + Reg B
- HMDA + Reg C
- SAFE + Reg G Reg H
- MAP + Reg N
- RESPA + Reg X
- Data Rights
- Reg M




## Obligations – BSA/AML/OFAC

- BSA Officer
- Customer Information Program ("CIP")
  Know Your Customer ("KYC")
  Identifying Beneficial Owners
  Customer Due Diligence ("CDD")
  Enhanced Due Diligence ("EDD")
  Transaction Monitoring
- Suspicious Activity and Other Reporting
- Internal Controls (Policies / Procedures)
- Training
- Independent Testing
- OFAC Screening



## Obligations – Privacy and Data Protection

- Federal law – Gramm-Leach Bliley Act ("GLBA"). a notice and opt-out regime
  - Draft legislation – American Privacy Rights Act of 2024
- State law – California, Colorado, Connecticut, Delaware, Indiana, Iowa, Kentucky, Maryland, Minnesota, Montana, Nebraska, New Hampshire, New Jersey, Oregon, Tennessee, Texas, Utah, Virginia, and more coming
- Contract – Bank partnership agreements
- International law – GDPR, PIPEDA

17

## Third Party Risk Management – Enforcement

Enforcement activity related to bank partnerships has increased significantly over the past few years

Selected actions
- Blue Ridge Bank (OCC, Aug 2022)
- Cross River Bank (FDIC, Mar 2023)
- Metropolitan Commercial Bank (Federal Reserve, Oct 2023)
- First Fed Bank (FDIC, Nov 2023)
- Choice Financial Group (FDIC, Dec 2023)
- Blue Ridge Bank (OCC, Jan 2024)
- Sutton Bank (FDIC, Feb 2024)
- Piermont Bank (FDIC, Feb 2024)

And more to come…

18

What solution would you propose for the challenges of BaaS?



QUESTIONS & DISCUSSION

Banking Law Fundamentals

# MERGERS AND ACQUISITIONS: THE REGULATORY REVIEW PROCESS

SCOTT G. ALVAREZ
FORMER GENERAL COUNSEL,
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 26, 2024

## Topics

The Process
- What approvals are needed? And which regulators are involved?
- Pre-filing meetings: who to talk to and what to expect

What are the standards? What blemishes are fatal?

Public Meetings: what are they and how do they work? (Don't panic)

What information is public?

How long will the process take?

Tips for managing the process

Forms

2

# Acquiring an IDI: What types of approvals are needed?

**First Acquisition of a DI by a company**.

- A company that is not a BHC must obtain approval from the Federal Reserve before acquiring *control* of its first bank or BHC (12 USC 1842(a)(1); 12 CFR 225.11), savings association or SLHC (12 USC 1467a(1));

**Acquiring Additional DIs by a BHC**.

- A BHC must get approval from the Federal Reserve before merging with, acquiring control of **or** acquiring more than 5% of the voting shares of a BHC, bank, (12 USC 1842(a), savings association or SLHC (12 USC 1843(j)).
- If the proposal involves merging IDIs, approval is also required under the Bank Merger Act (12 USC 1828(c)) from the primary Federal supervisor of the acquiring IDI and approval (from the same Federal agency) to establish new branching locations.
- The Banking Agencies must, by statute, notify the DOJ of all acquisitions/mergers involving an IDI, and DOJ is allotted a specific period to challenge the merger/acquisition under the Sherman and/or Clayton Acts.

**Other Acquisitions of IDIs**.

- In general, a company that is not a BHC must obtain approval under the Change in Bank Control Act (12 USC 1817(j)) from the primary Federal supervisor of an IDI/BHC/SLHC before acquiring more than 10% (but less than 25%) of the voting shares of the IDI/BHC/SLHC. (This requirement also applies to an individual or group of related individuals.)



# Acquiring a non-bank: What types of approvals are needed?

**Acquiring a non-bank financial company**.

- No approval from a Federal banking agency is required for an FHC to acquire *a nonbank financial firm* **so long as** the applicant is an FHC at the time of the acquisition and will continue to meet the requirements for being an FHC following the acquisition **UNLESS** the transaction involves an acquisition of nonbanking assets in excess of **$10 billion** (then approval from the Federal Reserve is required under section 4(j) of the BHC Act—12 USC 1843(j)).
- A BHC that does not meet the requirements to be an FHC must obtain approval from the Federal Reserve for most acquisitions of nonbank financial firms. (12 USC 1843(j)).
- A filing with DOJ under the Hart-Scott-Rodino Act (15 USC 18a(c)(8)) may be required for a BHC or an FHC to acquire a nonbank financial firm.

**Acquiring a Non-Bank Bank**.

- A company must obtain approval under the Change in Bank Control Act from the FDIC before acquiring control of an FDIC insured, state chartered "non-bank bank" (e.g., an industrial loan company) or from the OCC if the "non-bank bank" is nationally chartered (e.g., a nationally chartered limited purpose trust company or credit card bank) (12 USC 1817(j)).

# Overview of the Process

All of the regulatory processes for obtaining approval to acquire an insured depository institution:

- Require some type of public notice of the proposal, typically in the Federal Register and on the website of the reviewing agency and in some cases in a local newspaper, to allow the public an opportunity to submit comments;
- Require consultation with at least two Federal banking agencies, the Department of Justice, and, in cases involving a state-chartered IDI, the relevant State banking supervisor;
- Require review under similar statutory standards that are well understood.
  - See BHC Act, 12 USC 1842; Bank Merger Act, 12 USC 1828(c); Savings and Loan Holding Company Act, 12 USC 1467a(e); and Change in Bank Control Act, 12 USC 1817(j)(7).



# Overview of the standards of review under the Bank Holding Company Act

Financial, Managerial and Supervisory factors:

- The Federal Reserve must consider--
  - The financial and managerial resources and future prospects of the company and the banks concerned, including the competence, experience, and integrity of the officers, directors, and principal shareholders of the company or bank, and
- The Federal Reserve must disapprove any application if—
  - Access to information. The company fails to provide adequate assurances that it will make available to the Board information on the operations or activities of the company and any affiliate of the company determined by the Federal Reserve to be appropriate to determine and enforce compliance with this chapter; or
  - Consolidated Home Country Supervision. In the case of an application involving a foreign banking organization (FBO), the FBO is not subject to comprehensive supervision and regulation on a consolidated basis by the appropriate authorities in the bank's home country.
- Money Laundering and Bank Secrecy Act compliance: The Federal Reserve must consider the effectiveness of the company in combatting money laundering activities, including in overseas branches.

# Standards of Review (cont.)

Competitive factor: The Federal Reserve must disapprove any proposal to acquire a bank if—

- The proposal would result in a monopoly in any part of the United States, or
- The effect of the proposal in any section of the country may be substantially to lessen competition unless the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

Nationwide and State Deposit Caps: In the case of an interstate bank acquisition, the Federal Reserve may not approve the transaction if, upon consummation, the BHC would control more than--

- 10 percent of the total deposits held by depository institutions in the US, or
- 30 percent of the total deposits held by IDIs in the State where the target bank is located or such other limit set by State law (unless approved by the relevant State supervisor);

Liability Cap:

- The Federal Reserve may not approve any transaction that would result in a BHC controlling more than 10% of the *total liabilities* held by US financial institutions (IDIs, IDI holding companies, foreign banks in the US, and designated financial firms)



# Standards of Review (cont.)

Convenience and Needs of the Community:

- The Federal Reserve must consider the convenience and needs of the community to be served by the companies involved in the proposal.
  - This includes consideration of the performance of each IDI under the Community Reinvestment Act.

Financial Stability Factor:

- The Federal Reserve must consider the extent to which a proposed transaction would result in greater risks to the stability of the US banking or financial system.

# **Financial,** Managerial and Supervisory Factors

Financial Factor

- Focus is on the applicant organization; the applicant must be in good financial condition
  - Problems at the target must be fully addressable by the applicant
- The applicant must meet or exceed all regulatory capital requirements, both before and upon consummation of the proposal; if additional capital is needed, regulators will expect near certainty in capital raising efforts by the time of application
- Asset quality, liquidity and earnings record of the applicant must be satisfactory
- Examination ratings of the applicant (including all its subsidiaries) must be at least satisfactory prior to applying
- The applicant must have sufficient financial resources to complete the transaction and the integration of firms
- No significant examination criticisms



# Financial, **Managerial** and Supervisory Factors

Managerial factor

- Focus is on the applicant's management and on the proposed management for the combined organization, though expectation is that the applicant will fix any managerial weaknesses at the target firm
- Management must be satisfactory, capable and have a satisfactory plan for integrating the companies and operating the combined organization, including a management succession plan
  - New managers must be competent and have the relevant level of experience commensurate with the size, activities and complexity of the managerial needs of the combined organization.
  - The Agencies will likely request biographical and personal information about new, and perhaps existing senior management, and conduct a background check on senior management.
- Principal shareholders (that is, any shareholder that owns or controls 10% or more of the shares of the applicant and/or the resulting organization) must meet standards for competence and integrity, and likely will be subject to a background check.
- Problems at the Applicant. While there was a time when the Federal agencies would allow financial and managerial problems at the applicant to be fixed through, or at the time of, the transaction, those times have largely passed. Applicants are expected to have at least satisfactory management prior to filing for approval of an acquisition proposal, and to have satisfactory management for the combined organization ready before seeking approval for the acquisition.

# Financial, Managerial and **Supervisory** Factors

Access to Information

- Domestic Applicants: Must provide all information requested by the reviewing Agency
- Foreign Applicants: Must provide all information requested by the reviewing Agency **plus** provide assurances of access to all information regarding the FBO requested by the Agencies in the future. The Banking Agencies understand access to customer information may be limited; however, the Agencies must have access to sufficient information to monitor compliance by the FBO with US law, including the Bank Secrecy Act and various US sanctions. Access can be provided on foreign territory, but must be useable in the US.

Money Laundering and Bank Secrecy Act (BSA) compliance

- Compliance is essential; in general, poor BSA ratings in an examination or an open BSA enforcement order will preclude approval of a merger/acquisition proposal.
- Critical to address BSA compliance at all times and especially in advance of a merger/acquisition proposal.
  - Confirmation of compliance may precede public acknowledgment by the Agency; see BB&T Corp. release from BSA enforcement action after filing application to acquire SunTrust Corp. at https://www.federalreserve.gov/newsevents/pressreleases/enforcement20190418a.htm

Consolidated Home Country Supervision

- In the case of an FBO, the Federal Reserve must find that the FBO is subject to consolidated supervision in its home country in a manner equivalent to supervision by authorities in the United States.
  - This is a long, fact-intensive process that requires detailed legal analysis and extensive consultation with the supervisors in the home country of the FBO.



# Competitive Factor: Overview

Sherman and Clayton Act standards of review: The Banking Agencies are prohibited from approving a proposal that would:

- Result in a monopoly or further an attempt to monopolize **the business of banking** *in any part of the United States*, **or**
- Substantially lessen competition *in any part of the United States* unless the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

What is "the business of banking?" What is "any part of the United States"?

- The Supreme Court determined in United States vs Philadelphia National Bank, 374 US 321 (1963) that the "business of banking" for purposes of analyzing competitive effects under the US banking laws is "the cluster of banking products and services offered by commercial banks", and includes a combination of deposit-taking, lending and other related banking services.
- The Court also determined that banking markets are geographically local in scope.

The historical definitions used in analyzing bank mergers/acquisitions make competitive analysis in bank merger/acquisition cases both straightforward and transparent, while also greatly frustrating the banking bar in unusual cases.

# Competitive Factor:
# **Market Share analysis**

Market concentration and Market Share:

- The Banking agencies apply DOJ Guidelines using FDIC Summary of Deposit data to determine market share (available at www5.fdic.gov/sod/sodMarketBank.asp?barItem=2);
- Compute the HHI for each bank in the relevant market;
- Any thrift institution may be included at a 50% weighting of deposits; thrift deposits may be weighted at 100% if there is evidence that the thrift is engaged in a significant amount of small business lending.
- A credit union may be included with a 50% weighting of deposits, but only if the credit union has broad membership availability and branch offices that are readily accessible to the broad membership.

A useful tool for computing the competitive effects of a bank merger in any given market can be found at cassidi.stlouisfed.org



# Competitive Factor:
# **Defining Markets and Measuring Market Share**

Banking Markets Defined: Local banking markets are defined by the appropriate regulator and typically comprise an MSA, or one or more contiguous counties; contact the supervisor for the appropriate market definition

- Market definition may be changed if commuting data, local development data and/or other data show that local consumers travel farther (or less far) since market previously defined.

Market Share Measurements: DOJ Guidelines for Bank Merger Competitive Review rely on computation of the Herfindahl-Hirschman Index (HHI). www.justice.gov/opa/pr/2010/August/10-at-938.html.

- Typically, a bank merger/acquisition will not be challenged if:
  - The resulting market share for the acquiring banking firm is less than 35%, **AND EITHER**,
  - The resulting HHI in each affected market is less than 1800 (regardless of how much the HHI might change) **or**
  - The change in the HHI resulting from the proposal in each affected market is less than 200 points (regardless of the resulting HHI).
- The Banking agencies follow the DOJ Guidelines: See, e.g., https://www.federalreserve.gov/bankinforeg/competitive-effects-mergers-acquisitions-faqs.htm

# How to compute Market Share

| | Deposits (Millions) | Market Share | HHI | HHI after Merger |
|---|---|---|---|---|
| Dacotah Bank | $130 | 25.10% | 630 | 630 |
| **Plains Bank** | $88 | 16.99% | 289 | |
| Great Western Bank | $68 | 13.13% | 172 | 172 |
| Wells Fargo Bank | $65 | 12.55% | 157 | 157 |
| **Campbell Bank** | $60 | 11.58% | 134 | |
| Bank West | $59 | 11.39% | 130 | 130 |
| Western Dakota Bank | $27 | 5.21% | 27 | 27 |
| First National Bank | $21 | 4.05% | 16 | 16 |
| **Total for Market** | $518 | | **1556** | |
| | | | | |
| Combined Plains + Campbell | $148 | 28.57% | | 816 |
| **HHI after Merger** | | | | **1948** |
| **Δ HHI after Merger** | | | 1948-1556= | **392** |

15

# Market Share with a Thrift competitor

| | Deposits (Millions) | Market Share | Adjusted HHI | HHI after Merger |
|---|---|---|---|---|
| Dacotah Bank | $130 | 23.94% (25.10) | 573 (630) | 573 |
| **Plains Bank** | $88 | 16.21% (16.99) | 263 (289) | |
| Great Western Bank | $68 | 12.52% (13.13) | 157 (172) | 157 |
| Wells Fargo Bank | $65 | 11.97% (12.55) | 143 (157) | 143 |
| **Campbell Bank** | $60 | 11.05% (11.58) | 122 (134) | |
| Bank West | $59 | 10.87% (11.39) | 118 (130) | 118 |
| Western Dakota Bank | $27 | 4.97% (5.21) | 25 (27) | 25 |
| First National Bank | $21 | 3.87% (4.05) | 15 (16) | 15 |
| **Badlands Savings Bank** | **$50** | | | |
| **Badlands Savings (adjusted)** | **$25** | 4.60% | 21 | 21 |
| **Total Adjusted Market** | $543 (518) | | **1437** (1556) | |
| Combined Plains + Campbell | $148 | 27.26% (28.57) | | 743 (816) |
| **Market HHI after Merger** | | | | **1795** (1948) |
| **Δ HHI after Merger** | | | 1795-1437= | **358** (392) |

16

# Competitive Factor: **Missing the Mark**

Mitigating Factors: If a proposal does not meet the 1800/200 thresholds, it may still be approvable if there are mitigating factors, such as,

- A large number of remaining competitors,
- Recent entry by competitors into the market,
- Peculiar market structure.
- The number and strength of mitigating factors needed will depend on the size of the increase in market concentration and the resulting level of concentration. See NationsBank Corporation, 84 Federal Reserve Bulletin 129 (1998).

Divestiture of some parts of either the target bank or the applying bank is a cure for anti-competitive effects in individual markets. See Keycorp to acquire First Niagara (2016) https://www.federalreserve.gov/newsevents/pressreleases/files/orders20160712a1.pdf

The Department of Justice also reviews bank mergers/acquisitions, applying the same type of analysis as the Banking Agencies, plus a review of small business lending. The Banking Agencies must notify the DOJ of every bank merger/acquisition proposal. 12 USC 1849(b); 12 USC 1828(c).

17

# Deposit and Liability caps

**Nationwide Deposit Cap** on transactions involving the **Interstate acquisition/merger of an IDI**

- A Banking Agency may not approve an application if the applicant (including all its IDIs) controls, or upon consummation of the proposal, would control more than 10% of the total amount of deposits of IDIs in the United States. See 12 USC 1842(d)(1)(A); 12USC 1843(i)(8); 12 USC 1828(c)(13); 12 USC 1831u.
- The Federal Reserve will accept divestiture and reductions of deposits if the divestiture is not designed to be temporary. See Bank of America Corporation to acquire Fleet, 90 Federal Reserve Bulletin 217 (2004).

**State Deposit Cap** on transactions involving **interstate acquisitions of an IDI (e.g., acquisition of a bank by a BHC or thrift by an SLHC)**

- A Banking Agency may not approve an application if—
  - Immediately before the proposed acquisition, the applicant (including any of its IDIs) controls an IDI or a branch of an IDI in any state in which the target firm operates an IDI or a branch of an IDI, and
  - Upon consummation of the acquisition, the applicant (including all its IDIs and the target firm and its IDIs) would control 30% or more of the total amount of deposits of IDIs in that State, or such other cap as established by the host State, unless the State permits a higher percentage or otherwise approves the proposal. 12 USC 1842(d); 12 USC 1831u

18

# Deposit and Liability caps (cont.)

**Liability Cap** on **all acquisitions** (i.e., acquisitions of either an IDI or a nonbank)

- A financial firm may not acquire **any other company** if, following the acquisition, the firm would control more than 10% of the total liabilities of all financial firms operating in the US. 12USC 1852.
- Financial firms means an IDI, any company that controls an IDI, and any financial firm designated by the FSOC.
- Liabilities means the total assets of the firm minus total regulatory capital held by the firm.

**Exceptions to the Deposit and Liability Caps**

- **Failing IDIs**. The Appropriate Federal Banking Agency (AFBA) may—**without regard to the Nationwide or State Deposit Cap or the Nationwide Liability Cap**—approve any transaction to acquire an IDI of any size if the IDI is in default, in danger of default or is acquired in a transaction with FDIC assistance. See 12 USC 1842(d)(5); 12USC 1843(i)(8)(B); 12 USC 1828(c)(13)(B); 12 USC 1831u(e); 12 USC 1852(c).
- **De Minimis acquisitions**. The Federal Reserve may approve an acquisition of either an IDI or a nonbank company by a financial firm—**without regard to the Nationwide Liability Cap only**—if the acquisition is de minimis in size. 12 USC 1852(c).

19

# Financial Stability

The Federal Reserve must consider the risks of a transaction to the stability of the US banking or financial system.

- The Federal Reserve interprets this factor to require an assessment of whether the failure of the resulting firm, or disruption in the ability of the resulting firm to conduct its regular business, would likely impair financial intermediation or financial market functioning to a degree sufficient to inflict material damage on the broader economy.
- The Federal Reserve considers a variety of metrics, including the size of the resulting firm, the availability of substitutes for any critical services or products provided by the resulting firm, the interconnectedness of the resulting firm with the rest of the financial system, the complexity of the firm, the cross-border activities of the resulting firm and any special difficulties that might exist for resolving the resulting firm
- De minimis transactions: The Federal Reserve generally will permit (under delegated action) an acquisition by a firm of any size of a company with less than $2 billion in total assets; an acquisition where the resulting firm will have less than $25 billion in total assets, and corporate reorganizations.

20

# Financial Stability Factor

Over time, the Federal Reserve has focused its concerns about the financial stability factor on transactions involving the largest financial firms.

- See Capital One Financial Corporation, FRB Order 2012-2 (February 14, 2012).
  - The 24th largest depository organization in US by assets ($200 billion), but 8th largest by deposits ($127 billion)—1.4 percent of all US deposits was approved to acquire ING, fsb, which held $92 billion in assets and $82 billion in deposits and was the 17th largest depository organization by deposits. On consummation, the resulting firm became the fifth largest depository organization in US with $210 billion in total deposits, representing 2.3% of all US deposits; but only the 20th largest firm by assets with $292 in total assets. https://www.federalreserve.gov/newsevents/pressreleases/files/order20120214.pdf
- See KeyCorp, FRB Order 2016-12 (July 12, 2016), permitting the 32nd largest depository organization in the US with $98.6 billion in total assets to acquire First Niagra Financial Group with $40.1 billion in total assets.



# Convenience and Needs factor

**In General**. In every case involving the acquisition of an IDI, the Banking Agencies must consider the convenience and needs of the community to be served by the IDIs involved in the proposal, including each IDI controlled by the Applicant *and* each IDI to be acquired.

What is involved in evaluating the convenience and needs factor?

- The Federal Banking Agencies consider the past performance of the IDIs in helping to meet the credit needs of their communities and their performance under the Fair Lending laws. Pledges about future improvements in performance are NOT generally accorded significant weight (with one exception noted below).
- CRA ratings. The CRA ratings for each IDI of the Applicant must be at least Satisfactory overall prior to filing the application.
  - If the CRA ratings at a target IDI shows weaknesses, the Applicant must have a credible plan to improve those ratings.
  - If the CRA examination is more than 2 years old, the reviewing Agency may consider information regarding the IDI's CRA activities since the last CRA examination.

# More about Convenience and Needs

- The Plan going forward. The Applicant must have a plan to help meet the credit needs of the community it is entering though the merger/acquisition.
  - The Applicant may rely on the performance and programs of the target IDI if those are at least satisfactory, though larger firms are typically expected to do more than the target is already doing when entering a new community.
  - BHCs often find it helpful to establish agreements with community groups on an ongoing basis to help identify opportunities for serving the local community, including assistance in identifying credit-worthy borrowers and good banking opportunities. However, the Federal Reserve does not require or enforce agreements between BHCs and community groups.
- Fair lending performance must be at least satisfactory; focus is on lending to borrowers across income ranges and racial backgrounds.
  - HMDA is a convenient (but not the sole) measure of Fair Lending compliance and CRA performance; the Banking Agencies recognize that HMDA data are incomplete and inconclusive for demonstrating fair lending violations.
  - Supplemental data is often helpful in responding to fair lending allegations or concerns.
  - If an IDI has been charged by a Banking Agency with Fair lending law violations, the Agency is likely to require substantial evidence that the firm has corrected the violation before proceeding with any merger or acquisition. This typically requires substantial time and a supplemental examination by the relevant agency confirming that the violations have been corrected.



# Still more about Convenience and Needs

- Branches. Existing branch locations often are reviewed to ensure no redlining; however, the Banking Agencies typically do not require that the applicant identify prior to consummation of the proposal the specific branches that will be opened or closed following consummation (there is a separate process for branch closings that requires public notice and meetings)

- Public Comment. All applications/notices for approval to acquire an IDI require public notice and an opportunity for public comment
  - The Banking Agencies regard public comment as a valuable method for learning about the credit needs of the affected communities and gaining insights into the community's view about the adequacy of an applicant's efforts to help meet those credit needs.
  - It is important for the Applicant to address all significant concerns raised by public comments.
  - Public comments generally require consideration by the Washington office of the relevant agency and preclude action under streamlined approval procedures; however, unfavorable public comments do not preclude approval of a proposed acquisition.

# Public Meetings

In cases involving significant public interest, the reviewing agency may conduct one of more public meetings.
- A public meeting is usually called only in cases where the transaction is significant for at least one community and there is significant public interest as exhibited by numerous public comments and requests for meetings.
- Public meetings allow the reviewing agencies to hear from the community about the applicant's (and the target firm's) service to the community (including CRA performance), the banking needs of the community, and the potential effects of the proposal on competition and on the convenience and needs factor.

Public meetings are informal.
- Not a formal hearing; no cross-examination
- Only Agency representatives may ask questions and request information
- The Agency will arrange a venue, set an agenda, and create a transcript available to the public
- All participants are encouraged to submit their comments in writing; written comments are made available to the public, though confidential information may be redacted
- Public meetings are typically not about safety and soundness or managerial or money laundering or other factors
- Various laws provide for a separate process for reviewing branch closings and opening

Public meetings are not a game of numbers; they are meant to provide an efficient way to collect information in cases involving broad public interest.

See Federal Reserve Press Release announcing the BB&T/SunTrust public meeting at https://www.federalreserve.gov/newsevents/pressreleases/files/other20190314a1.pdf



# How long will the review process take?

The BHC Act requires the Federal Reserve to act on every application within 91 days;
- However, the 91 day period does not start until the record on the application is complete, and restarts every time new information is received by the Federal Reserve.
- There is also a 1-year limit, but Applicants with issues that require more than 1 year to resolve typically agree to waive that limit.

Federal Reserve Statistics for M&A cases for 2020:
- The Federal Reserve reviewed 144 M&A applications out of a total of 824 total applications in 2020 (all types combined);
- 144 M&A cases were approved, 14 withdrawn, 0 denied;
- 69 days avg processing time; 45 days median processing time
  - Cases without adverse public comment took 64 days to review, on average (140 cases)
  - Cases with adverse public comment took 232 days on average to review (4 cases)
- See https://www.federalreserve.gov/publications/semiannual-report-on-banking-applications-activity.htm

Contract deadlines will not rush agency process

Length of the review process is ultimately determined by the number and complexity of issues

# Tips:
# Before filing an application or notice

Contact regulators in advance of filing any application or notice for regulatory approval.

- Meeting with the reviewing agency in advance of filing a request for approval is useful for identifying issues and the types of information that could address those issues
- The Federal Reserve has a pre-filing process that will help identify—though not resolve—issues that may affect processing of an application or notice
- Meeting can help identify whether examination issues are considered disqualifying or may require a special examination in advance of any approval
- Do not expect an answer at any pre-meeting or in any pre-filing process on whether the merger/acquisition will be approved

Do not file any application or notice if all IDIs do not have at least a Satisfactory CRA rating

The Applicant should have adequate regulatory capital and liquidity in advance of filing any application or notice

Perfection is not required, but potential applicants should have demonstrated dedication to resolving issues, no significant outstanding enforcement matters, and no significant managerial issues outstanding at time of application

The Federal Reserve will not allow an application to linger while significant problems are addressed



# Tips:
# After filing an application or notice

Supervisory issues:

- Once an application or notice is filed, be responsive to every request for information from the reviewing agency (don't argue about whether the information is relevant). If the reviewing agency asks for something you think they already provided, point out exactly where it is or give it again. The reviewing agency must build the appropriate record to support its decision.
- Be quick as well as complete in responding to information requests. Agency questions often come in bunches and information can be provided in stages, rather than all at once. Providing the reviewing agency with access to knowledgeable experts at the Applicant (rather than intermediaries) can speed up the process.

Branches: Branch closings need not be finalized prior to the review process, even if challenged by public commenters. There is a separate public process required for closing branches in low- and moderate-income areas

- However, the Applicant's branch closing policy will be a focus of review. That policy must be open and fair and not result in redlining.

# Tips:
# Public comments

The public is important to the process:
- The process provides an opportunity for the Applicant to connect with customers and potential customers and community groups that can help generate business.

Public comments:
- Respond to all issues raised by commenters. It's OK to dispute allegations from commenters, but be responsive as well: e.g., don't simply claim applicant is addressing community needs, provide supporting data.
- The CRA record of the applicant is more important than the CRA record of the target UNLESS the applicant is expecting to replace its programs and management with the programs and management of the target. Make a general decision whether some or all of the target's programs will be kept before filing.

Public record and Ex parte communications:
- Application materials, public comments and responses to agency information requests and to public comments will be made publicly available. An Applicant may request (and be granted) confidential treatment of information that is truly confidential (such as financial information and examination information).
- Do not expect the reviewing agency to discuss a matter with the Applicant, on an ex parte basis, that has been raised by a commenter. For example, the reviewing agency will not discuss a fair lending allegation made by a commenter without including the commenter, and will provide any response made by the Applicant to the commenter.



# Acquisitions of Nonbanking companies

Prior Notice for non-FHCs. A BHC that is not an FHC must provide notice to the Federal Reserve before acquiring any non-IDI or starting de novo any nonbanking activity. (See 12 USC 1843(j)).

Limited review for FHCs. An FHC generally is not required to provide notice to or obtain approval from the Federal Reserve prior to engaging in any financial activity or acquiring a company engaged in a financial activity UNLESS:
- The company to be acquired has total assets in excess of $10 billion, (12 USC 1843(k)(6)(B)(ii), or
- The activities of the FHC are limited under section 4(m) of the BHC act because the FHC has fallen out of compliance with the FHC requirements (12 USC 1843(m)).

Standard of Review. Where prior notice or approval is required for a covered nonbanking transaction, the Federal Reserve must consider whether performance of the activity by the BHC can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the US banking or financial system. (12 USC 1843(j)).

Department of Justice review: Acquisitions of nonbanking companies may also be subject to review by the Department of Justice under the Hart-Scott-Rodino Act. Consult with DOJ. (See 15 USC 18a(c)(8) and 12 USC 1843(k)(6)(B)(iii)).

# Forms

All Federal Reserve application forms:
https://www.federalreserve.gov/supervisionreg/afi/afiresources.htm

FDIC bank merger application form:
https://www.fdic.gov/regulations/applications/resources/mergers.html

OCC bank merger application form: https://www.occ.gov/tools-forms/index-tools-forms.html#bankers

BARACK FERRAZZANO
Financial Institutions Group

# The Role of the Banking Sector in Preventing Money Laundering and Terrorism Financing (BSA-AML)

## Banking Law Fundamentals

**June 26, 2024**

**Presented by:**
**John Geiringer**
**john.geiringer@bfkn.com**

**Chicago, Illinois**
**(312) 984-3217**

200 West Madison Street, Suite 3900 | Chicago, Illinois 60606 | T. 312.984.3100 | bfkn.com

BARACK FERRAZZANO
Financial Institutions Group

# BACKGROUND

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP 

## Money Laundering

- Criminal practice of processing ill-gotten gains ("dirty" money) through series of transactions
- Funds are "cleaned" so that they appear as proceeds from legal activities

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Money Laundering Stages

- Placement: introducing funds from / for illegal activity into financial system
- Layering: disguising and distancing illicit funds from illegal source through series of financial transactions
- Integration: returning laundered illicit funds to expendability status

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## Terrorist Financing Attributes

- More challenging to detect and identify
- Often different characteristics than money laundering
- May involve low dollar value transactions and appearance of innocence
- Could involve variety of sources

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## Economic Sanctions

Prohibited trade or financial transactions based on U.S. foreign policy and national security goals against countries, entities, and individuals that threaten the U.S.

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

## Relevant Statutes (Anti-Money Laundering)

- Financial Recordkeeping and Currency and Foreign Transactions Reporting Act of 1970 (Bank Secrecy Act)
- USA PATRIOT Act of 2001
- AMLA (2020)
- Others

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Relevant Statutes (Economic Sanctions)

- Trading with the Enemy Act of 1917
- International Emergency Economic Powers Act of 1977
- Antiterrorism and Effective Death Penalty Act of 1996
- Countering America's Adversaries Through Sanctions Act of 2017 (CAATSA)
- Others

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## Additional Authority

- Executive Orders
- United Nations
- Financial Action Task Force (FATF)
- Egmont Group of FIUs
- The Wolfsberg Group
- Others

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## Relevant Agencies

- Treasury Department
  Office of Terrorism and Financial Intelligence
  - FinCEN
  - OFAC
- Prudential banking regulators
  (FDIC, OCC, FRB, states - FFIEC)
- Department of Justice
- Others

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

## U.S. Department of Treasury Guidance

- 2024 National Strategy for Combatting Terrorist and Other Illicit Financing
- 2024 National Money Laundering Risk Assessment
- 2024 National Terrorist Financing Risk Assessment
- 2024 National Proliferation Financing Risk Assessment

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## SUSPICIOUS ACTIVITY REPORTS

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

BARACK FERRAZZANO
Financial Institutions Group

## Reportable Events

- Transactions aggregating ≥ $5,000 involving potential money laundering or BSA violations
- Violations aggregating ≥ $5,000 if suspect identified
- Violations aggregating ≥ $25,000 if no suspect identified
- Insider abuse in any amount
- Other suspicious activities

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


BARACK FERRAZZANO
Financial Institutions Group

## Completing SAR Form

Include information about:

- Suspect(s)
- Suspicious activity categories
- Dollar amount involved
- Any loss to Bank
- Information about Bank
- Narrative description

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

BARACK FERRAZZANO
Financial Institutions Group

## General Filing Timeframes

- 30 days after date of initial detection
- If no suspect identified, may delay filing for additional 30 days
- If suspicious activity continues to occur, file update every 90 days

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


BARACK FERRAZZANO
Financial Institutions Group

## Immediate Notice Required

- For violations requiring immediate attention, should immediately notify law enforcement / regulators and file SAR
- Contact FinCEN Financial Institutions Hotline (1-866-556-3974) if customer potentially linked to terrorist activity

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## SAR Confidentiality

- Disclosure of SAR prohibited
- Prohibited from notifying person described in filing

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## Notice of SAR Filings

- Prompt notice by management to Board
  - may include summaries
- If SAR subject is senior officer or director, use alternative procedures
- Maintain relevant documentation

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

# CURRENCY TRANSACTION REPORTS

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Generally

- Deposit, withdrawal, exchange of currency or other payment or transfer, by, through, or to a financial institution involving a transaction in currency > $10,000
- Filed within 15 days

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

## Structuring and Aggregation

- Conducting transactions to evade CTR filing requirements
- Multiple transactions completed by (or on behalf of) any person resulting in cash in/out > $10,000 during short period treated as single transaction

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## CTR Reporting Exemptions

- Mandatory exemptions
- Discretionary exemptions
- Ineligible for exemptions

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## Monetary Instruments Purchases

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## Monetary Instruments Purchases

- Issuing or selling monetary instruments purchased with cash in amounts of $3,000 - $10,000
- Includes bank checks, bank drafts, cashier's checks, money orders and traveler's checks
- Obtain and record identifying information on purchaser and specific transaction information

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

# OFFICE OF FOREIGN ASSETS CONTROL

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Sanctions Programs

- Comprehensive
- Limited
- List-based (regimes and activities)

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

BARACK FERRAZZANO
Financial Institutions Group

## Specially Designated Nationals (SDN) List

- Prohibited parties list
- Over 6,000 individuals and entities
- Constantly updated

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


BARACK FERRAZZANO
Financial Institutions Group

## Required Actions

- Blocking or rejecting
- Filing due within 10 days

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## Framework for OFAC Compliance Commitments

- Management commitment
- Risk assessment
- Internal controls
- Testing and auditing
- Training

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## OFAC Issues

- Transliterations
- Fuzzy logic
- 50% rule

Evaluate software limitations

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

# AML PROGRAM REQUIREMENTS

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Pillars

- System of internal controls
- Independent testing
- BSA Officer responsible for compliance
- Training for appropriate personnel

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## Customer Identification Program

- Required information
- Customer verification
- Comparison with government lists
- Customer notice
- Record retention

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## FinCEN Advisory (August 2014)

Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance

- Engaged leadership
- Compliance not compromised by revenue interests
- Information shared throughout the bank
- Leadership provide adequate human and technological resources
- Effective program tested by independent and competent party
- Leadership and staff understand how BSA reports are used

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

# Customer Due Diligence Rule

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## Purpose of CDD Rule

- Explicit CDD requirements
- Identify / verify identity of beneficial owners (not nominees or straw men) of legal entity customers, subject to exclusions / exemptions

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## CDD Rule Amendments

- Conduct ongoing risk-based CDD (EDD)
- Understand nature / purpose of customer relationships
- Conduct ongoing monitoring to identify / report suspicious transactions and maintain / update customer information on risk basis

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## Beneficial Ownership Requirements

- Establish/maintain written procedures reasonably designed to identify/verify beneficial owners of legal entity customers
- Ownership prong (25%) and control prong
- New accounts
- CTA shifting burden to companies

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

# GOVERNMENTAL INQUIRIES

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Types

- Informal
- Collaborative
- Subpoenas
- Section 314(a), (b) requests
- National Security Letters
- Geographic Targeting Orders

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

# ENFORCEMENT ACTIONS

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Types

- Informal / formal
- Corrective / punitive
- Entities / individuals

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

## Interagency BSA/AML Enforcement

Formal Enforcement Actions

Agency could issue C&D order for BSA Compliance Program noncompliance based on:

- Failure to establish and maintain reasonably designed Program
  - Written Program
  - Implementation of Program
  - Defects in one or more Program elements
- Failure to correct previous Program problems

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## Interagency BSA/AML Enforcement (cont.)

Other Enforcement Actions

Depending on:

- Severity of noncompliance, weaknesses, or deficiencies
- Capability and cooperation of bank's management
- Agency's confidence that bank will take appropriate and timely corrective action

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Barack Ferrazzano
Financial Institutions Group

## FinCEN Considerations

- Nature and seriousness of violations
- Knowledge and intent
- Remedial measures
- Financial condition of institution / individual
- Payments and penalties related to other enforcement actions
- Other factors

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## OFAC Considerations

- Willful or reckless violation of law
- Awareness of conduct at issue
- Harm to sanctions program objectives
- Individual characteristics
  - Commercial sophistication
  - Size of operations and financial condition
  - Volume of transactions
  - Sanctions history

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

## OFAC Considerations (cont.)

- Compliance program
- Remedial response
- Cooperation with OFAC
- Timing in relation to sanctions imposition
- Other enforcement action
- Future compliance/deterrence effect
- Other relevant factors on case-by-case basis

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP




## FINAL THOUGHTS

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

BARACK FERRAZZANO
Financial Institutions Group

## The Anti-Money Laundering Act of 2020

- AML priorities
- Antiquities dealers coverage
- Beneficial ownership to FinCEN
- Domesticating BSA compliance
- FinCEN no-action letter process
- Expended government foreign subpoena power
- Foreign affiliate SAR sharing

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


BARACK FERRAZZANO
Financial Institutions Group

## The Anti-Money Laundering Act of 2020 (cont.)

- “Keep open” safe harbor
- Penalty enhancements
- Public-private partnerships
- Streamlined SAR and CTR reporting
- Virtual currency regulation
- Whistleblower expansion

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

## Hotspots

- Domestic violent extremism
- Derisking
- Cybersecurity
- Cannabis
- Virtual currencies
- Others

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP


Barack Ferrazzano
Financial Institutions Group

## QUESTIONS?

*This information was distributed by the law firm of Barack Ferrazzano Kirschbaum & Nagelberg LLP, 200 West Madison Street, Suite 3900, Chicago, Illinois 60606, T. 312.984.3100, as a general source of information and does not constitute an opinion or legal advice and does not create an attorney-client relationship with readers. This information may constitute attorney advertising material in some jurisdictions. Any tax advice contained in this informational material was not intended to be used, and cannot be used, by you (or any other taxpayer) to avoid penalties under the Internal Revenue Code of 1986, as amended. We are sending you this e-mail primarily for your information, to meet your needs and further our valued relationship. For more information, please review our privacy notice: bfkn.com/privacy*

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

BARACK FERRAZZANO
Financial Institutions Group

**John M. Geiringer**
**(312) 984-3217**
**john.geiringer@bfkn.com**

As the regulatory section leader of the firm's Financial Institutions Group, John concentrates his practice on regulatory, governance and investigative matters involving financial institutions. He is a frequent speaker and author in the financial institutions area on issues surrounding banking regulations, examinations and enforcement actions.

John teaches banking law and regulation at Chicago-Kent College of Law's Graduate Program in Financial Services Law and serves on the board of advisors of its Institute for Compliance. He also teaches national security law and is the founding Co-Director of its Center for National Security and Human Rights Law.

Prior to joining the Firm in 1999, John was both a bank regulator and a compliance consultant. John also obtained practical experience with respect to bank operations and compliance issues as a regulatory consultant with a regional accounting firm, performing compliance reviews and training for a variety of financial institutions.

© 1984-2024 Barack Ferrazzano Kirschbaum & Nagelberg LLP

Banking Law Fundamentals

# Bank Failures and Orderly Resolution

**Session P:** ***See, Chapter 12, The Keys to Banking Law, 3rd Edition, Karol K. Sparks***

**Sara A. Kelsey**

© June 2024

## Why Do We Care about Bank Failures?

In the U.S. financial system, banks play a unique and central role in our financial system. Banks:

- Offer transaction accounts
- Are the backup source of liquidity for all other institutions
- Serve as the transmission belt for monetary policy

A key safeguard of our financial system is the stability provided by:

- The FDIC's deposit insurance and its resolution authority
- The Federal Reserve's role as lender of last resort

2

# How Does FDIC Deposit Insurance Work?

- Paid for by the banks through a premium -- risk-based assessments paid into the FDIC's Deposit Insurance Fund ("DIF");
- Assessment rate computed differently for Large (Greater or Equal to $10 Billion), Highly Complex and Small (Less than $10 Billion) Banks and applied to average consolidated total assets minus average tangible equity (12 CFR 327)
- Insures deposits up to $250,000 per legal capacity, per bank;
- Does NOT insure the bank or the bank's other creditors, the bank's holding company or other affiliates, or foreign deposits;
- Insured depositors are paid by the FDIC in its corporate capacity immediately upon a bank's failure;
- In the bank receivership, FDIC Corporate becomes subrogated to the rights of the depositors it has paid off. Insured U.S. deposits have priority over foreign deposits in a receivership.

3

# Why Did Congress Create the FDIC to Resolve Bank Failures?

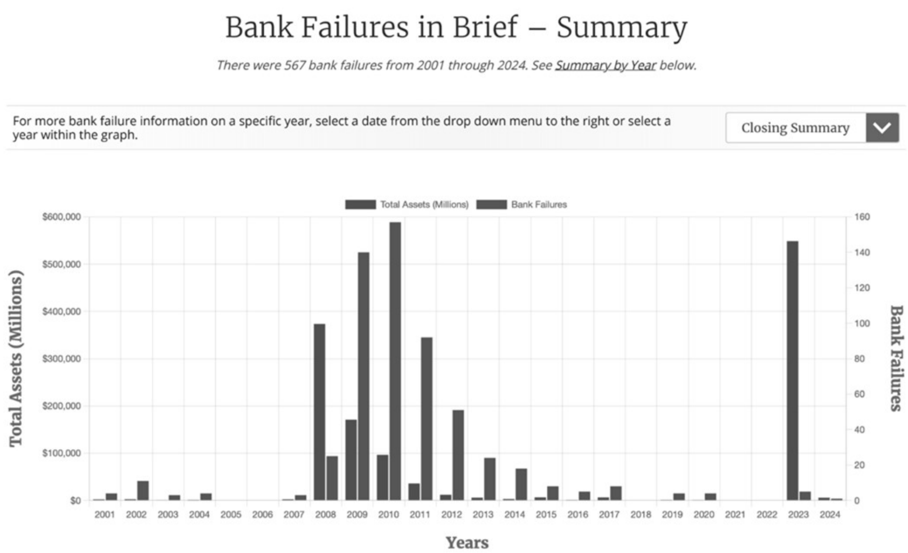
Prior to the Banking Act of 1933 legislation that created the FDIC:

- Bank and Thrifts were resolved by their chartering authorities under general corporate bankruptcy laws
- Depositors were treated like all other creditors, receiving their funds after the bank liquidation was completed
- On average, federal liquidations took 6 years, although they could take up to 21 years
- Between 1921-1933, during which more than 1,200 banks failed, depositors received an average of 58% (national banks) or 62% (state banks) at the end of a liquidation
- This led depositors to withdraw their money on even the rumor that a bank might fail, leading to runs on bank deposits, which could *cause* a bank to fail
- Congress created FDIC deposit insurance and resolution powers to stop this cycle and maintain financial stability

4

# Bank Failures 2001 – Q1 2024

https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/index.html




5

# Bank Failure & Resolution: the Process Simplified

The FDIC:

- Is Appointed as Receiver (except Open Bank Assistance)
- Determines Resolution Strategy
- Marshalls Assets
- Deals with Claims

Congress gave the FDIC additional Resolution Authority (beyond Banks) to the FDIC after the Global Financial Crisis:

- Orderly Resolution Authority

FDIC's in-depth information on the resolution process:
The FDIC's Resolution Handbook is being revised. For an understanding of FDIC's resolution process, please refer to the "Crisis and Response, An FDIC History, 2008-2013," Chapter 6. Bank Resolutions and Receiverships. https://www.fdic.gov/bank/historical/crisis/chap6.pdf

## Who Fails a Bank? Who Appoints a Receiver?

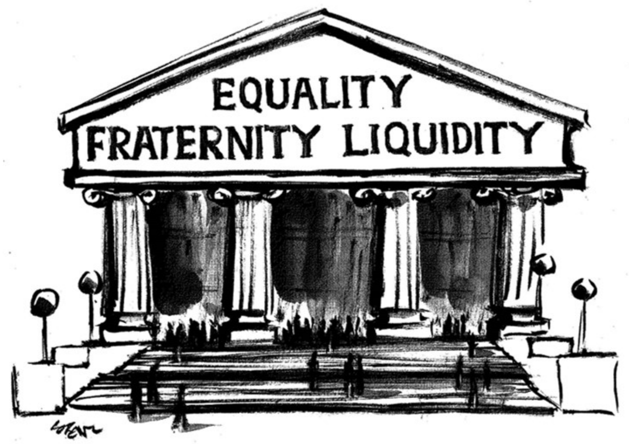
- Bank failures are announced by the FDIC in a press release, usually issued after the close of business on a Friday afternoon
- But it is the **chartering authority** that gave birth to a bank that signs the bank's death warrant, FAILS the bank and APPOINTS A RECEIVER (almost always the FDIC):
    - **OCC** for National Banks and Federal Thrifts
    - **State Supervisor** for State Chartered Banks and Thrifts

    **But never say never:**
- It is possible for the FDIC to exercise its backup authority to FAIL a bank. FDIC Self-Appointment Authority was added by the FDIC Improvement Act (FDICIA) in 1991 (See 12 USC 1821 (c)(10))
    - FDIC must consult with appropriate State or Federal banking agency
    - May self appoint if necessary to reduce loss or risk of loss to insurance fund, <u>and</u>
    - There are grounds for appointment
- It is possible that the FDIC will NOT be appointed receiver or will REFUSE to act as one

7

## Appointments May Be Challenged

- Scope of review: arbitrary or capricious standard
- OTS appointment upheld, *Franklin Savings Association v. Director*, *OTS*, 943 F.2d 1127 (10th Cir. 1991)
- Ex Parte seizure upheld, *Fahey v. Mallone*, 332 U.S. 245, 253-54




9

# Bank Resolutions:
## What are the grounds for appointment?

12 USC Section 1821(c)(5) (A)-(M)

- Assets insufficient for obligations – assets are less than obligations to creditors and others
- Substantial dissipation of assets or earnings – due to violation of law or regulation or unsafe and unsound practice
- Unsafe or unsound condition
- Cease or Desist Order – willful violation of final order
- Concealment – of bank's books & records; refusal to submit for inspection to examiner or bank's regulator(s)
- Inability to meet obligations, including depositors' demands (illiquidity) in the normal course of business
- Violation of law or unsafe or unsound practice or condition likely to cause insolvency or substantial dissipation of assets or earnings; weaken the bank's condition; or otherwise seriously prejudice the interests of the bank's depositors or the DIF

10

# Grounds for Appointment as Receiver, cont.

12 USC Section 1821(c)(5) (A)-(M)

- Money laundering offense (18 USC 1956 or 1957)
- Cessation of insured status
- Consent to appointment
- Prompt Corrective Action-related (12 USC 1831o(b):
  - Losses incurred or likely to be incurred that will deplete all or substantially all bank capital and there is no reasonable prospect for the bank to become Adequately Capitalized without Federal assistance
  - Undercapitalized and has no reasonable prospect of becoming Adequately Capitalized; fails to become Adequately Capitalized when required to do so; fails to submit a Capital Restoration Plan acceptable to that agency within prescribed time, or materially fails to implement a Capital Restoration Plan submitted and accepted
  - Bank is Critically Undercapitalized or otherwise has substantially insufficient capital

# Prompt Corrective Action

- "Each . . . Federal banking agency and the Corporation (acting in the Corporation's capacity as insurer of depository institutions under this chapter) shall carry out the purpose of this section by taking prompt corrective action to resolve the problems of insured depository institutions."

*See* 12 USC 1831o

# Prompt Corrective Action

12 U.S.C. Section 1831

- Purpose: to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund
- Appropriate Federal banking agency and the FDIC (acting in the FDIC's corporate capacity as the insurer of depository institutions) shall carry out the purpose of this section by taking prompt corrective action to resolve the problems of insured depository institutions
- Capital requirements are prescribed by each appropriate Federal banking agency by regulation and must include a leverage limit and a risk-based capital requirement

13

# Prompt Corrective Action

Regulatory Capital Categories

https://www.fdic.gov/regulations/laws/rules/1000-4000.html

**1000 - Federal Deposit Insurance Act**

**SEC. 38. PROMPT CORRECTIVE ACTION.**

**(a) RESOLVING PROBLEMS TO PROTECT DEPOSIT INSURANCE FUND.**--

(1) PURPOSE.--The purpose of this section is to resolve the problems of insured depository institutions at the least possible long-term loss to the Deposit Insurance Fund.

(2) PROMPT CORRECTIVE ACTION REQUIRED.--Each appropriate Federal banking agency and the Corporation (acting in the Corporation's capacity as the insurer of depository institutions under this Act) shall carry out the purpose of this section by taking prompt corrective action to resolve the problems of insured depository institutions.

*[Codified to 12 U.S.C. 1831o(a)]*

*[Source: Section 2[38(a)] of the Act of September 21, 1950 (Pub. L. No. 797; 64 Stat. 882), effective September 21, 1950, as added by section 131(a) of title I of the Act of December 19, 1991 (Pub. L. No. 102--242; 105 Stat. 2253), effective December 19, 1992; section 8(a)(36) and (37) of the Act of February 15, 2006 (Pub. L. No. 109--173; 119 Stat. 3615), effective date shall take effect on the day of the merger of the Bank Insurance Fund and the Savings Association Insurance Fund pursuant to the Federal Deposit Insurance Reform Act of 2005]*

**(b) DEFINITIONS.**--For purposes of this section:

(1) CAPITAL CATEGORIES.--

(A) WELL CAPITALIZED.--An insured depository institution is "well capitalized" if it significantly exceeds the required minimum level for each relevant capital measure.

(B) ADEQUATELY CAPITALIZED.--An insured depository institution is "adequately capitalized" if it meets the required minimum level for each relevant capital measure.

(C) UNDERCAPITALIZED.--An insured depository institution is "undercapitalized" if it fails to meet the required minimum level for any relevant capital measure.

(D) SIGNIFICANTLY UNDERCAPITALIZED.--An insured depository institution is "significantly undercapitalized" if it is significantly below the required minimum level for any relevant capital measure.

(E) CRITICALLY UNDERCAPITALIZED.--An insured depository institution is "critically undercapitalized" if it fails to meet any level specified under subsection (c)(3)(A).

# Prompt Corrective Action:
## Undercapitalized Banks

- Appropriate Federal banking agency must closely monitor undercapitalized banks
- Capital restoration plan required from undercapitalized bank within 45 days
- Federal banking agency to act on plan within 60 days of submission and must provide copy of any approved plan to the FDIC
- Undercapitalized banks are restricted as to asset growth and require prior approval for acquisitions, branching or new activities

15

# Prompt Corrective Action:
## Significantly Undercapitalized Banks and Undercapitalized Banks that fail to submit or implement capital restoration plans

- Recapitalization required
- Affiliate transactions restricted
- Restrictions on interest rates, asset growth and activities
- Removal/replacement of Board and senior management
- Prohibition on the acceptance of deposits from correspondent banks
- Prior approval required for any capital distributions made by parent bank holding company
- Divestitures of bank subsidiaries, affiliates or the bank itself required
- Any other action to carry out the purposes of prompt corrective action
- Compensation of senior executive officers restricted

16

## Prompt Corrective Action:
### Critically Undercapitalized Banks

- In addition to the above restrictions applicable to Undercapitalized and Significantly Undercapitalized banks, the Appropriate Bank Regulatory Agency must restrict the activities of a Critically Undercapitalized bank, prohibiting it from:
  - entering into any material transactions;
  - extending credit for highly leveraged transactions;
  - amending the bank's charter or bylaws;
  - making any material change to its accounting methods; engaging in any covered transactions with affiliates;
  - paying excessive compensation or bonuses; and paying interest rates higher than the prevailing rates of interest on insured deposits in the bank's normal market areas.
- A Receiver must be appointed within 90 days
- Up to two 90-day extensions may be allowed
- Critically Undercapitalized bank MUST be closed not later than 270 days

17

## FDIC as Receiver or Conservator
### 12 U.S.C. Section 1821(d)

- Powers of the FDIC as Receiver are similar to those of a Bankruptcy Trustee. Like a Trustee, the Receiver steps into the shoes of the insolvent party…
- Congress has given the FDIC "superpowers" beyond those of a Bankruptcy Trustee, which allow the FDIC to expedite the liquidation process in order to maintain confidence in the banking system and maximize the cost-effectiveness of the receivership process to preserve a strong deposit insurance fund.

18

## Bankruptcy Law Does Not Apply to Depository Institutions ("Banks" or "IDIs")

- **Bankruptcy Code Section 109: Who May Be A Debtor**

  Section 109(b)(2):

  *a "bank, savings bank, cooperative bank, savings and loan association, building and loan association, … credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act" may not be a Chapter 7 debtor.*

- Section 109(d):

  *exclusions for Chapter 7 debtors also apply in Chapter 11 cases.*

19

## Bank Holding Company Bankruptcies

- Yet Banks Are Part of Larger Organizations (Including Bank Holding Companies) Subject to Bankruptcy Law. Bank holding company bankruptcies should, in principle, operate just as other corporate bankruptcies:

  *with a few express exceptions in the Bankruptcy Code, and*

  *with some complications in the relationship between the bank holding company debtors and their bank subsidiaries.*

- We will turn to some of these exceptions and complications later in the presentation.

20

# The Purposes, Powers and Processes of Bankruptcy And Bank Resolution Are Very Different



## Comparison of FDIC Resolution/ Receivership/Conservatorship To Bankruptcy

| Insolvency Regime | FDIC Resolution/ Receivership/Conservatorship | Bankruptcy |
|---|---|---|
| Entities covered | Banks (including insured banks not within §3 of BHC Act) and thrifts | Everything except banks, thrifts, insurance companies, Fannie, Freddie and FHLBs |
| Objectives | Limit impact of failure on overall economy and financial markets; "least cost" resolution unless Systemic Risk Determination | Through liquidation or reorganization:<br>• Maximize returns to creditors<br>• Give debtor chance for "fresh start"<br>• Be fair to all creditors |
| Source of Funding | • Liquidated assets/proceeds of P&A transaction<br>• FDIC Deposit Insurance Fund; supported by assessments paid by banks and thrifts<br>• Backed by full faith and credit of the U.S. Govenrment | Liquidated or reorganized assets |
| Initiator | • Chartering authority: OCC, OTS, State Regulator<br>• FDIC back-up authority | • Company's management ("voluntary"); or<br>• Creditors (upon default) ("involuntary") |
| Control | Ex parte seizure<br>Bank or thrift charter dissolved | In Chapter 11, company generally remains in control of business<br>In Chapter 7 (and some Chapter 11 cases), a trustee is appointed<br>Corporate charter survives |
| Oversight | • Administrative<br>• Judicial review extremely limited | • Judicial oversight, review and appeal |

# Comparison of FDIC Resolution/ Receivership/Conservatorship To Bankruptcy

| Insolvency Regime | FDIC Resolution/ Receivership/Conservatorship | Bankruptcy |
|---|---|---|
| Management, Creditor and Shareholder Rights | • Removal of management<br>• Elimination of shareholder rights and powers<br>• Creditors have no say | • In Chapter 11, management generally retains control over major decisions<br>• Most often, shareholders are limited and former creditors become equity holders |
| Powers | Administrative:<br>Superpowers to provide for seamless continuation of access to deposits and continuation of banking functions, include:<br>• Contract repudiation/disaffirmation<br>• Allow/disallow claims<br>• Reorganize/merge/divest entities<br>• Sell assets<br>• May invoke limited stay of 90/45 days | Judicial:<br>• Automatic stay<br>• Contract repudiation/disaffirmation<br>• Allow/disallow claims<br>• Reorganize/merge/divest entities<br>• Sell assets<br>• Fraudulent and preferential transfers avoidable |
| QFCs | One business-day window to:<br>• assume<br>• transfer<br>• permit unwind | Immediate unwind |
| Speed | • Early intervention<br>• Immediate resolution | Robust and fair judicial process may take years, decades |




"We're still the same great company we've always been, only we've ceased to exist."

## FDIC Receivership SUPER POWERS

- Claims process
- Contract repudiation if allowing performance would be “burdensome” and “disaffirmance or repudiation… will promote the orderly administration of the institution’s affairs.”
- Stay of litigation (up to 45 days after the appointment of a conservator or 90 days after the appointment of a receiver).
- Avoidance powers
- Special defenses
- Ipso facto clauses unenforceable
- Cross guarantee liability
- Directors and officers liable for gross negligence



## More FDIC Receivership SUPER POWERS

- Power to defeat claims against FDIC’s interests in assets it has acquired in receivership. To prevail on a claim against the FDIC’s interest in an asset, claimant must show that there was a written agreement, executed contemporaneously with the institution’s acquisition of the assets, approved by the institution’s board of directors or its loan committee, and continuously reflected on the institution’s books
- Courts may not enjoin the Receiver
- QFCs – FDIC has until 5 pm the next business day to decide whether to:
  - Transfer
  - Repudiate OR
  - Allow counterparty to unwind

## Resolution Strategy Determined

- Valuation, Marketing, Soliciting and Accepting Bids (ideally 90-105 days)
- Since 1991, additional options due to "least cost" test
- Bid packages, information meeting, confidential due diligence
- Bids submitted 1-2 weeks before closing
- Resolution Strategy Determined at Appointment

## Least Costly Resolution

- Least costly resolution required
- Valued on present value basis, using realistic discount rate
- Difference from pre-FDICA (1991) more general cost test
- The determination of which method is the least costly resolution is "made as of the date on which the Corporation makes the determination to provide such assistance to the institution . . . ." *See* 12 USC 1823(c)(4)(C)
- Can pass uninsured deposits if not more costly
- Difficult valuation mechanics — especially in situations where asset value does not cover <u>all</u> deposits
- EXCEPTION FROM LEAST COSTLY RESOLUTION REQUIREMENT: SYSTEMIC RISK RESOLUTION

*See* 12 USC 1823(c)(4)

# Systemic Risk Determinations
## 12 USC 1823(c)(4)

- Supermajority (2/3) approval of FDIC Board and Board of Governors of Federal Reserve System
- Approval of Secretary in consultation with President
- Determination that use of exception would avoid or mitigate "serious adverse effects on economic conditions or financial stability"
- Examples during Global Financial Crisis: Wachovia, Citigroup, Bank of America, Temporary Liquidity Guaranty Program
- Recent examples: Silicon Valley Bank, Signature Bank
- FDIC is required to recover the loss to the DIF arising from a Systemic Risk Determination through special assessment(s) on insured depository institutions, depository institution holding companies (with the concurrence of the Secretary of the Treasury with respect to holding companies), or both, as the FDIC determines to be appropriate, and shall consider: the types of entities that benefit from the determination; economic conditions; the effects on the industry; and such other factors as the FDIC deems appropriate and relevant to the action taken or the assistance provided. 12 USC 1823 (c)(4)(G)(ii)

# Recent Bank Failures using SRD

- 3.10.23 California Department of Financial Protection and Innovation closes Silicon Valley Bank, Santa Clara, CA
- 3.10.23 FDIC appointed receiver (cost to DIF of failure estimate: $16.1 Billion)
- 3.10.23 FDIC transfers all of the deposits and substantially all of the loans to SVB Bridge Bank
- 3.12.23 NYS Financial Services Department closes Signature Bank, NY, NY
- 3.12.23 FDIC appointed receiver (cost to DIF of failure estimate: $ 2.4 Billion)
- 3.12.23 FDIC transfers all deposits to Signature Bridge Bank
- 3.12.23 SYSTEMIC RISK DETERMINATION
- 3.12.23 IMPACT OF SRD: FDIC estimates cost of $15.8 = cost of covering uninsured deposits
- 3.12.23 FDIC enters into a P&A with acquirer Flagstar Bank, NA, Hicksville, NY for certain Signature Bridge Bank deposits and loans (all depositors made whole)
- 3.26.23 FDIC enters into a P&A with acquirer First-Citizens Bank & Trust Company, Raleigh, NC for deposits and loans (all depositors made whole)

## Recent Bank Failure NOT Using SRD

- 5.1.23 California Department of Financial Protection and Innovation closes First Republic Bank, San Francisco, California
- 5.1.23 FDIC appointed receiver (cost of failure to DIF estimate, $13 Billion)
- 5.1.23 JPMorgan Chase Bank, NA, Columbus, Ohio acquires all deposits, substantially all assets, through P&A agreement with FDIC.
- IMPACT ON DIF of all three failures: $13 Billion + $2.7 [$18.5 Billion - $15.8 Billion] = $15.7 Billion

## Overview Types of Resolution Transactions:
May Be Used Alone or with Other ResolutionTransactions:

- Purchase and Assumption
- Deposit Payoff/Liquidation
- Bridge Bank
- Deposit Insurance National Bank
- Previous
  - Open Bank Assistance (theoretical only in non-systemic cases since 1991)
  - Pass Through Receivership/Conservatorship (not used since mid-2008)

# Resolution Transactions

- Purchase & Assumption Agreement
  - Insured only, or all deposits – as determined by application of "least cost" test
  - With or without Loss Share
  - Some loss – sharing is a flexible tool, eg:
    - Prior to April 2010, FDIC shared 80% of expected losses and 95% of unexpected losses
    - From April 2010, limit of 80%
    - From September 2010, three tranches of loss sharing, with bidder setting loss percentage on first and third tranches
  - Average losses during this period – 2009, 28.6%, first six months of 2010, 23.38%, from July 1 to September 10, 2010, 16.96%
  - With or without branch breakup

# Resolution Transactions, cont.

  - With branch breakup, multiple franchise purchasers
  - Optional loans can be purchased under a separate Loan Sale Agreement
  - Multiple Purchasers of optional loans
- "Clean" Purchase & Assumption Agreement
  - Insured only or all deposits
  - Typically used when there is limited time to arrange a transaction or substantial risk of fraud
- Whole Bank P&A
  - Insured only or all deposits
  - One purchaser of all loans and branches under one agreement

## Resolution Transactions, cont.

- Payout (Liquidation)
  - Loans may be purchased under separate Asset Sales Agreement
  - Insured deposits only
  - Penn Square, 1982
- Deposit Insurance Transfer Agreement
  - One Paying Agent for insured deposits only
  - Loans may be purchased under separate Loan Sale Agreement

## Resolution Transactions, cont.

- Organization of new institutions
- 12 U.S.C. § 1821(d)(2)(F)
- The FDIC may, as receiver, organize new savings association and insured national banks or bridge banks.

## Resolution Transactions, cont.

- Bridge Bank - 12 USC § 1821(n)
  - Receiver transfers most assets and liabilities to newly chartered national bank controlled by the FDIC
  - FDIC has two years (with extensions, up to five years) to resolve institution
  - Extended to thrifts after IndyMac failure (July 11, 2008)
  - Useful for institution for which there is not sufficient time to find an acquirer
  - Single bridge bank can handle multiple bank failures

## Resolution Transactions, cont.

- Deposit Insurance National Bank (DINB)
- 12 U.S.C. § 1821 (m)
  - Stop gap to avoid a payout when the relative size of the bank would cause a disruption in the community
  - Only insured deposits are transferred
  - If DINB issues stock, shareholders of failed bank have right of first refusal to purchase stock
  - Two examples:
    (New Frontier Bank,
    Grealey, Colorado, 4/10/09,
    Community Bank of Las Vegas, 8/17/09)

## Resolution Transactions, cont.

- Pass-through Receivership/Conservatorship
  - Failed institution is "passed through" a receivership to a newly chartered institution which is placed into conservatorship
  - Shareholders' claims are not passed to conservatorship and are fixed to a date certain
  - Operates similarly to a bridge bank but cannot contain multiple institutions
  - BIF or SAIF institutions under prior law
  - IndyMac is most recent example; would be a bridge bank resolution under new law

## Resolution Transactions, cont.

- Open Bank Assistance
- 12 U.S.C. 1823(c) (8) authorizes direct FDIC assistance to open institutions
- However, the least cost requirement and the prohibition against protecting uninsured depositors and other creditors (12 U.S.C. §1823(c)(4)(E)) or benefiting shareholders (12 U.S.C.§ 1821(a)(4)(B)) has effectively eliminated the FDIC's ability to use open bank assistance except for systemic failure
- First Penn, 1980; Con't Illinois, 1984,
  First City, Houston, 1988 (59 separate banks)

## Resolution Transactions, cont.

- "Open Bank" Conservatorship
  - FDIC becomes conservator without a receiver being appointed
  - Puts institution in FDIC's control without displacing shareholders (no purchase and assumption transaction)
  - Unlikely to be used in future because of FDI Act prohibitions on benefiting shareholders

## Marshalling of Assets

- FDIC as Conservator or Receiver is required to maximize net present value and minimize loss – 12 U.S.C. § 1821(d)(13)(E)

## Marshalling of Assets: Cross Guaranty Liability

12 U.S.C. § 1815(c)

- The FDIC has up to two years to assess commonly controlled insured financial institutions for a failure within the group
- The assessment is generally equal to the estimated loss to the DIF for the resolution of the affiliated institutions
- The FDIC will assess cross guaranty liability only where such assessment is determined to result in the lowest cost to the DIF. The FDIC's Board must approve the assessment of cross guaranty liability
- The assessment is subject to judicial review under the Administrative Procedures Act
- In the past cross guaranty liability has not been widely assessed; instead a practice of waivers and settlement has developed
- The FDIC assessed cross guaranty liability against Advanta Corp.

## Marshalling of Assets: Voidable Transactions

- FDIC can avoid the transfer of any interest that was fraudulently transferred within 5 years of the appointment of the receiver
- FDIC can recover against subsequent transferees, if they were not good-faith purchasers
- FDIC may seek asset freeze under FRCP 65

*See* 12 USC 1821(d)(17) and (18)

## Marshalling of Assets: Enforceability

- Ipso facto clauses permitting acceleration upon appointment of receiver or conservator are unenforceable against FDIC as receiver – 12 U.S.C. §1821(e)(13)
- Covers nondefault early prepayment and similar provisions
- Netbank failure and servicing issues where FDIC as receiver is servicer
- Requirements for consent for transfers generally no longer effective

## Marshalling of Assets: Repudiation

- FDIC may repudiate contracts of the failed bank which are determined to be burdensome – 12 U.S.C. § 1821(e)
- Must be within "reasonable" time
- Receiver's liability for damages from repudiation are limited to direct, compensatory damages from the date of appointment to date of repudiation
- Special rule for repudiated leases – contractual rent and ability to stay

## Marshalling of Assets: Capital Maintenance Claims

FDIC as receiver has brought a number of capital maintenance claims using various authorities including its cease-and-desist authority. Examples of these claims include:

- IndyMac Bancorp Inc. (more than $5 billion)
- Franklin Bank Corp (more than $2 billion)
- Guaranty Financial Group nc. ($1.95 billion)
- BankUnited Financial Corp. ($1.47 billion)
- Downey Financial Corp. ($1.4 billion)
- UCBH Holdings Inc. ($535 million)

## Qualified Financial Contracts

- Special rule limits repudiation of Qualified Financial Contracts ("QFC's") by receiver — 12 U.S.C. 1821(e)(8)
- QFC's are securities and commodities contracts, forwards, swaps, repurchase contracts
- Permits set off termination and close out by counter party if not affirmed or transferred by FDIC receiver by
  5 PM on business day after <u>failure</u>
- Receiver cannot cherry pick, must affirm/transfer all or no QFC's with county party and affiliates

## Side Agreements

- 12 U.S.C. § 1823(e) provides that no agreement that diminishes FDIC's interests in an asset is valid unless it is in writing, executed contemporaneously by both parties, approved by the bank's board of directors, and has been continuously a bank record since execution
- *D'Oench Duhme v. FDIC*, 315 U.S. 447 (1943)
- FDIC Policy Statement on 12 U.S.C. § 1823(e) -62 FR 5984-01

## Creditor Claims

- Claims Priorities
  - Administrative expenses of Receiver
  - Deposit liabilities (insured and uninsured as a single class)
  - General creditors (including foreign deposits)
  - Subordinated debt of bank
  - Shareholders

*See* 12 USC 1821(d)(11)(A)

Prior to the enactment of FIRREA, there was no uniform statutory procedure for filing and handling claims against failed financial institutions. FIRREA created a uniform and relatively clear procedure for determination and payment of claims. In 1993, the Depositor Preference Statute established a uniform priority for the order in which claims are paid.

## Creditor Claims

- 12 U.S.C. § 1821(g) provides that the FDIC is subrogated to all the rights of any depositor to the extent that FDIC has paid the insured amount of the deposit
- Typically, FDIC is the largest creditor of a failed financial institution

## Creditor Claims: Process

- Notification to claimants by publication
- Claim must be filed within 90 days of notice
- Determination by Receiver within 180 days
- Late-discovered claims are barred, but may be allowed in receiver's discretion
- Dissatisfied claimant has 60 days to seek judicial review in Federal District Court
- The claims process is the exclusive means for a creditor to receive payment from a failed institution. Payment may be with cash, if the receivership has it, or with a receiver's certificate. A receiver's certificate is recognition of the validity of the claim, and if and when the receiver pays a dividend, the claimant exchanges the receivership certificate or a part thereof for cash. Often there is a series of dividends paid from a receivership.

## BHC FAILURES
## These Larger Organizations May Fail Only at Certain Levels, or at Multiple Levels…

- Sometimes both the bank holding company and the bank fail. Examples: Bank of New England (1991); WaMu (9/08); IndyMac Bancorp (7/08); The Colonial Bancgroup (8/09).
- Sometimes only the bank holding company fails. Examples: CIT (11/09); CapMark (holding company not Federal Reserve regulated) (10/09).
- It is possible for only the bank to fail (many examples).
- In all of these scenarios, the interplay of U.S. bankruptcy and FDIC resolution law provides very interesting work for lawyers.

53

## BHC FAILURES
## Interaction Between Bank Holding Company Bankruptcies and Bank Insolvencies

- Adequate Capital Obligations of Parent BHCs – Deemed Assumption & Priority: Section 365(o) and Section 507(a)(9) (In re Imperial Credit Industries, Inc., 527 F.3d 959 (9th Cir. 2008); In re The Colonial Bancgroup, Inc., Chapter 11 Case No. 09-32303 and Adv. Pro. 09-03087 (Bankr. M.D. Ala. 2009)
- The Automatic Stay Applied to Non-Debtor Subsidiaries: Sections 362, 105, and 109 (In re Deltacorp, Inc., 111 B.R. 419 (Bankr. S.D. N.Y. 1990))
- Fraudulent Transfer Actions Against the FDIC: Sections 548 and 365(o) and 12 U.S.C. § 1828(u) (Imperial Credit; Colonial Bancgroup)
- Breach of Duty Actions Against the FDIC (Golden Pacific Bancorp v. FDIC, 375 F.3d 196 (2d Cir. 2004))

54

# Interaction Between Bank Holding Company Bankruptcies and Bank Insolvencies

- Dissipation / Takings / Conversion Claims Against the FDIC (Washington Mutual, Inc. v. FDIC, Case No. 09-cv-00533 (D.D.C., filed March 20, 2009)
- Intercompany Claims (Loans, Taxes, Capital Contributions, Preferences, Fraudulent Transfers, Indemnification, etc.) (WaMu)

55

# Dodd-Frank Has Changed Things If the Bankruptcy of a BHC Will Create Serious Adverse Effects on National Financial Stability

- Before Dodd-Frank:
  - FDIC could only resolve insured depository institutions. It could not resolve:
    - The IDI's holding company
    - The IDI's subsidiaries
    - Any nonbank FC
- After Dodd-Frank:
  - FDIC may unwind failing BHCs and nonbank FCs as an alternative to bankruptcy
    - Must be necessary to prevent serious adverse effects on national financial stability
    - Bankruptcy - slow; better treatment of creditors
    - OLA – fast; less respect for creditor priorities

56

## Orderly Liquidation Authority under Title II of the Dodd-Frank Act

- OLA Subject to strict conditions, including:
  - recommendation from at least two federal regulators
  - consultation by Treasury Secretary with the President
  - availability of expedited judicial review
- Taxpayer bailouts expressly prohibited
- No prefunded resolution fund
  - FDIC may borrow from Treasury to fund a liquidation
  - Must repay first by reclaiming funds from shareholders and unsecured creditors
  - Then by risk-based assessments on large BHCs and nonbank FCs

57

## Orderly Liquidation Under Title II of Dodd-Frank Act

- Taxpayer bailouts expressly prohibited
- No pre-funded resolution fund
  - FDIC may borrow from Treasury to fund a liquidation;
  - Must repay first by reclaiming funds from shareholders and unsecured creditors;
  - Followed by risk-based assessments on large BHCs and NBFCs.
- Single Point of Entry Strategy for SIFIs is being developed by the FDIC, 78 Fed.Reg. 76,614
- OLA has not yet been used – stay tuned!

# Ethical Issues Facing Lawyers Representing Banking Institutions

## Banking Law Fundamentals

June 26, 2024

Scott G. Alvarez, John A. Buchman, and John M. Geiringer

# Regulatory Relations

2

## Regulatory Engagement

- Supervision vs. litigation
- Preserving your client’s relationship
- Obtaining good feedback and outcomes
- Examiner treatment

3

## Understanding the Client

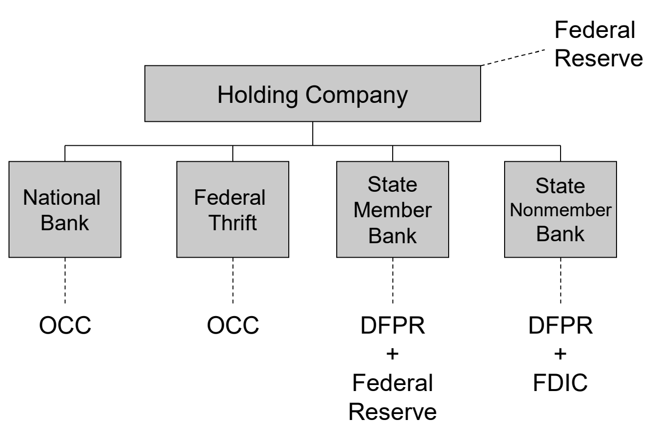
4

## Institution Information

- FDIC/ BankFind Suite
- Federal Reserve/ National Information Center (NIC)
- FDIC/ Call Reports
- FFIEC/ Uniform Bank Performance Report (UBPR)
- Reports of Examination and regulatory correspondence
- Enforcement actions
- Governance documents
- Others



## Organizational Structure and Regulators



## Understanding the Sources

7

## Legal and Regulatory

- Statutes
- Regulations/ Federal Register
- Supervisory guidance
- Examination handbooks
- Reports of Examination and regulatory correspondence
- Enforcement actions
- Failed bank reports
- Speeches and Congressional testimony
- Others

8

# Asset Threshold Issues

| Asset Threshold(s) | Provision(s) |
|---|---|
| $48 million | Home Mortgage Disclosure Act reporting requirements |
| $50 million | Management interlock restrictions , Insurance activities |
| $150 million | Streamlined SEC reporting requirements |
| $300 million | Expedited acquisition eligibility and/or streamlined acquisition reporting requirements |
| $330 million | Community Reinvestment Act requirements |
| $500 million | BHC risk-based capital requirements, Corporate governance requirements |
| $1 billion | Corporate governance requirements, Flood insurance escrow requirements |
| $1.322 billion | Community Reinvestment Act requirements |
| $2.23 billion | High-priced mortgage threshold |
| $3 billion | Expedited acquisition eligibility and/or streamlined acquisition reporting requirements, Corporate governance requirements, Small BHC Policy Statement, Collins Amendment exemption, 18-month examination cycle, Streamlined stock buyback and redemption reporting requirements |
| $5 billion | Tailored call reports |
| $7.5 billion | Expedited acquisition eligibility and/or streamlined acquisition reporting requirements |
| $10 billion | CFPB primary regulator for consumer compliance, Interchange fee cap ("Durbin Amendment"), Volcker Rule, Portfolio QM, Mortgage escrow requirements, CBLR eligibility, Swap margin and capital requirements |
| $20 billion | Thrift charter opt out |

Source: Congressional Research Service (2021)



# "Secret Law"

[M]any of the control doctrines . . . have been unwritten, or have been written but not well publicized, or in some cases even disseminated. And as a result, the practical determinants of when the Board will deem one company to control another, can in some cases not be discovered except through supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco.

Randal Quarles (FRB Vice Chair for Supervision)
April 23, 2019

## Case Study

Control Definitions

- Bank Holding Company Act/ Regulation Y
- Change in Control Act/ Regulation Y
- 23A/B of the Federal Reserve Act/ Regulation W
- Regulation O
- Illinois Banking Act



## Case Study

Dividends for Illinois State Member Banks

- Illinois Banking Act
- Federal Reserve/ Regulation H
- Federal Reserve/ SR 09-4
- Examination findings
- Enforcement actions

## Case Study

Affiliate Transactions

- Dodd-Frank Act revises 23A/23B of the FRA
- Changes to covered transactions, collateral requirements, credit exposure, investment funds, exemptions
- Regulation W not yet revised accordingly

13

## Understanding the Mission

14

## Legal vs. Business/Policy Advice

- "What may I do?" vs. "What should I do?"
- Identify pros and cons
- Outside counsel vs. in-house role



## Regulatory Opinion Types

Options

- Confidential vs. disclosed
- Informal vs. formal interpretations

Factors

- Engagement considerations
- Certainty
- Timing

## Attorney-Client Privilege

17

## Examination and Visitation Authority

| | |
|---|---|
| DFPR | 205 ILCS 5/48 |
| FDIC | 12 U.S.C. 1820 |
| FRB | 12 U.S.C. 248 |
| OCC | 12 U.S.C. 481 |

18

## Unfettered Access?

The Federal Reserve examines, on a regular basis, institutions for which we have been granted supervisory authority by Congress and, through that authority, has complete and unfettered access to an institution's most sensitive financial information and processes, including information that would otherwise be privileged and not subject to public disclosure.

19

## Statutory Exception

The submission by any person of any information to [banking agencies] for any purpose in the course of any supervisory or regulatory process of such [agency] shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under Federal or State law as to any person or entity other than such [agency].

12 U.S.C. 1828(x)

20

## Common Issues

- Legal advice
- Examinations
- Proactive disclosures
- Internal investigations
- Enforcement

21

## Conflicts of Interest

22

## Potential Clients

- Bank
- Employees
- Board of directors
  - Inside vs. outside
  - Board factions
- Holding Company
- Shareholders

23

## Potential Conflict Situations

- Dominant management/ significant shareholder
- Mergers and acquisitions
- Enforcement actions
- Troubled banks
- Others

24

## Regulatory Confidentiality Issues

25

## Confidential Supervisory Information

- Scope of definition
  - Examination reports and ratings
  - Regulatory correspondence
  - Other information

26

## Confidential Supervisory Information (cont.)

- Disclosure situations
  - Insurance companies
  - Securities disclosures
  - M&A
  - Others

27

## Suspicious Activity Reports

- SARs (and existence) confidential, except for BSA responsibilities
- Existence/ non-existence of SARs confidential, including SAR information if reveals SAR existence
- If impermissibly asked to disclose SAR (or SAR information), decline to produce and notify FinCEN/federal banking agency

28

## SEC Issues

29

## SEC "Up-the-Ladder Rule"

- Report material violations to CLO / CEO
- If futile, report to Audit Committee, Independent Committee, or Board
- If inappropriate response, report reasons to CLO, CEO, and directors
- Disclose to SEC if:
  - prevents substantial injury
  - prevents perjury/fraud
  - rectifies consequences of material violation that caused substantial injury

30

## Speech by SEC Commissioner Allison Herren Lee (March 4, 2022)

- Revisiting "Up-the-Ladder Rule"
- Legal advice should reflect interests of corporation/shareholders
- Independent/rigorous analysis of materiality issues
- Minimum standards for attorney competence/experience
- Continuing legal education requirements
- Obligation to investigate red flags
- Law firm oversight

31

## Potential Liability

32

## IAP Liability

Institution-Affiliated Party

- any director, officer, employee, or controlling shareholder (other than a BHC/SLHC) of, or agent for, a bank;
- any other person who has filed or is required to file a change-in-control notice;
- any shareholder (other than a BHC/SLHC), consultant, joint venture partner; or any other person who participates in the conduct of the affairs of a bank; or
- any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in violations, breaches of fiduciary duty, or unsafe or unsound practices, which caused or are likely to cause more than a minimal financial loss to, or a significant adverse effect on, the bank

33

## FDIC Professional Liability Recoveries and Expenses

| Type of Claim | Total Recoveries – 2007-2022 | |
|---|---|---|
| Securities | | |
| RMBS | $2,043,643,910 | (45.5%) |
| Other | $65,002,496 | (1.4%) |
| D&O Liability | $1,326,494,017 | (29.5%) |
| Accountant Malpractice | $461,635,367 | (10.3%) |
| MMF | $241,442,946 | (5.4%) |
| Bond | $204,239,458 | (4.6%) |
| Appraiser Malpractice | $45,738,132 | (1.0%) |
| Attorney Malpractice | $44,424,157 | (1.0%) |
| Other Professional Claims | $34,413,216 | (0.8%) |
| Insurance Issuer | $22,478,837 | (0.5%) |
| Financial Instruments – LIBOR | $767,300 | (0.0%) |
| **Total** | **$4,490,279,836** | **(100.0%)** |

34

## Other Issues

35

## Hot Spots

- State law issues
- Dealing with the media
- Deposit insurance
- Troubled bank situations
  - Advance retainers
  - Document retention
- Others

36

## Questions?

37

# Banking Law: Acronyms, Lingo and Jargon (2019)

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **§ 24 (Seventh)** | 12 U.S.C. § 24(Seventh) | The general powers authority for national banks that requires their activities to be the "business of banking" or "incidental thereto." Many state banks have the same powers by virtue of state parity or wild card statutes. |
| **ACH** | Automated Clearing House | A processing network whereby interbank transactions are cleared through batch electronic file entries. The ACH Network allows billions of direct deposit and direct payment transactions to be sent in account-to-account transfers. |
| **Advanced Approaches** | | Refers to the large or "core" international banks (generally defined for U.S. purposes as having total assets of $250 billion or more, or consolidated foreign exposures of $10 billion or more) that are subject to Basel II. |
| **AIB** | American Institute of Banking | Provides adult program education and training to bankers. |
| **ALLL** | Allowance for Loan and Lease Losses | The reserve financial institutions must maintain against loan and lease losses. It is a contra account on the asset side of the bank balance sheet to reduce gross loans to net loans and absorb loan and lease losses. |
| **AML** | Anti-Money Laundering | Usually referred to with the Bank Secrecy act as "AML-BSA", part of the regulatory regime aimed at money laundering, terrorist financing, tax evasion, and other criminal activities. |
| **AOCI** | Accumulated Other Comprehensive Income | A bank earnings entry that reflects unrealized gains and losses on bank available-for-sale securities. Under Basel III, AOCI flows through capital unless the bank opted out in the first quarter of 2015. |
| **ATR** | Ability-to Repay | Required by sections 1411 and 1412 of Dodd-Frank and the CFPB's amendments to Reg Z, which generally compel creditors to make a reasonable, good faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling (excluding an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan) and establishes certain protections from liability under this requirement for "qualified mortgages." See QM. |
| **Bank-eligible** | 12 U.S.C. § 24 (Seventh)<br>12 C.F.R. Part 1 | Refers to the types of securities in which banks may invest under 12 C.F.R. Part 1– generally high-grade debt instruments. |
| **BASEL** | The Basel Committee on Banking Supervision | Provides a forum for cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. The Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision. |
| **BASEL I** | The original Basel Committee Framework for Capital Adequacy | The original risk-based capital guidelines, based upon the 1988 capital accord adopted by the international Basel Committee on Banking Supervision. It imposed minimum capital standards on banks and thrifts, and, for the first time, it required a risk-weighting of assets in connection with the calculation of required capital ratios. It also required off-balance sheet exposures to be weighted and brought back on the balance sheet. |
| **BASEL II** | The Basel II Framework for Capital Adequacy | In 2008, the U.S. banking agencies collaboratively began to phase-in capital standards based on a second capital accord, referred to as "Basel II," for Advanced Approaches institutions. Basel II emphasized internal assessment of credit, market and operational risk, as well as supervisory assessment and market discipline in determining minimum capital requirements. |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown. 

# Banking Law: Acronyms, Lingo and Jargon (2019)

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **BASEL III** | The Basel II Framework for Capital Adequacy | The capital reform being implemented internationally in response to the global financial crisis. The rules require banks and holding companies to hold more and better quality capital. The U.S. Basel III rules became effective on January 1, 2015. See Reg Q, 12 C.F.R. 217. |
| **BHC** | Bank Holding Company | Any entity "controlling" a financial institution whose deposits are insured by the Federal Deposit Insurance Corporation. See also FHC. |
| **BHCA** | Bank Holding Company Act of 1956 12 U.S.C § 1841 et seq | Contains relevant definitions and governs the activities of companies that control banks, including Bank Holding Companies and Financial Holding Companies. |
| **BHCA § 3** | 12 U.S.C. § 1842 | The section of the BHCA that applies to companies becoming BHCs and acquiring banks. |
| **BHCA § 4(c)(8)** | 12 U.S.C. §1843(c)(8) | The section of the BHCA that restricted BHC's to activities "closely related to banking or a proper incident thereto." The list of activities permitted under 4(c)(8) was frozen by Gramm-Leach-Bliley. It is in Reg Y at 12 C.F.R. 225.28. |
| **BIF** | Bank Insurance Fund | Created by FIRREA; the part of the FDIC insurance fund that insured the deposits of banks as opposed to thrifts. Now combined with SAIF as one DIF fund. |
| **Biggert-Waters** | The Biggert-Waters Flood Insurance Reform Act of 2012 | Amended the National Flood Insurance Act. See NFIP. |
| **BMA** | Bank Merger Act | A part of the FDIA and NBA that provides the rules for banks to merge and consolidate. |
| **Board** | Board of Governors of the Federal Reserve System | Overall governing board of the various Federal Reserve banks located around the country and responsible for U.S. monetary policy. Also the regulatory authority for BHCs and THCs and primary federal regulator of state banks that are members of the Federal Reserve System. See Fed and FRS. |
| **BOLI** | Bank-Owned Life Insurance | Refers to limited types of life insurance that banks and thrifts may legally own. Such products may not be held for investment purposes but may be held to hedge liabilities, for instance employee benefit obligations of a bank/thrift. The bank regulatory agencies have released interagency guidance on BOLI. |
| **BOPEC** | **B**anks, **O**ther Subsidiaries, **P**arent, **E**arnings, **C**apital | The former examination rating system used by the Fed for bank holding companies. |
| **BSA** | Bank Secrecy Act of 1970 | Requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities. |
| **Bureau** | Bureau of Consumer Financial Protection | See CFPB |
| **C&D** | Cease and Desist Order | Issued by regulators to a bank, thrift, holding company or its Institution Affiliated Parties (Officers, Directors, etc.) to require affirmative action or stopping actions that violate law or are unsafe and unsound. |
| **C&I** | Commercial and Industrial | Describes bank commercial loans. |
| **Call Report** | Periodic Reports of Condition | Quarterly financial report filed by financial institutions. |
| **CAMELS** | **C**apital Adequacy, **A**sset quality, **M**anagement, | The examination rating system used by bank regulatory agencies with numerical ratings of 1-5. 1 is best, 5 is worst. |

# Banking Law: Acronyms, Lingo and Jargon (2019)

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | **E**arnings, **L**iquidity and Market **S**ensitivity | |
| **CARD Act (or Credit CARD Act)** | Credit Card Responsibility and Disclosure Act of 2009 | Addresses abuses in credit card practices including imposing limits on changes in terms and raising rates; limits fees and expiration dates on gift cards. |
| **CBLR** | Community Bank Leverage Ratio | Basil III "off-ramp" for institutions with total consolidated assets of less than $10 billion provided by Section 201 of the Regulatory Relief Act. The banking agencies set the CBLR at 9% of tangible equity to total assets for a qualifying bank to be well-capitalized. A community banking organization is eligible to elect the framework if it has less than $10 billion in total consolidated assets, limited amounts of certain assets and off-balance sheet exposures, and a CBLR greater than 9%. The electing institution would not be required to calculate the existing risk-based and leverage capital requirements of the Basel III Rule and would not need to risk weight its assets for purposes of capital calculations. |
| **CCAR** | Comprehensive Capital Analysis and Review | A supervisory assessment by the Fed of the capital planning processes and capital adequacy of the larger, complex BHCs (over $250 billion). One component is testing against a severely adverse macroeconomic scenario specified by the Fed. It is intended to demonstrate that the banks have robust, forward-looking capital planning processes that account for their unique risks and sufficient capital to continue operations throughout times of economic and financial stress. |
| **CDD** | Customer Due Diligence | Required as a part of AML-BSA compliance, a bank's responsibility to verify the identity of a bank customer. It is the process where relevant information about the customer is collected and evaluated for any potential risk for the organization or money laundering/terrorist financing activities |
| **CDFI** | Community Development Financial Institutions | Program to use federal resources to invest in and build the capacity of CDFIs to serve low-income people and communities lacking adequate access to affordable financial products and services. CDFI's can obtain TARP funds at lower cost. |
| **CDO** | Collateralized Debt Obligation | A type of derivative, used to repackage individual loans into a product that can be sold to investors on the secondary market. |
| **CDS** | Credit Default Swaps | A swap agreement between two counterparties. "Covered CDS" are purchased by a buyer with an interest in the underlying reference obligation as a hedge against the buyer's risk of loss on such reference obligation. A buyer may purchase a CDS on a reference entity in which the buyer does not hold any interest, in order to speculate (rather than hedge against the risk of loss) on the future creditworthiness of the reference entity (e.g., buying a CDS on a security issued by an entity in financial distress). |
| **CEBA** | Competitive Equality Banking Act of 1987 | Established new standards for expedited funds availability; recapitalized the Federal Savings & Loan Insurance Company (FSLIC); expanded FDIC authority for open bank assistance transactions, including bridge banks. |
| **CECL** | Current Expected Credit Loss | CECL is a controversial GAAP accounting standard adopted by FASB in the wake of the global financial crisis that will change how depository financial institutions of any size account for expected credit losses. CECL requires financial institutions to record "life of loan" loss estimates at origination or purchase. This replaces the "incurred loss" (ICL) accounting model and changes the way in which financial institutions manage the ALLL by requiring forecasting on loan performance. It also applies to credit losses on held-to-maturity securities. CECL took effect in Q1 2020 for large IDIs with holding companies that are registered with the SEC. Effectiveness was otherwise delayed for smaller reporting BHCs and banks and credit unions until 2023. |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown.

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **CET 1** | Common Equity Tier 1 | Basel III not only increased most of the required minimum capital ratios, but it introduced the concept of "Common Equity Tier 1 Capital," which consists primarily of common stock, related surplus (net of Treasury stock), retained earnings, and Common Equity Tier 1 minority interests, subject to certain regulatory adjustments. As of January 1, 2015, the Basel III Rule requires CET 1 to risk-weighted assets of 4.5%. |
| **CFPB** | Bureau of Consumer Financial Protection | The Bureau that operates as an independent part of the Federal Reserve and regulates consumer financial products and certain providers of such products under Title X of Dodd-Frank. Its regulations are codified at 12 C.F.R. 1000 et seq. |
| **C.F.R.** | Code of Federal Regulations | Federal banking regulations are codified in 12 C.F.R. under the part assigned to the federal banking regulator promulgating the regulation. Certain interpretations of statutes are also included in 12 C. F. R. |
| **Check 21** | Check Clearing for the 21st Century Act<br>12 C.F.R. 229 | A law that allows banks to handle paper checks electronically through check images and has given rise to remote deposit of checks and the use of substitute checks and image replacement documents in connection with check clearing and settlement. |
| **CIP** | Customer Identification Procedures | Know your customer requirements imposed by the USA Patriot Act. See KYC. |
| **CLA** | Consumer Leasing Act | Provides for uniform disclosure of terms and costs of consumer leases; similar to Truth in Lending; requires lease agreements to include certain terms, including a statement of the number of lease payments and their dollar amounts, penalties for not paying on time and whether a lump sum payment is due at the end of the agreement |
| **CLAR** | Comprehensive Liquidity Analysis and Review | A supervisory assessment by the Fed of the liquidity planning processes of the larger, complex BHCs. |
| **CMP** | Civil Money Penalty | Fines imposed by regulators against financial institutions and IAPs under the FDIA. |
| **Comptroller** | Comptroller of the Currency | The Comptroller is the chairman of the Office of the Comptroller of the Currency, which charters and regulates all national banks and federal thrifts. |
| **Collins Amendment** | DFA §171(b) | A provision of DFA that requires bank and thrift holding companies (except those with under $3 billion in assets) to hold capital on a consolidated basis as stringent as that required for insured depository institutions. |
| **Correspondent Bank** | | Depository institutions hold deposits of each other and provide services to others and to their customers. These arrangements are generally contractual in nature and involve banks as "correspondents" of each other. Upstream correspondent banks provide services to smaller institutions, know as downstream correspondents. |
| **Council** | Financial Stability Oversight Council | See FSOC. |
| **CP** | Commercial Paper | Short Term corporate debt of less than nine months' duration. |
| **CRA** | 1. Community Reinvestment Act<br>2. Consumer Reporting Agency | 1. Requires a financial institution to provide lending and banking services to the entire community it serves, in particular to low- and medium-income neighborhoods. It is the subject of a separate compliance exam by the applicable regulator with exam ratings: outstanding, satisfactory (high and low), needs to improve, and substantial noncompliance. Unlike other exam ratings, CRA ratings are published. The Act permits protests to be filed in connection with certain merger and acquisition applications.<br>2. Companies that collect information and provide reports on consumers that are used to decide whether to provide consumers |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | credit, insurance, or employment, and for other purposes. Equifax, Experian and TransUnion and the large national CRA's. |
| **Crapo** | The Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 | Also known as the "Regulatory Relief Act", Crapo was enacted in May of 2018 to modify or remove certain financial reform rules and regulations. The law roles back a number of Dodd-Frank provisions, especially dealing with community and regional banks: the SIFI test was increased to $250 billion (from $50 billion); less than $10 billion are generally exempt from Volcker Rule and risk committee requirement; between $50 billion and $100 billion are exempt from enhanced prudential standards (resolution planning, stress tests, single party credit limits) immediately and no longer subject to stress testing; less than $10 billion may adopt CBLR only (off-ramp for Basel III) of 9% (as set by agencies); small BHC rules apply to $3 billion and less; mortgage relief; reciprocal deposit relief from brokered deposit restrictions. |
| **CRE** | Commercial Real Estate | Generally, refers to commercial lending secured by real property. The bank regulatory agencies have released guidelines for banks to develop risk management practices and levels of capital that are commensurate with the level and nature of their concentrations. |
| **CSBS** | Conference of State Bank Supervisors | A clearinghouse for ideas to solve common problems of state bank regulators and to advocate for the continuation of the Dual Banking System. |
| **CSI** | Confidential Supervisory Material | The agencies view any information included in an examination report (including CAMELS ratings), and any information derived therefrom to be confidential. They also consider informal enforcement proceedings and information gathered from investigations as CSI. Sharing of this information without permission of the regulatory agency is a violation of Federal law. |
| **CTR** | Currency Transaction Report | A report that U.S. financial institutions are required to file for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through, or to the financial institution which involves a transaction in currency of more than $10,000. |
| **CUNA** | Credit Union National Association | Non-governmental, not-for-profit, trade group representing and lobbying for credit unions. |
| **CUSO** | Credit Union Service Organization | Subsidiaries of credit unions that may engage in a broader range of activities than the credit union itself. |
| **DCC** | Debt Cancellation Contracts | A type of credit insurance recognized as not being insurance by the banking agencies. DCC's are a contract between the financial institution and the debtor pursuant to which debt is paid off a death or disability, and sometimes on termination of employment. OCC regulations on the product are in 12 CR Part 37. |
| **DDA** | Demand Deposit Account | A transaction deposit account – better known as a checking account. Banks must hold reserves on transaction accounts under Reg D. |
| ***de novo*** | Latin: new | Used as a reference to newly formed banks and newly formed branches. |
| **DFA** | The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 | See Dodd-Frank. |
| **DFAST** | Dodd Frank Annual Stress Testing | A test that banks with total consolidated assets of more than $50 billion must run annually against a severely adverse macroeconomic scenario to determine the ability of the financial institution to deal with an economic crisis. Required by Section 165(i)(2) Dodd-Frank. |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **DIDMCA** | Depository Institutions Deregulation and Monetary Control Act of 1980 | Established "NOW Accounts." Began the phase-out of interest rate ceilings on deposits. Established the Depository Institutions Deregulation Committee. Granted new powers to thrift institutions. Raised the deposit insurance ceiling to $100,000. |
| **DIF** | Deposit Insurance Fund | The DIF is administered by the FDIC and provides deposit insurance for all insured banks and thrifts in the U.S. Various categories of deposits are insured up to $250,000. |
| **Discount Window** | | Credit facilities in which financial institutions go to borrow funds from the Federal Reserve. These loans, which are priced at the discount rate, are often structured as secured loans to alleviate pressure in reserve markets. It helps to reduce liquidity problems for banks and assists in assuring the basic stability of financial markets. |
| **Dodd-Frank** | The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 | The major financial reform package enacted in 2010, Dodd-Frank boasts 16 titles and creates 13 new Federal offices, with its principal mission to prevent systemic risk from threatening the financial system. |
| **DPC** | Debt Previously Contracted | Property banks are permitted to own for a limited number of years after they take it as collateral for a loan that defaults. |
| **DRR** | Designated Reserve Ratio | The FDIC manages the DIF with a DRR goal as a % of insured deposits. The current goal is to obtain a DRR of 2%. |
| **Dual Banking System** | | A system of bank regulation unique to the United States whereby banks may be chartered either by each of the 50 states and territories or by the federal government and each of those jurisdictions has certain regulatory controls over the banks and charters. Also true of savings and loan associations and credit unions. |
| **ECOA** | Equal Credit Opportunity Act | Consumer protection statute with implementing regulations that prohibits discrimination in lending practices. |
| **EDD** | Enhanced Due Diligence | As a part of AML-BSA compliance, bank due diligence policies, procedures, and processes should be enhanced for customers that pose higher money laundering or terrorist financing risks present increased exposure to banks. |
| **EDGE** | Edge Act Corporation | Created by the Edge Act, §25 of the Federal Reserve Act, it is a subsidiary of a bank, federally chartered by the Fed, which is established in the United States to offer services to only non-US residents and institutions. The services offered include deposit and loan services. Implementing regulation is Reg K (12 C.F.R. Part 211) under the Federal Reserve Act. It is a subsidiary of a bank. |
| **EESA** | Emergency Economic Stability Act of 2008 | Created TARP and guarantee programs to stabilize the economy during the global financial crisis. |
| **EFTA** | Electronic Fund Transfer Act Reg E (12 C.F.R. Part 1005) | Establishes the rights and liabilities of consumers as well as the responsibilities of all participants in EFT activities; provides for the establishment of minimum standards for the transmission of funds electronically and provides for the establishment of regulations to deal with the manner and effect of such transfers. |
| **EPS** | Enhanced Prudential Standards | Section 165 of the Dodd-Frank Act required the Board to establish enhanced prudential standards for bank holding companies and foreign banking organizations with total consolidated assets of $50 billion (changed to some $100 billion and all $250 billion by Crapo) or more and nonbank financial companies that were designated by FSOC for supervision by the Board. The standards include enhanced risk-based and leverage capital, liquidity, risk management and risk committee requirements; a requirement to submit a resolution plan; single-counterparty credit limits; stress test requirements; and others as the Board determines. |
| ***e*SLR** | Enhanced Supplementary Leverage Ratio | A rule to strengthen the leverage ratio standards for the largest, most interconnected U.S. banking organizations. It applies to U.S. top-tier bank holding companies with more than $700 billion in consolidated |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | total assets or more than $10 trillion in assets under custody (covered BHCs) and their insured depository institution (IDI) subsidiaries (the eight large U.S. banking organizations meet the size thresholds and their IDI subsidiaries). Covered BHCs must maintain a leverage buffer greater than 2 percentage points above the minimum supplementary leverage ratio requirement of 3 percent, for a total of more than 5 percent, to avoid restrictions on capital distributions and discretionary bonus payments. IDI subsidiaries of covered BHCs must maintain at least a 6 percent supplementary leverage ratio to be considered "well capitalized" under the agencies' prompt corrective action framework. |
| **FACT Act** | Fair and Accurate Credit Transactions Act of 2003 | Extensive amendments to the then existing Fair Credit Reporting Act to improve the accuracy and transparency of the national credit reporting system and preventing identity theft and assisting victims; restricts sharing of consumer information among affiliates without an opt out; contains provisions enhancing consumer rights in situations involving alleged identity theft, credit scoring, and claims of inaccurate information; allows consumers to request and obtain a free credit report once every twelve months from each of the three nationwide consumer credit reporting companies (Equifax, Experian and TransUnion). |
| **FASB** | Federal Accounting Standards Board | The organization primarily involved in developing Generally Accepted Accounting Principles. |
| **FBO** | Foreign Banking Office(s) | Refers to a foreign banking office of a domestic bank. |
| **FCRA** | Fair Credit Reporting Act | Consumer protection statute and regulations relating to the reporting of credit history. |
| **FDCPA** | Fair Debt Collection Practices Act | Provides rules for debt collection practices under regulations of the CFPB. |
| **FDIA** | Federal Deposit Insurance Act of 1950 | Revised and consolidated earlier FDIC legislation into one act. Embodies the basic authority for the current operation of the FDIC. |
| **FDIC** | Federal Deposit Insurance Corporation | Provides federal insurance for deposits of virtually all commercial banks and thrifts, i.e., savings banks and savings and loans and serves as receiver in bank and thrift failures. The FDIC is also the principal federal regulator of state-chartered banks that are not members of the Federal Reserve System and state-chartered thrifts. |
| **FDICIA** | Federal Deposit Insurance Corporation Improvement Act of 1991 | Increased the powers and authority of the FDIC; recapitalized the Bank Insurance Fund; created new supervisory and regulatory examination standards; established new capital requirements for banks; ordered the creation of a risk-based deposit insurance assessment scheme; mandated a least-cost resolution method and prompt resolution approach to problem and failing banks; and created new Truth in Savings provisions. Also limited the authority of state banks and their subsidiaries to act as principal in activities prohibited to national banks without approval of the FDIC and prohibited insurance underwriting through state banks, except to the extent permitted to national banks. |
| **Fed or Federal Reserve** | Federal Reserve System | Refers to the central bank of the U. S. comprised of the Board and 12 Federal Reserve Banks. Also the regulatory authority for BHCs and THCs and the primary federal regulator of state banks that are members of the Federal Reserve System. See FRS. |
| **Federal Funds Rate** | | A fluctuating interest rate per annum equal to the weighted average of the rates on overnight Federal Funds transactions with members of the Federal Reserve System which are arranged by Federal funds brokers, all as published for a particular day by the Federal Reserve Bank of New York. |
| **FEMA** | Federal Emergency Management Agency | Oversees the National Flood Insurance Program, which requires participating communities to adopt and enforce ordinances that meet or exceed FEMA requirements to reduce the risk of flooding. See NFIP. |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown. 

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **FFIEC** | Federal Financial Institutions Examination Council | Interagency body composed of the FED, FDIC, and OCC empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions regulated by each of them and to make recommendations to promote uniformity in the supervision of financial institutions; was given additional statutory responsibilities by section 340 of the Housing and Community Development Act of 1980 to facilitate public access to data that depository institutions must disclose under HMDA and the aggregation of annual HMDA data, by census tract, for each metropolitan statistical area. |
| **FHC** | Financial Holding Company | A bank holding company which has requested and qualified to become a financial holding company and which has elected to engage in "financial activities" as defined in the Gramm Leach Bliley Act. In effect it is a holding company which may have subsidiaries engaged in commercial banking, investment banking and insurance. It and its subsidiary banks/thrifts must be well-capitalized and well-managed and in compliance with CRA and must maintain compliance with those tests or be subject to loss of powers. |
| **FHFA** | Federal Housing Finance Agency | The independent agency created in 2008 to regulate and supervise the GSEs, see FHFB. |
| **FHFB** | Federal Housing Finance Board | Created by FIRREA. Is under HUD and supervises the 12 FHLB's. |
| **FHLB** | Federal Home Loan Banks | 12 Regional Banks regulated by FHLBB until FIRREA. Now regulated by Federal Housing Finance Board. Primarily serve as source of residential mortgage credit. |
| **FHLBB** | Federal Home Loan Bank Board | Established in 1932 as the regulator of federal and state savings and loan association or "thrifts". FIRREA replaced it with the OTS. |
| **FHLMC** | Federal Home Loan Mortgage Corporation | Commonly known as Freddie Mac, it is a federal government-sponsored enterprise (GSE) of the United States Government authorized to make loans and loan guarantees. Freddie Mac buys mortgages on the secondary market, pools them, and sells them as mortgage-backed securities to investors on the open market. |
| **FICO** | The Financing Corporation | A mixed-ownership governmental corporation chartered by the former Federal Home Loan Bank Board pursuant to the Competitive Equality Banking Act of 1987 to function as a financing vehicle for the recapitalization of the former FSLIC. FICO issued 30-year noncallable bonds of approximately $8.1 billion that matured in September, 2019. FICO's authority to issue bonds ended on December 12, 1991. Since 1996, federal legislation has required that all FDIC-insured depository institutions pay assessments to cover interest payments on FICO's outstanding obligations. The final payment was in March of 2019. |
| **FinCEN** | Financial Crimes Enforcement Network | The U.S. Department of the Treasury established the Financial Crimes Enforcement Network in 1990 to provide a government-wide multisource financial intelligence and analysis network. The organization's operation was broadened in 1994 to include regulatory responsibilities for administering the Bank Secrecy Act. |
| **FIO** | Federal Insurance Office | Created by Dodd-Frank as a part of Treasury. Its mandate is not to be a regulator or supervisor --that role stays with the states -but to monitor all aspects of insurance, assist Treasury and coordinate efforts in certain respects, recommend insurers who may be nonbank companies subject to supervision by the Federal Reserve, make preemption determinations and consult with state insurance regulators |
| **FINRA** | Financial Industry Regulatory Authority | The largest self-regulatory organization (SRO) for broker-dealers. It was created in July 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. Broker-dealers and their registered representatives and associated persons must hold licenses issued by FINRA, for instance |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown. 

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | Series 7 and 24. FINRA produces and enforces the FINRA Rulebook. |
| **Fin Sub** | Financial Subsidiary | A type of subsidiary of a bank created by the Gramm-Leach-Bliley Act that has greater securities powers than the parent bank. The bank must be well-capitalized and well-managed to own a fin sub and must meet other prudential requirements. |
| **FIRIRCA** | Financial Institutions Regulatory and Interest Rate Control Act of 1978 | Created the FFIEC. Established limits and reporting requirements for bank insider transactions. Created major statutory provisions regarding electronic fund transfers. |
| **FIRREA** | Financial Institutions Reform, Recovery, and Enforcement Act of 1989 | Abolished FSLIC and gave FDIC the responsibility of insuring the deposits of thrift institutions in its place; created the Savings Association Insurance Fund (SAIF) as part of the FDIC insurance fund to cover thrifts while the fund covering banks was called the Bank Insurance Fund (BIF) was kept separately; abolished the FHLBB and created two new agencies, the Federal Housing Finance Board (FHFB) and the Office of Thrift Supervision (OTS), to replace it; created RTC as a temporary agency to manage the assets of failed thrifts. |
| **FNMA** | Federal National Mortgage Association | Commonly known as Fannie Mae, FNMA is a GSE that purchases qualifying residential home mortgages on the secondary market, pools them, and sells them as mortgage-backed securities to investors on the open market. |
| **FOMC** | Federal Open Market Committee | Part of the Federal Reserve Board that sets economic policy. |
| **FRS** | Federal Reserve System | The central banking system of the United States. It is a quasi-public (government entity with private components) banking system composed of (i) the presidentially appointed Board of Governors of the Federal Reserve System in Washington, D.C.; (ii) the Federal Open Market Committee; (iii) 12 regional Federal Reserve Banks located in major cities throughout the nation acting as fiscal agents for the U.S. Treasury; (iv) numerous private U.S. member banks, which subscribe to required amounts of non-transferable stock in their regional Federal Reserve Banks; and (v) various advisory councils. |
| **FSA** | Federal Savings Association | A federal depository institution charter originally established to focus on consumer real estate lending under the Home Owners' Loan Act. Chartered by and regulated by the OTS before Dodd-Frank and the OCC after July 21, 2011. Also, an abbreviation that a federal saving association can use in its name. |
| **FSB** | Federal Savings Bank | A federal depository institution charter originally established to focus on consumer real estate lending under the Home Owners' Loan Act. Chartered by and regulated by the OTS before Dodd-Frank and the OCC after July 21, 2011. Also, an abbreviation that a federal saving association can use in its name. |
| **FSLIC** | Federal Savings & Loan Insurance Corporation | A subsidiary of the FHLBB which provided deposit insurance to S&L's. Abolished by FIRREA, it was replaced by the FDIC, as insurer of all U.S. deposits. |
| **FSOC** | Financial Stability Oversight Council | Council created by Title I of Dodd-Frank and chaired by the Secretary of the Treasury. It is composed of representatives from the principal federal financial regulatory agencies and a representative of the insurance industry, with its principal mission to prevent systemic risk from threatening the financial system. In so doing, the Council will fill gaps in supervision, monitor financial market developments, identify emerging risks in firms and market activities, and facilitate coordination of interagency policy and resolution of disputes. |
| **GAAP** | Generally Accepted Accounting Principles. | Accounting standards adopted by FASB. |
| **Garn-St Germain** | Garn-St Germain Act | Deregulated the limitations of S&L's to take demand deposits and establish money market accounts; S&L's were authorized to make commercial, corporate, business, or agricultural loans up to 10% of |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | assets; expanded the powers of thrift institutions into a broader scope of activities and limited the insurance powers of bank holding companies; expanded FDIC powers to assist troubled banks; authorized a new capital assistance program, the Net Worth Certificate Program, under which the FSLIC and the FDIC would purchase capital instruments called Net Worth Certificates from savings institutions with net worth to assets ratios under 3%, and would later redeem the certificates as they regained financial health. |
| **Glass-Steagall** | Glass-Steagall Act | Established the FDIC as a temporary agency. Separated commercial banking from investment banking, establishing them as separate lines of commerce. Gramm-Leach-Bliley revised and eliminated most of the Glass-Steagall act relating to affiliations between investment banking organizations and commercial banks. The provisions dealing with limitations on bank activities were not modified by the GLBA. |
| **GLBA** | Gramm-Leach-Bliley Act of 1999 | Repealed most of the Glass Steagall Act of 1933. Allows national banks to underwrite municipal bonds. Allows FHCs to engage in underwriting and selling insurance and securities, conducting both commercial and merchant banking, investing in and developing real estate and other "complimentary activities." Preserves authority of states to regulate insurance, but prohibits state actions that have the effect of preventing bank-affiliated firms from selling insurance on an equal basis with other insurance agents. Makes significant changes in the operation of the Federal Home Loan Bank System, easing membership requirements and loosening restrictions on the use of FHLB funds. Restricts the disclosure of nonpublic customer information by financial institutions. |
| **GSE** | Government-Sponsored Enterprise | Entities that are government related: FREDDY MAC, FANNY MAE, and the Federal Home Loan Banks |
| **G-SIB** | Global Systemically Important Bank | A financial institution whose distress or disorderly failure, because of its size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. They must hold additional loss absorption capacity tailored to the impact of their default, to be met with common equity. The list is updated from time to time and includes JPMorgan Chase, Citigroup and Bank of America. |
| **Hedge** | | An investment strategy to reduce the risk of adverse price movements in an asset. A hedge consists of taking an offsetting position in a related security, such as a futures contract. |
| **Hedge Fund** | | An investment vehicle that pools capital from a number of investors and invests in securities and other instruments. They are administered by a professional management firm, and often structured as a limited partnership, limited liability company, or similar vehicle. They are typically structured to avoid registration under the federal securities laws. |
| **HMDA** | Home Mortgage Disclosure Act of 1975 | Establishes minimum and uniform disclosures of the terms and related charges for Home mortgages. |
| **HOEPA** | Home Ownership and Equity Protection Act of 1994 | Amends TILA to require additional disclosures and additional protections for closed end not-purchase money mortgages on principal residences; targets high interest and high fee loans mainly in the home equity area. Assignees of such loans are also liable for penalties. Fed issues regs defining rates which trigger the applicability and setting forth required disclosure forms and information. |
| **HOLA** | Home Owners Loan Act | Established the savings association charter and pro vides the rules for their supervision and regulation. The OCC now is the regulator with supervisory responsibility. |
| **IAP** | Institution Affiliated Party | Officers, Director, Principal Shareholders, Independent Contractors (which can include attorneys and accountants under some situations). The banking regulators may take enforcement actions against IAPs in certain circumstances, including imposing CMPs. |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **IBF** | International Banking Facility | A banking entity that any US bank, or a US branch/subsidiary of a foreign bank, or an Edge Act Corporation establishes in the United States to offer services to only non-US residents and institutions. The services offered include deposit and loan services. |
| **IDI** | Insured Depository Institution | Refers to banks and thrifts, any financial institution with FDIC-insured deposits. Frequently used in rulemaking by the banking agencies. |
| **IHC** | Intermediate Holding Company | As part of the Dodd-Frank Act's enhanced prudential standards, foreign banking organization with $50 billion or more in U.S. non-branch/agency assets were required to place virtually all U.S. subsidiaries underneath a top-tier U.S. intermediate holding company. IHC's are subject to U.S. Basel III, capital planning, Dodd-Frank stress testing, liquidity, risk management requirements and other U.S. EPS on a consolidated basis. |
| **KYC** | Know Your Customer | The due diligence that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them. In the USA, KYC is typically a policy implemented to conform to a customer identification program mandated under the Bank Secrecy Act and USA PATRIOT Act and to prevent identity theft fraud, money laundering and terrorist financing. It is a process which banks must continually undertake from the start of a customer relationship to the end. |
| **LCR** | 1. Liquidity Coverage Ratio<br>2. Least Cost Resolution | 1. Liquidity is a measure of the ability and ease with which bank assets may be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. The LCR is designed to ensure that the banking entity has an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet liquidity needs for a 30-calendar day liquidity stress scenario. The U.S. bank regulatory agencies implemented the LCR in September 2014 for the large banking organizations.<br>2. Refers to the requirement that the FDIC determine the least costly manner in which to resolve a failed IDI. |
| **Leverage Ratio** | | A ratio of Tier 1 capital to book assets used to identify capital adequacy. |
| **LFI** | Large Financial Institution | A rating system imposed by the Federal Reserve in 2019 that replaces RFI/C(D) for holding companies $100 billion in assets or over. The LFI rating system is designed to: (i) align with current supervisory programs and practices for LFIs; (ii) enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and (iii) provide greater transparency to firms regarding the supervisory consequences of a given rating. |
| **LH&A** | Life, Health and Accident | Types of insurance some financial institutions and holding companies may sell (depending on the powers of the charter) that cover risks associated with death, accidents and health Certain kinds of life insurance with investment characteristics are considered to be NDIPs. Bank sales are subject to Consumer Protections in the Sale of Insurance, adopted by all the agencies. See 12 C.F.R. Part 14 for national banks and federal thrifts. |
| **Living Will** | | Required by Dodd-Frank for the largest institutions. All BHCs with over $250 billion in assets (and on a case-by-case basis, some over $100 billion) are required to submit and obtain approval of a plan to unwind the organization in the event of insolvency. |
| **Line of Business** | | Refers to an activity of a company which is reasonably separable. The SEC requires that there be separate breakdowns of key economic data for each line of business of a registered company that accounts for more than 20% of the company's revenues. |
| **Loans-to-One Borrower** | 12 USC § 84 for national banks. | The lending limit that a bank may extend credit to one borrower. |

# Banking Law: Acronyms, Lingo and Jargon (2019)

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **LTOB** | See Loans-to-One-Borrower | |
| **Member bank** | Member of FRS | State banks that choose to become members of the FRS and have the Fed as their primary federal regulator. They purchase stock in the FRB in their area to become members. |
| **MBS** | Mortgage-Backed Security | An asset-backed security that is secured by a mortgage, or more commonly a collection of hundreds of mortgages. The mortgages are sold to a group that "securitizes", or packages, the loans together into a security that can be sold to investors. In the U.S., they may be issued by government-sponsored enterprises like Fannie Mae or Freddie Mac, or they can be "private-label", issued by structures set up by investment banks. |
| **MDI** | Minority Depository Institution under Section 8 of FIRREA | The FDIC's Policy Statement defines MDI as any Federally insured depository institution where 51 percent or more of the voting stock is owned by minority individuals. "Minority" as defined by Section 308 of FIRREA means any "Black American, Asian American, Hispanic American, or Native American." The voting stock must be held by U.S. citizens or permanent legal U.S. residents to be counted in determining minority ownership. In addition to institutions that meet the ownership test, institutions will be considered minority depository institutions if a majority of the Board of Directors is minority **and** the community that the institution serves is predominantly minority. |
| **MMDA** | Money Market Deposit Account | A type of savings account under Reg D. Certain transfers are limited to 6 per month. |
| **MRB** | Marijuana-Related Business | An acronym one would not have expected to find in banking, but, as states legalize marijuana, MRB's as bank customers becomes a bigger risk and AML-BSA issue. |
| **MOU** | Memorandum of Understanding | Agreement between regulator and institution regarding require change in practices and operations. |
| **MRA** | Matter Requiring Attention | An examiner instruction to management of an examined entity to correct a violation of law or other commission or omission. |
| **MRIA** | Matter Requiring Immediate Attention | An examiner instruction to management to correct a problem immediately. |
| **N.A.** | National Association | An abbreviation that a national bank can use in its name instead of national bank. |
| **NACHA** | National Automated Clearinghouse Association | The administrator of the ACH Network. It manages and enforces the ACH Operating Rules and is a payments industry trade association. The NACHA Rules provide the legal foundation for the ACH Network. |
| **NAFCU** | National Association of Federal Credit Unions | Trade Association of Federal Credit Unions |
| **NASCUS** | National Association of State Credit Union Supervisors | A professional regulators association composed of State credit union regulators, which is the primary resource and lobbyist for the 47 state governmental agencies that charter, regulate and examine the nation's state-chartered credit unions. (Delaware, South Dakota and Wyoming have no laws permitting state-chartered credit unions.) Also acts as the liaison to federal agencies, including the NCUA. |
| **NASD** | National Association of Securities Dealers | Formerly, the SRO for most broker-dealers. Now FINRA. |
| **NBA** | National Bank Act of 1864 | Established a national banking system and the chartering of national banks,; established the Office of the Comptroller of the Currency (OCC) as the administrator of national banks. |
| **NCUA** | National Credit Union Administration; National Credit Union Act | The primary supervisor of federal credit unions. It insures deposit of both state and federal credit unions and the administrator of the National Credit Union Share Insurance Fund (NCUSIF), the insurer of most state-chartered credit unions. The Act establishes and provides |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | authority for NCUA and provides the legal framework for the charter of federal credit unions and the regulation of federal and state credit unions. |
| **NCUSIF** | National Credit Union Share Insurance Fund | Equivalent of FDIC deposit insurance for customers of credit unions. |
| **NDIP** | Nondeposit Investment Product | Includes securities, mutual funds, annuities and life insurance with investment features. Typically referred to in the context of bank direct or indirect sale of the products to retail customers, which is the subject of the Interagency Statement on Retail Sales of Nondeposit Investment Products. |
| **NFIP** | National Flood Insurance Program | Provides a means for property owners to financially protect themselves against floods. The Federal Emergency Management Agency (FEMA) oversees the program, which requires participating communities to adopt and enforce ordinances that meet or exceed FEMA requirements to reduce the risk of flooding. Homeowners must secure the flood insurance policy before closing on a property and renew it every year to cover the principal balance on the loan. When financial institutions make mortgage loans on properties in flood zones, they have an obligation to place flood insurance and force-place such insurance if the mortgagor fails to do so. |
| **Nonmember bank** | | State banks that do not choose to be members of the FRS and have the FDIC as their primary federal regulator. |
| **NOW** | Negotiable Order of Withdrawal | A type of transaction account like a checking account. Banks must hold reserves on transaction accounts under Reg D. |
| **NPR** | Notice of Proposed Rulemaking | Required by administrative law, it is a notice published in the Federal Register when one of the agencies of the U.S government, including the banking agencies, wishes to add, remove, or change a rule or regulation as part of the rulemaking process. NPR's give the public the opportunity to submit comments that must be considered in connection with final rulemaking. |
| **NSF** | Non-sufficient Funds (bad check charges) | Refers to a fee charged when there are insufficient funds to settle a check or card obligation. |
| **OCC** | Office of the Comptroller of the Currency | A bureau of the Treasury that charters and supervises national banks and federal thrifts. It has rulemaking authority under the NBA and HOLA. |
| **ODP** | Overdraft Protection | A service many banks offer so that depositors can overdraw their bank accounts and have the overdraft covered, subject to fees. If structured properly, the service has historically been exempt from federal law regarding consumer open-end credit, but overdrafts of ATM and debit card transactions are subject to an opt-in under Reg E, 12 C.F.R. 1005. |
| **OFAC** | Office of Foreign Assets Control | An agency of the United States Department of the Treasury. OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign states, organizations, and individuals. |
| **Op Sub** | Operating Subsidiary | A subsidiary controlled by a bank or thrift that may only engage in the activities of the parent bank. |
| **OREO** | Other Real Estate Owned | Classification for assets of a financial institution acquired in foreclosure of collateral securing a loan. |
| **OTS** | Office of Thrift Supervision | A part of Treasury that regulated federal thrifts and thrift holding companies and was the federal regulator for state thrifts before the DFA transfer date, when it merged with the OCC. |
| **Overdraft** | | When there are insufficient funds in an account and the bank makes the payment. Overdraft practices and charges are restricted by Reg E. |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **Overline** | Overline Loan | A loan that exceeds the bank's lending limit. |
| **Oversight Council** | Financial Stability Oversight Council | See FSOC. |
| **Part 1** | 12 C.F.R. Part 1 | Generally refers to the regulations of the OCC at 12 C.F.R. Part 1 that restrict the investments national banks, federal thrifts and state member banks may make. Many state non-member banks are subject to the same rules if state law so provides. |
| **P&C** | Property and Casualty Insurance | Type of insurance some financial institutions and holding companies may sell that covers risks of destruction or loss of personal and commercial properties. Bank sales are subject to Consumer Protections in the Sale of Insurance, adopted by all the agencies. See 12 C.F.R. Part 14 for national banks and federal thrifts. |
| **PCA** | Prompt Corrective Action | Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators' powers depends on whether the institution in question is "adequately capitalized," "undercapitalized," "significantly undercapitalized" or "critically undercapitalized," in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators' corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution's asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to sell itself; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution. |
| **QFC** | Qualified Financial Contract | Refers to swaps, derivatives and repurchase agreements that the FDIC must determine to affirm or unwind within one day of receivership of a failed IDI. |
| **QM** | Qualified Mortgage | The CFPB's QM requirement implements sections 1411 and 1412 of Dodd-Frank, which generally require creditors to make a reasonable, good faith determination of a consumer's ability to repay (ATR) any consumer credit transaction secured by a dwelling (excluding an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan) and establishes certain protections from liability under this requirement for QMs. |
| **QTL** | Qualified Thrift Lender | A test that savings associations must meet to be regulated as thrifts instead of banks or BHCs. The test requires a majority of assets to be dedicated to mortgage and consumer lending. DFA imposes more severe sanctions on savings associations that do not meet the test, including prohibiting dividend payments to shareholders. |
| **Reg or Reg.** | Regulation | Abbreviation used to reference a particular regulation. Bank regulatory agencies promulgate regulations under most statutes for which they have rulemaking authority. Under the Administrative Procedures Act, such proposed regulations are subject to notice and comment. They are published in the Federal Register. Federal banking regulations are codified in 12 C.F.R. in the part dedicated to the regulator promulgating the regulation. |
| **Reg B** | Equal Credit<br>12 C.F.R. Part 1002 | Former Fed regulation transferred to CFPB that implements the Equal Credit Opportunity Act. The purpose of Reg B is to promote the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status or age |

| **Banking TERM** | **REFERENCE** | **DEFINITION** |
|---|---|---|
| | | (provided the applicant has the capacity to contract under state law). The regulation also prohibits the denial of credit merely because an applicant's income is derived from public assistance sources, such as Social Security disability payments. Reg B focuses on the fair treatment of customers in the granting of credit. At its heart, the regulation says the decision to grant credit is to be based on the borrower's ability to meet the lender's credit standards. Matters such as the race, age or marital status of the borrower or the borrower's reliance on public assistance to repay the loan have no place in the decision to lend. |
| **Reg C** | Home Loan Disclosure<br>12 C.F.R. Part 1003 | Requires banks and thrifts to collect and report information as to loan applications received and mortgage loans made by or purchased by them. Information as to income level, race, gender, and other similar information is collected and compared to determine if discriminatory practices exist. |
| **Reg D** | 1. Fed regulation on deposit accounts 12 C.F.R. 204<br>2. Regulation promulgated by the SEC that constitutes a significant private offering exemption under the Securities Act of 1933 | 1. Under Fed Reg D, the various kinds of deposit accounts are defined and reserve requirement are established. Also, limitations apply to transaction in savings accounts.<br>2. Under SEC Reg D substantial amounts of capital may be raised by private sales of equity securities to accredited investors so long as offers to other persons are limited. |
| **Reg E** | Electronic Funds Transfers<br>12 C.F.R. Part 1005 | Former Fed regulation transferred to CFPB that implements the Electronic Funds Transfer Act. Provides for disclosures and limitations on activities in connection with devises that access accounts. Also implements the CARD Act on gift card limitations and overdraft requirements. |
| **Reg K** | International Banking<br>12 C.F.R. Part 211 | Fed regulation that provides for the regulation of banking activities of U.S. Banks offshore; activities of foreign banks within the U.S.; and sets capital requirements for international structures. |
| **Reg O** | Insider Transactions<br>12 U.S.C. §375 | Fed regulation implementing legal limitations on loans to officers, directors, and principal shareholder of banks and certain affiliates. |
| **Reg P** | Privacy<br>12 C.F.R. Part 1016 | Implements the GLBA Title V privacy provisions by requiring all financial institutions to institute privacy policies with respect to consumer non-public personal information (NPPI) and disclose the same annually and upon account opening. Reg P is for bank holding companies and state member banks. The federal banking agencies have virtually identical regulations. |
| **Reg Q** | Federal Reserve capital rules under Basel III and DFA<br>12 C.F.R. 217 | Provides for the capital regime for U.S. banks, thrifts and their parent companies effective January 1, 2015. See Basel III. |
| **Reg R** | Joint Fed/ SEC Regulation dealing with Securities Activities of Banks required by GLBA<br>12 C.F.R. 218 (Fed)<br>17 C.F.R. 247 (SEC) | Defines the scope of securities activities that banks, thrifts, and credit union may conduct without registering with the Securities Exchange Commission as a securities broker and implements the most important exceptions from the definition of the term broker for banks under section 3(a)(4) of the Securities Exchange Act of 1934. Specifically, the regulation implements the statutory exceptions that allow a bank, subject to certain conditions, to continue to conduct securities transactions for its customers as part of its trust and fiduciary, custodial, and deposit "sweep" functions and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker. |
| **Reg W** | Affiliate Transactions<br>(12 U.S.C. 371 c and c-1)<br>12 C.F.R. Part 223 | Federal Reserve regulation that implements Sections 23A and 23 B of Federal Reserve Act. These related laws restrict covered transactions between a bank and its affiliates and require many affiliate transactions to be on market terms. |

# Banking Law: Acronyms, Lingo and Jargon (2019)

| **Banking TERM** | **REFERENCE** | **DEFINITION** |
|---|---|---|
| **Reg X** | Implements RESPA<br>12 C.F.R. 1024 | Regulation originally by HUD but with CFPB as successor, sets out requirements under RESPA, including disclosure requirements and anti-kickback provisions. |
| **Reg Y** | Implements the BHCA<br>12 C.F.R. Part 225 | Regulation by Fed that implements the Bank Holding Company Act, including application requirements and the list of activities permitted under section 4(c)(8). |
| **Reg DD** | Truth in Savings<br>12 C.F.R. Par 1030 | Former Fed regulation transferred to CFPB that implements the Truth in Savings Act. Provides for uniform disclosures to depositors so they can easily compare rates and restrictions regarding savings accounts. |
| **Repo** | Repurchase Agreement | A financial transaction in which on party "purchases" a government security form another party and then resells it the next day (overnight repo) or at a specified term (term repo) for the purchase price plus interest. Often an IDI is the repos seller to a customer and the repos is accomplished through a sweep of funds from the customer's DDA as a means to earn interest on the deposit or provide safety of the funds above the FDIC-insured amount. Repos must be secured on behalf of the purchaser with a priority lien on the government securities as if a secured financing. |
| **Reserves** | 12 C.F.R. Part 204 | Federal Reserve regulations require insured depository institutions to maintain reserves against their transaction accounts (primarily NOW and regular checking accounts). The reserve requirements are subject to annual adjustment by the Federal Reserve. |
| **RESPA** | Real Estate Settlement Procedures Act | Sets out required disclosures for mortgage loans and prohibits illegal steering of loans and kickbacks for home mortgage referrals. |
| **RFC** | Resolution Funding Corporation | Created by FIRREA to provide funding for RTC operations during and after the thrift crisis when FSLIC, the insurer for savings and loan associations, ran out of funds. |
| **RFI/C(D)** | Federal Reserve BHC Rating System for holding companies under $100 billion | The main components of the RFI rating system are risk management practices (R component) and financial condition (F component) of the consolidated organization, and an assessment of the potential impact (I component) of a holding company's nondepository entities on its subsidiary depository institution(s). A holding company under the RFI rating system is assigned a composite rating (C) based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). A holding company under the RFI rating system is also assigned a depository institution (D) component rating that generally mirrors the primary regulator's assessment of the subsidiary depository institution(s). |
| **Riegle-Neal** | Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 | Eliminates state barriers to national expansion of banks and BHCs. Allows interstate mergers between banks, subject to concentration limits, state laws and CRA evaluations. |
| **ROA** | Return on Assets | A ratio of an institution's net earnings to total assets. Often used a benchmark to indicate how well a bank is earning. |
| **ROE** | 1. Return on Equity<br>2. Report of Exam | 1. A ratio of a bank's net earnings to total equity. Often used a benchmark to indicate how well a bank is earning.<br>2. The report examiners deliver to financial institutions following an examination. The report will include exam findings and the rating assigned to the institution. It must be signed by the directors and is considered the confidential property of the banking agency which examined the institution. |
| **RTC** | Resolution Trust Corporation | Created by FIRREA; given the responsibility of managing and disposing of the assets of failed institutions. An Oversight Board was created to provide supervisory authority over the policies of the RTC. |
| **RWA** | Risk-Weighted Assets | The denominator of the capital requirements, except for the leverage ratio. Assets are assigned risk-weighting amounts that are then |

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | applied to determine total assets. Off-balance sheet exposures are also brought on the balance sheet and risk weighted. |
| **S&L** | Savings and Loan Association or Savings Association | Refers to a state or federally charted savings and loan association. A depository institution that historically focused its business on mortgage lending and savings. Now it is regulated by the OCC if it is a federal association and the FDIC and the state if it is state chartered. |
| **S&LHC** | Savings and Loan Holding Company | A company that owns one or more savings associations. SLHC's were regulated by the OTS until the July 21, 2011 and now regulated by the Federal Reserve. |
| **Safety and Soundness or S & S** | | The catch-all prudential rules applicable to banks/thrifts to assure the health of our financial system. The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings. In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If an institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. |
| **SAIF** | Savings Association Insurance Fund | Created by FIRREA; insured the deposits of thrifts but later consolidated with BIF into a single fund administered by the FDIC, the DIF. |
| **SAR** | Suspicious Activity Report | Report required to be filed where deposits or other activities may, but not necessarily, indicate the violation of law or regulation. |
| **SEC** | Securities and Exchange Commission | The SEC is a federal agency created to protect investors and maintain the integrity of the securities markets (exchanges and over-the-counter markets). It has rulemaking authority and enforces the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as the Investment Advisor Act of 1949, the Investment Company Act of 1940 and the Trust Indenture Act. |
| **SFHA** | Standard Flood Hazard Area | The areas for which flood insurance is available under the NFIP as determined by FEMA. Lenders must document the flood hazard determination as part of the mortgage lending process. |
| **SICC** | Standard Industrial Classification Code | A numerical code developed by the Department of Commerce whereby virtually any business activity has a numerical indicator This code can be found in financial reference manuals and is utilized by the SEC as part of the periodic filings it requires of registered companies. It is also used by a number of other governmental authorities including the Federal Trade Commission and the Antitrust Division of the Department of Justice. |
| **SIDD** | Separately Identifiable Department or Division | Has relevance in connection with certain advisory activities under GLBA that banks may either conduct through a subsidiary or through a SIDD. |
| **SIFI** | Systemically Important Financial Institution | FHC or non-bank supervised by the Federal Reserve as systemically important under Dodd-Frank. |
| **SLA** | Shared Loss Agreement | Used by the FDIC in connection with the resolution of failed institutions to keep assets in the banking sector and minimize losses. Winning bidders for the deposits of failed institutions enter into SLAs with the FDIC. |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown. 

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **SMDIA** | Standard Maximum Deposit Insurance Amount | It is the amount of FDIC insurance on accounts at banks and thrifts. Single accounts (owned by one person with no beneficiaries): $250,000 per owner; Joint Accounts (two or more persons with no beneficiaries): $250,000 per co-owner; IRAs and other certain retirement accounts: $250,000 per owner; Revocable trust accounts: Each owner is insured up to $250,000 for each unique eligible beneficiary named or identified in the revocable trust, subject to specific limitations and requirements. |
| **Spence Act** | Savings and Loan Holding Company Act of 1959 | Created a temporary moratorium on acquisition of additional thrifts by multi thrift holding companies and limited S&L Holding Companies to a single thrift. Established the regulatory framework for holding companies that owned more than one thrift. |
| **SRO** | Self-regulatory Organization | A membership-based organization that creates and enforces rules for members based on the federal securities laws. SROs, which are overseen by the SEC, are the front line in regulating broker-dealers. |
| **Sweep** | | Refers to a number of financial transactions between a bank and its customers pursuant to which funds above a target balance are moved out of a customer account and then are returned the next morning or at the term. Sweeps allow DDA funds to earn interest and /or provide safety above the FDIC-insured amount. Sweeps can be into repos, money market funds, MMDA's, affiliate banks, etc. |
| **TAG** | Transaction Account Guarantee | A guarantee of the FDIC that provided customers of participating institutions with full coverage on transaction accounts. It was one of the arsenal of programs put in place to avert the financial crisis, especially to prevent liquidity crises. Dodd-Frank continued TAG until December 31, 2012. |
| **TARP** | Troubled Asset Relief Program | Established under EESA and was intended to provide a mechanism for the purchase of troubled assets from financial institutions under either an auction option (if there is a market price) or a direct purchase option and, in the latter situation, may take a non-voting equity interest in the selling institution. It turned into a mechanism to infuse capital into institutions through Treasury's purchases of preferred stock and warrants. |
| **TBTF** | Too Big to Fail | A wide-spread belief that certain very large financial institutions would cause wide-spread systemic problems if they were to fail. Title II of DFA is dedicated to mitigation of TBTF. |
| **Texas Ratio** | | A leading indicator of financial institutions that may fail – adversely classified assets plus OREO divided by tangible equity capital plus reserves. A Texas ratio of 100 % is the sign of a troubled bank. |
| **THC** | Thrift holding company | See S&LHC. |
| **Thrift** | | A term used generally to apply to S&Ls. |
| **Tier 1** | Tier 1 Capital Ratio | The core measure of a bank's financial strength from a regulator's point of view. It consists primarily of shareholders' equity but may also include preferred stock that is irredeemable and non-cumulative and retained earnings. |
| **Tier 2** | Tier 2 Capital | Capital not included in Tier 1, typically subordinated debt, preferred stock that is not perpetual or accumulates skipped dividends, and part of the ALLL. It is used to calculate the Total Risk-based Capital Ratio. |
| **TISA** | Truth in Savings Act | Part of the larger Federal Deposit Insurance Corporation Improvement Act of 1991 that is implemented by Reg DD. It established uniformity in the disclosure of terms and conditions regarding interest and fees when giving out information on or opening a new savings account to allow the consumer to make informed decisions. |
| **TILA** | Truth in Lending Act | Initial and subsequent legislation establishing uniform nationwide consumer protection in lending and subsequently leasing of family homes and household items by requiring uniform disclosures of |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown. 

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| | | information as to the terms of the loans/leases. Subparts are: FCBA Fair Credit Billing Act, FCCCPA Fair Credit and Credit Card Protection Act, HELCPA Home Equity Lines of Credit Protection Act, HOPEA Home Ownership and Equity Protection Act |
| **TISA** | Truth in Savings Act | Part of the larger Federal Deposit Insurance Corporation Improvement Act of 1991 and is implemented by Reg DD. It established uniformity in the disclosure of terms and conditions regarding interest and fees when giving out information on or opening a new savings account to allow the consumer to make informed decisions. |
| **TLAC** | Total loss-absorbing capacity | For domestic GSIBs, DFA requires the Federal Reserve to set a minimum level of long-term debt that could be used to recapitalize these firms' critical operations upon failure. The TLAC requirement can be met with both regulatory capital and long-term debt. The debt would convert to equity upon failure so that shareholder, not taxpayers, would absorb the losses. |
| **Transfer Date** | | The date under Dodd-Frank on which many of the bank regulatory changes occurred –July 21, 2011. |
| **Treasury** | US Department of the Treasury | Supervises the federal banking system. |
| **TRID** | **T**ruth-in-Lending **R**ESPA **I**ntegrated **D**isclosure | Includes integrated home mortgage disclosures required to be created by the CFPB under Dodd-Frank. |
| **TRuPs** | Trust Preferred Securities | These instruments, which were issued by a special purpose entity ("SPE") created by a BHC, qualified under GAAP as minority interests in a consolidated subsidiary and therefore as regulatory capital. In 1996, the Federal Reserve expanded the definition of cumulative preferred stock to TRuPS, which could count as capital within a 25% Tier 1 sublimit. However, under both DFA and Basel III, TRuPS were excluded from capital, except securities that were issued prior to May 19, 2010 by bank holding companies with less than $15 billion of assets as of December 31, 2009, may be retained as Tier I Capital subject to certain restrictions. |
| **UFIRS** | Uniform Financial Institution Rating System | Internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special attention or concern, adopted by the FFIEC on November 13, 1979. |
| **Unitary S&LHC** | Unitary Thrift/Savings Association Holding Company | A holding company of only one federal or state savings association that was grandfathered under GLBA and may engage in any activity, including any commercial activity. |
| **USA PATRIOT Act** | Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 | Expands the authority of US law enforcement agencies for the stated purpose of fighting terrorism in the United States and abroad. Among its provisions; increases the ability of law enforcement agencies to search telephone, e-mail communications, medical, financial and other records; eases restrictions on foreign intelligence gathering within the United States; expands the Secretary of the Treasury's authority to regulate financial transactions, particularly those involving foreign individuals and entities; and enhances the discretion of law enforcement and immigration authorities in detaining and deporting immigrants suspected of terrorism-related acts; also expands the definition of terrorism to include domestic terrorism, thus enlarging the number of activities to which the USA Patriot Act's expanded law enforcement powers can be applied. Title III of the Act is known formally as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (IMLA Act). Expands the duties of banks in reporting high-risk activities, it also substantially raises the stakes for non-compliance with federal money laundering legislation and increases the scope of businesses now required to participate in anti-money laundering efforts |

© 2019 *Karol K. Sparks* – A special thanks to Henry "Bucky" Fox for identifying the need for an acronym list when he attended Banking Law Basics and for starting this project with 4 pages – how it has grown.

| Banking TERM | REFERENCE | DEFINITION |
|---|---|---|
| **USPAP** | Uniform Standards of Professional Appraisal Practice | Quality control standards applicable for appraisal analysis and reports in the United States and its territories and Canada. |
| **Volcker Rule** | Section 619 of Dodd-Frank, known colloquially as the "Volcker Rule" because of its patronage by former Federal Reserve Board chairman Paul Volcker | An amendment to the BHC Act that restricts banks from making certain kinds of speculative investments that do not benefit their customers. Specifically, it: prohibits insured depository institutions and their affiliates from: (i) engaging in "proprietary trading"; (ii) acquiring or retaining any equity, partnership or other ownership interest in a hedge fund or private equity fund; and (iii) sponsoring a hedge fund or a private equity fund. |
| **Well-capitalized** | | Banks/thrifts and their holding companies (except for BHCs with less than $3 billion in assets) must be well-capitalized for numerous regulatory purposes. BHCs and all bank/thrift subsidiaries must be well-capitalized to be FHCs. The measures under Basel I are: A leverage ratio of Tier 1 Capital to total assets of 5% or greater; a ratio of Tier 1 Capital to total risk-weighted assets of 6% or greater; and a ratio of Total Capital to total risk-weighted assets of 10% or greater.<br>In order to be a well-capitalized under Basel III, a bank/thrift and holding company must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more (a new category); a Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more. |
| **Well-managed** | | Banks/thrifts and their holding companies must be well-managed for numerous regulatory purposes. BHCs and all bank/thrift subsidiaries must be well-capitalized to be FHCs. It means that the Management rating in the CAMELS ratings was a 1 or 2. |
| **Wild card** | | A law that matches powers of one type of financial institution to another. Usually, a state law that permits a state bank to engage in the activities permissible to a national bank by interpretation of the OCC. However, it may work the other way as well. |
| | | |
| | | |