**Walther**

**INTRODUCTION AND OVERVIEW**:

**WHAT IS A "BANK":**

1. Three Ways to Define a Bank:
   1. **Legal** **Form** - chartered by federal or state gov't; generally must have "bank" in its name
   2. By **services** it offers - accepting deposits and making loans
   3. By **economic function** - a *financial* *intermediary* providing *transaction* *services* to customers
2. **Credit** **Unions**
   1. May be state or federally chartered
   2. **No** **stock** issued; owners have "*common* *bond*" (mutual)
   3. Some still are not insured
   4. No federal income taxes paid
3. **Thrifts**
   1. Savings banks, S&L, Building & Loans
   2. Can be federally or state chartered
   3. Traditionally limited to *non-commercial* deposits & lending
   4. Invests in securities or bonds
   5. Can chose to be **mutual** (owned by depositors) **OR** **stock**
4. **Bank Holding Company Act Definition** (12 USC §1841(c)): Any institution:
   1. Insured by the FDIC, or
   2. Organized under state or federal laws which BOTH:
      1. Accepts *demand deposits* or *deposits that the depositor may withdraw by check* or similar means for payment to third parties or others, AND
      2. Is engaged in the business of making *commercial loans*
5. **Economic** **Function Definition**
   1. **Financial** **Intermediary** - Benefits:
      1. Diversification
      2. Economies of scale
      3. Expertise
      4. Convert illiquid investments into liquid ones
      5. Safe place to store money
   2. **Transactional** **Services**:
      1. Banks provide an accounting system of exchange - a means of *transferring wealth through bookkeeping entries*
      2. More efficient than currency
      3. Maintain accounts at the Federal Reserve

**BANK RUNS, THE MONEY SUPPLY, AND THE PAYMENT SYSTEM:**

1. Banks **may be "*special*" for three reasons**:
   1. Susceptibility to runs and panics
   2. Their role in the money supply
   3. Their role in the payment system - transferring wealth through bookkeeping entries, through clearing checks & electronic pmt
2. Role in the **Money** **Supply**
   1. How does the Federal Reserve control money supply? (not precision tools because gov't can't control loans and purchases of securities)
      1. Reserve requirements
         1. An *increase* in reserves required *decreases* money supply
         2. An *decrease* in reserves required *increases* money supply
      2. Buy and sell U.S. gov't securities (open market operations)
      3. Discount window - loans to banks (usually controlled by *moving the discount rate* up or down)
         1. Discount rate is NOT fed funds rate, which is the rate that banks charge each other for money kept on reserve at the Fed; usually about 1% lower
         2. Fed funds rate is lower because banks want to lend their money rather than have Fed lend it - to get interest
         3. Government doesn't usually set fed funds rate, but it's usually tied by the market to the discount rate
3. Susceptibility to Runs and Panics
   1. **Bank** **Run** - where a large number of depositors converge on a bank at a given time
   2. **Bank** **Panic** - a generalized loss of confidence in banks
   3. Northern Rock problem:
      1. Were making bad mortgage loans and were funding with borrowings from US banks instead of deposits;
      2. Credit crunch in US stops their funding and Northern Rock loan base hurts because of housing market
      3. Problem with funding loans with borrowing is that duration and maturities don't match
   4. Preventing Bank Panics:
      1. Guarantee Deposits
      2. Inspire Confidence
      3. Provide Additional Liquidity - Gov't lends money
4. Most banking law is *designed to prevent bank runs and panics* by:
   1. Keeping individual banks healthy, AND
   2. Keeping the economy as a whole healthy

**WHY REGULATE BANKS?:**

1. Policy debates turn on whether banks are "**special**":
   1. *Disfavored* view of banks
      1. Regulatory intervention unlike any other business
      2. Pervasive governmental controls
   2. *Favored* view of banks
      1. Few other businesses can offer government deposit insurance protection
      2. Beneficial regulatory constraints on competition
2. Distinction between *internal* and *external* costs:
   1. Bank failures have large *external* costs
3. **Corrigan** (worked for Fed - wants special regulatory treatment):
   1. Banks offer transaction accounts - payable on demand, which creates a mismatch of maturities of assets & liabilities and susceptible to insolvency
   2. Backup sources of liquidity to other financial markets
   3. Belt for monetary policy
4. **Aspinwall** (worked for JPMorgan Chase):
   1. Banks are *not* special - Virtually all financial services are also provided by other, non-regulated industries (credit unions, credit cards, etc.)
   2. The improvement of financial services and the strengthening of financial entities require fewer (not more) restrictions on pricing, service lines, and location

**BANKING REGULATORY STRUCTURE:**

1. Types of Regulators:
   1. Federal banking regulators
   2. State banking regulators
   3. Other government agencies
2. **Federal** **Regulators**:
   1. **Office of the Comptroller of the Currency (OCC)**:
      1. Charters and examines national banks
      2. Funded by fees paid by national banks
   2. **Federal** **Reserve** **System**:
      1. Regulates state *member* (of Fed) banks (banks may elect this)
      2. "Umbrella" regulator for bank holding companies (except when they only own a single thrift)
      3. Funded by earnings on Treasury securities
   3. **Office** **of** **Thrift** **Supervision (OTS)**:
      1. Charters and examines regulated thrifts
   4. **Federal** **Deposit** **Insurance** **Corporation (FDIC)**:
      1. Insures deposit accounts for banks and thrifts
      2. Primary regulator of state *nonmember* (of Fed) banks
      3. May examine *any* insured institution
      4. Deals with failed banks and thrifts
      5. Funded by fees from insured institutions
   5. **National Credit Union Administration**:
      1. Charters and regulates federal credit unions
      2. Insures and acts as a "central bank" for state and federal credit unions
3. **State Regulators**:
   1. Texas Department of Finance
4. **Other** **Regulators**:
   1. **Department** **of** **Justice**
      1. For criminal matters - typically money laundering
      2. Reviews mergers for antitrust violations
   2. **Securities & Exchange Commission (SEC)** - for accounting practices and stock sales
   3. **Department of Housing and Urban Development (HUD)** - for discrimination on home loans
   4. **Financial Crimes Enforcement Network (FinCEN)** - in Treasury; for suspicious activity reports, etc.
5. Evaluation of Regulatory Structure (pages 65-68):
   1. Advantages:
      1. A fragmented system may provide protection against excessive regulation (banks can just switch to another regulator)
      2. Competition among regulators for the business
      3. Splintering into numerous interest groups
   2. Disadvantages:
      1. Race to the bottom (due to competition)
      2. Hard to create single accountability measure
      3. Waste (too many groups overseeing things)
6. How does regulation benefit banks?
   1. Public confidence
   2. FDIC insurance
   3. Federal Reserve - a lender of last resort
   4. Gov't policies suppress competition - *barrier to entry* for banks

**BANK CHARTERS**

**ENTRY INTO BANKING:**

1. **Forming a Bank**:
   1. Which regulatory agencies can *charter* a financial institution?
      1. OCC
      2. OTS
      3. NCUA
      4. State banking regulators
   2. Chartering a bank is *different than organizing a business entity*:
      1. Financial institution charters are **not a right** - requires application and major investigation - WHY?
         1. Want to protect people from runs and panics
         2. Protection for depositors
         3. FDIC protection of its fund
         4. Easier to control the economy with fewer banks
      2. There is a **dual federal/state system** for issuing charters
   3. **Six Stages for Establishing a Bank**:
      1. Form an organization of at least 5 members
      2. Prefiling meeting with regulators
      3. File application with the OCC
         1. Identify at least 5 natural persons to serve as organizers
         2. Articles of Incorporation signed by all directors
         3. File a notarized organization certificate
            1. Name of the bank including "national"
            2. Place of operations
            3. Amount of capital stock & number of shares
            4. Name, address, & amt of stock issued by *each* person
         4. Notice and comment period
         5. Bank files a business plan
      4. Preliminary conditional approval / File application with the FDIC - usually takes 120 days
         1. Complete legal formalities
         2. Raise the capital
         3. Establish building, operations, management, etc.
         4. Get FDIC insurance certificate
         5. Pre-opening examination
         6. Preliminary *approval may expire or be revoked* - usually for (i) engaging in banking prematurely, OR (ii) not raising sufficient capital within a year
      5. Fulfilling any conditions
      6. Final approval
   4. **OCC considers the following factors**:
      * 1. Reasonable chance of success
        2. Organizers familiar with national banking laws
        3. Competent organizers/directors/management
        4. Capital sufficiency
        5. Safety and soundness
        6. Effect on FDIC
        7. Responsibility under Community Reinvestment Act
   5. 12 USC §27: **Mandatory Charter Issuance**, *so long as* the applicant meets the statutory criteria - despite discretion
2. **Judicial Review of Chartering Decisions**
   1. Camp v. Pitts (OCC denies application for a charter twice - "no need for a bank")
      1. Standard of review is whether Comptroller's adjudication was *arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law*
   2. Today there are very few challenges to bank charter applications because you're fighting a regulator that you'd have to deal with from here on

**INTERACTION BETWEEN FEDERAL AND STATE LAW:**

1. General Preemption Laws
   1. Supremacy Clause - federal law is the supreme law of the land
   2. 10th Amendment - the powers not delegated to the federal government by the Constitution, nor prohibited by it to the states, are reserved to the states
   3. Preemption affects federal *and* state financial institutions
2. **Preemption** **Tests**:
   1. **"Express" Preemption**: where a federal statute includes a preemption clause *explicitly withdrawing* specified powers from the states
      1. Courts must only:
         1. Interpret the scope of the preemption clause, and
         2. Evaluate its constitutionality - whether Congress had the power (almost never argued now because banking falls under the Commerce Clause)
   2. **"Field" (Implied) Preemption**: where *federal regulation is so pervasive* that it leaves *no room for states regulators* (not likely because of the long history of the dual banking system)
   3. **"Conflict" Preemption (major type)**: where there is no express preemption or field preemption, federal law preempts state law with which it *"actually conflicts"*, which occurs when:
      1. Compliance with both laws is *physically impossible*; OR
      2. State law *stands as an obstacle* to the accomplishment and execution of the full purposes and objectives of Congress (most common)
3. Watters v. Wachovia Bank (Wachovia Mortgage becomes operating subsidiary of Wachovia Nat'l Bank; State doesn't want to give up regulation of Wachovia Mortgage)
   1. Federal law states that states cannot investigate, examine, or otherwise regulate a national bank (no visitorial powers)
   2. Wachovia Mortgage, previously a Michigan entity, became a wholly-owned subsidiary of Wachovia Bank to circumvent state regulation
   3. At the federal level, operating subsidiaries are treated as their parent bank
   4. Majority finds a conflict preemption situation (see notes)
      1. **Dodd Frank Act-** overrules the Watters case. 12 USC 25b
         1. Allows states to regulate some banking activity
            1. “consumer financial protection statutes”
            2. Allows states to regulate **operating subsidiaries**
            3. Consumer Financial Protection Bureau – state attorneys general can sue under these federal rules.
            4. **General Preemption Std-** state laws are only preempted if law has discriminating effect on state bank, OR can have Preemption under the standard of the **Barnett Bank** case- it “significantly impairs” federal law. After reading Barnett again, this is not insignificant.

**BANK POWERS**

**STATE BANKS:**

1. Two-Step Process to Determine Whether *State* Bank Can Conduct an Activity:
   1. Does the *chartering state's law* authorize the activity, either *expressly* or in a *"wild-card" statute* (e.g. authorizing state banks to conduct any activity permissible for national banks)?
   2. Even if so, does *federal law* limit or prohibit the activity?
      1. State bank cannot *acquire or retain any equity investment* of a type *impermissible for a national bank* (§1831a(c)(1))
      2. State bank cannot *underwrite insurance*, except to the limited extent permissible to national banks (§1831a(b)(1))
      3. State bank may not engage as a principal in any type of activity that is not permissible for a national bank *unless* the bank is (§1831a(a)(1)):
         1. Adequately capitalized, AND
         2. FDIC has determined that the activity would pose no significant risk to the Deposit Insurance Fund.

**NATIONAL BANKS:**

1. **Enumerated Powers**:
   1. All powers granted to corporations (12 USC §24):
      1. Elect directors, appoint officers, adopt bylaws, issue stock, make contracts, sue and be sued, make gifts, exist *indefinitely*
   2. Receive deposits (§24(Seventh))
   3. Discount and negotiate promissory notes and other evidence of debt (e.g. make unsecured loans)
   4. Make loans secured by personal property
   5. Invest in high-quality debt securities
   6. Broker securities for their customers
   7. Deal in foreign exchange
   8. Makes loans secured by real property (§371)
   9. Lease-finance personal property (§24(Tenth))
   10. Offer trust services (§92a)
   11. Act as insurance agents in small towns (§92)
   12. Make investments "primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families" (§24(Eleventh))
   13. Explicitly *denied* powers:
       1. Generally cannot own real property (§29)
       2. Own corporate stock or underwrite corporate securities (§24(Seventh))
       3. Underwrite insurance (15 USC §6712(a))
       4. Charge interest above the legal rate (12 USC §85)
2. **Incidental Powers**:
   1. Generally, a bank cannot undertake an activity if no statute expressly permits a national bank to conduct that activity
   2. HOWEVER, the National Bank Act provides an *"incidental powers" clause* authorizing banks "to exercise ... all such *incidental powers* as shall be *necessary* to carry on the *business of banking*..."
   3. Arnold Tours, Inc. v. Camp (Comptroller issues regulation allowing banks to have travel agency department)
      1. Banks cannot operate a travel agency because it is not a valid exercise of the incidental powers in §24(Seventh)
      2. "**Necessary** to carry on the business of banking" - **only if** it is "**convenient** **or** **useful** in connection with the performance of one of the bank's established activities pursuant to its express powers under the Nat'l Bank Act"
   4. M&M Leasing Corp. v. Seattle First Nat'l Bank (leasing of personal property acquired on specific request of and use by customer)
      1. Court says that leasing is expressly permitted when it is the *functional equivalent* of a "loan of money on personal security" - basically a *lease-finance situation*
      2. Evolving standard for the "business of banking" - the powers must be construed to permit the use of new ways of conducting a very old business of banking
   5. NationsBank of North Carolina v. Variable Annuity Life Insurance Co. (OCC allows bank to act as an agent for the sale of annuities)
      1. Court uses ***Chevron* deference** to determine whether the OCC's ruling is permissible:
         1. Is the intent of Congress clear? If so, the end.
         2. If the statute is *silent or ambiguous*, then is the agencies interpretation based on a *permissible construction of the statute*? Does it *fill a gap or define a term* that's *reasonable in light of the legislature's design*? If so, agency's judgment gets controlling weight.
   6. **Data processing services** are permissible, typically
3. **Real Estate**
   1. A bank may purchase, hold, and convey real estate for the following purposes, and for NO others §29
      1. May hold property acquired by foreclosing on a debt (REO);
      2. May hold property acquired in “satisfaction of debts previously contracted (DPC) in the course of its dealings—voluntary settlement of a debt
      3. May acquire and hold as shall be necessary for its accommodation in the transaction of its business – (ex. Bank premises)
         1. Must bear a reasonable relationship to business needs
         2. Needs approval if investment exceeds the amount of the bank’s capital stock (§371(d))
      4. Can hold property to pursuant to its power to “make investments designed primarily to promote the public welfare” §24
         1. Can exceed 5% of capital only with OCC Approval
         2. Cannot, in any event, ever exceed 10% of capital
   2. Why the limitations?
      1. To keep the capital flowing in the daily channels of commerce
      2. To deter banks from embarking in hazardous real estate speculation
      3. To prevent the accumulation of large masses of such property in the hands of a bank.
4. **Securities**
   1. §16 Restrictions on all banks:
      1. Bank must limit its “business of dealing in securities and stock…to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account.”
         1. EXCEPT: bank may underwrite, deal in, and invest in US Govt securities, and general obligations of state and local govts.
         2. EXCEPT: bank may purchase for its own account, investment securities - investment grade corporate debt securities – under OCC regulations (can’t exceed 10% of bank’s capital)
      2. Generally, cannot purchase for its own account any shares of stock of any corporation. (so, how do they get around this though?)
   2. §21 Prohibits Securities Firms from taking deposits (that’s a bank’s job, not a securities firm)
   3. Debt Securities Investments
      1. Type I – US government bonds; state and local general obligation bonds; no restrictions on investing in these securities.
      2. Type II – State and Political Subdivision for Housing, University, Dorm Purposes – *restricted to less than 10% of capital and surplus for any one obligor* (So, can have more than 10%, but must be from different obligors?)
      3. Type III – Corporate Bonds; Municipal Bonds that are not general obligation bonds – *restricted to less than 10% of capital and surplus for any one obligor.*
      4. Type IV – small business; mortgage related securities – *restricted to less than 25% of capital and surplus for any one obligor.*
      5. Type V – fully secured by interest in a loan pool, IF the bank could invest directly – *restricted to less than 25% of capital and surplus for any one obligor*.
   4. Equity Securities Investment: Prohibited, except for
      1. Subsidiaries
      2. Bankers bank
      3. Bank service companies
      4. Small business investment companies
      5. Repurchasing own stock (limited)

**GEOGRAPHIC EXPANSION**

**RATIONALE FOR GEOGRPAHIC EXPANSION:**

1. Arguments FOR restriction: prevent undue concentration of banks, which can:
   1. Reduce competition
   2. Reduce local control
   3. Be unfair to rural areas, small banks
   4. Give too much control/power to a few banks
   5. Jeopardize safety and soundness
   6. Lead to costly bailouts
2. Arguments AGAINST restrictions on expansion:
   1. Increases competition
   2. Full service banking in rural areas
   3. Enhances check clearing
   4. Capital flows to efficient uses
   5. Economies of scale – reduces costs
   6. Geographic diversification – fewer failures (diversifies your exposure, which decreases risk)
   7. Improves Safety and Soundness

**INTERSTATE EXPANSION BY BANK HOLDING COMPANIES**

1. Acquiring Firms OTHER than Banks
   1. Lewis v. BT Investment Managers – (NY BHC wants to acquire to investment advisory service companies in Florida)
      1. Florida passes a law in response to BT’s application for acquisition which says that out of state BHC’s are prohibited from owning or controlling a business within the state that sells investment advisory services to any customer.
      2. Court looks to the Commerce Clause to analyze the issue
      3. Dormant Commerce Clause – states can’t do anything to frustrate interstate commerce
      4. Court - where simple economic protectionism is affected by state legislation, the law is PER SE invalid.
      5. BHC’s can acquire banks and other firms in other states, regardless of the state’s laws.
2. Acquiring Banks
   1. BHC’s can acquire an out of state bank regardless of state law, so long as the BHC is adequately capitalized and adequately managed. 12 USC §1842(d)1(A)
   2. Riegle-Neal Act: a bank holding company may acquire “a bank located in a state other than the home state of such bank holding company”
      1. However, state age laws (where state only allows BHC to acquire a target bank that has been in existence for a certain number of years) are preserved (not to exceed 5 years).
3. Riegle-Neal Act Concentration Limitations
   1. BHC cannot acquire an out of state bank if the BHC would control more than 10% of all US deposits in FDIC-insured depository institutions.
      1. Can still expand through internal growth, branching, acquiring a bank in its home state – just can’t acquire an out of state bank.
   2. BHC cannot acquire a bank in a state where it already has a depository institution or branch if the BHC would control more than 30% or more of all deposits in FDIC-insured institutions in that state.
      1. States may allow deposit concentration above that level.
   3. Concentration limits do NOT apply when and FDIC-insured bank fails.
      1. I.e. FDIC can hand off to a bank to take over a failed bank notwithstanding the 30% state deposit rule or 10% US deposit rule.

**GEOGRAPHIC EXPANSION BY BANKS**

1. Intrastate Branching – pg 188
   1. **McFadden Act** – generally permits national banks to branch only to the extent permissible for state banks
   2. First Natl Bank in Plant City v. Dickinson (natl bank wants to start armored car service)
      1. Issue is whether armored car service to pick up deposits is a “branch” under 12 USC §36(j)
      2. 12 USC 36(j) [McFadden Act] – **Branch –**any branch bank, branch office, branch agency, additional office, or any branch place of business..at which deposits are received, or checks paid, or money lent.
      3. Court wants to further competitive equality – doesn’t want the national banks to be able to do things prohibited to state banks.
         1. Thus, armored car service is NOT okay.
   3. Clarke v Securities Industry Association (national bank wants to open discount brokerage)
      1. Bank’s securities discount brokerage does NOT fall within the McFadden Act’s definition of a “branch.”
      2. Competitive Equality only applies to CORE banking functions- operation of a discount brokerage is not one.
2. Interstate Mergers of Affiliated Banks (affiliated banks are banks owned by the same BHC)
   1. Mergers are permitted unless the state opted-out within a limited period
3. Interstate Branching
   1. McFadden Act prohibits this, with the following exceptions:
      1. 30 mile rule
      2. Thrifts
      3. Holding companies
   2. **Most prohibitions are taken away by the Riegle-Neal Act**, but the exceptions (if they were needed) still remain.
   3. **Riegle-Neal Act – allows interstate branching IF** (opt-in):
      1. Permitted by state law, AND
      2. Not primarily for “deposit production”
   4. De Novo interstate branching is permitted, but only if state opts-in (de novo = new)[is this from riegle-neal act?]
   5. State statute must expressly authorize it, not allowed merely by implication. [riegle-neal act?]

**SAFETY AND SOUNDENESS**

12 USC §1818(b)1 – Any federal regulatory agency may issues a cease and desist order if a banking institution engages in, or is about to engage in, any unsafe or unsound practices.

**CAPITAL**

1. Meaning of capital for regulatory purposes = net worth
2. **Regulatory Capital Requirements:**
   1. Regulators must establish “minimum levels of capital”
      1. $1 million for national banks (this doesn’t matter as much as other two, because generally regulators enforce bank capital standards with the leverage limit and risk-based capital standards)
      2. Leverage limits
      3. Risk-based capital standards
   2. **Leverage Limit –** pg. 252/256 and subsequent pages
      1. Requires FDIC insured banks to maintain at least a **4% ratio** of **capital to total assets** in order to qualify as “adequately capitalized.”
      2. **Calculation:** Tier 1 Capital / Total Assets > 4%
      3. **Two Step Process** to calculate Leverage Ratio:
         1. Calculate the Banks Tier 1 Capital, which is the sum of:
            1. Common Shareholder Equity
            2. Any *noncumulative, perpetual preferred shares* (more like stock, and not bonds; no accumulated interest/dividends), AND
            3. Any minority shareholdings in consolidated subsidiaries (bank has control over these)
         2. Divide that number, the Tier 1 Capital, by the bank’s total assets.
   3. **Risk-based Capital Standards pg. 257**
      1. Used to take account of credit risk and off-balance sheet items.
      2. **Calculating the Risk-based Capital Ratio: pg. 259-265**
         1. **Step 1 –** sort bank’s assets into **Risk Weighted Categories** [NOTE: these are DIFFERENT percentages than the later credit equivalent amounts! Don’t fuck that up!]:
            1. **0% -** cash, federal govt securities, foreign currency obligations of US govt and certain foreign govts, balances kept at Fed Reserve or certain foreign central banks, and gold bullion
            2. **20% -** U.S. state and local govt obligations, obligations conditionally guaranteed by the U.S. govt, claims against US banks, and mortgage-backed securities guaranteed by Fannie Mae or Freddie Mac
            3. **50%** - first mortgage loans on one-to-four family residences, revenue bonds issued by state and local govts.
            4. **100%** - **loans to private borrowers,** commercial letters of credit, the bank’s own premises and equipment, real property acquired by foreclosure
         2. **Step 2** – take each class of the bank’s off-balance sheet items and multiply the face amount by the appropriate **credit conversion factor** to produce the **credit equivalent amount.**
            1. **0% -** unused portions of lines of credit expiring within one year; the unused portion of lines of credit made for more than one year if the bank regularly reviews such lines of credit and can cancel them at anytime; and the unused portion of retail credit card lines of credit that the bank has the unconditional right to cancel at any time.
            2. **20% -** commercial letters of credit
            3. **50% -** “transaction related contingencies;” includes performance-based standby letters of credit, such as those backing contractors and suppliers performance [unlike financial guarantee type letters of credit (which is more like guaranty) these letters guarantee performance of a nonfinancial obligation; also applies to **unused portion of** lines of credit, including home equity lines of credit made for **more than one year**
            4. **100% -** applies to “direct credit substitutes;” including financial-guarantee type standby letters of credit (i.e. standby letters of credit that act as a guaranty); assets sold without recourse; and legally binding commitments to purchase assets on specified future dates.
         3. **Step 3 –** sort the credit-equivalent amounts into the appropriate risk-weighted categories. Thus, standby letters of credit will go into 100% category if it guarantees a private borrowers debt, but only the 50% category if it guarantees municipal revenue bonds. **\*important to be careful here: this is where people fuck up\***
         4. **Step 4 –** multiply the dollar total for each of the four risk-weighted categories by the relevant percentage for that category. (i.e. 4100 million total for 50% category: then multiple $100 million by 50% which equals = $50 million)
         5. **Step 5 –** add the dollar total for the four risk-weighted categories. The dollar total equals the bank’s **risk-weighted assets.**
         6. **Step 6 – determine the amount of Tier 1 and Tier 2 Capital**; i.e. determine how much of bank’s capital counts as Tier 1 and how much as Tier 2 working from the balance sheet (remember- Tier 2 capital CAN NEVER exceed amount of Tier 1 Capital).
            1. **Tier 1 –** common shareholders equity; noncumulative perpetual preferred stock (pg. 253-54); minority shareholdings in consolidated subsidiaries (pg.266);[note: that common shareholders equity number itself includes par or stated value of common shares any paid-in capital, surplus, and retained earnings] [“core capital”]
            2. **Tier 2 –** all other capital [“supplementary capital”]

**Preferred shares –**preferred shares that don’t count as Tier 1 capital (because unpaid dividends cumulate or the shares have a limited life) if the issuer has the right to defer paying dividends on the shares. (If issuer doesn’t have right to defer payments on preferred shares, they may not be capital AT ALL, because that is arguably debt.)

**Hybrid Capital Instruments –** instruments which combine certain characteristics of debt and equity; e.g. perpetual debt, which bears interest in perpetuity without the principal ever becoming due. (bank mgrs ideally want to count it as debt for tax purposes and equity for regulatory purposes)

**Term Subordinated Debt –** that, when issued, had a weighted average maturity of 5 years. **Debt must be:** unsecured and subordinated to the claims of depositors.

**General Loan**-**loss Reserves -**  and **Net Unrealized Appreciation on Equity Securities** – two obscure elements of Tier 2 Capital discussed on pg 266-67

* + - 1. **Step 7** – **calculate “total capital” by adding Tier 1 Capital and Tier 2 Capital,** but follow these restrictions:
         1. Tier 2 Capital may NEVER exceed Tier 1 Capital; i.e. do not include more dollars of tier 2 capital than the bank has in tier 1 capital.
         2. Include subordinated debt and intermediate-term preferred shares in Tier 2 capital ONLY in a combined amount up to 50% of the bank’s Tier 1 capital. Thus, if 10 million in Tier 1 Capital, max from subordinated debt and intermediate-term preferred shares is a total of $5 million. (preferred shares are intermediate-term if, when issued, they had a maturity of between 5 and 20 years).
         3. Include a general loan-loss reserve in capital ONLY in an amount up to 1.25% of risk-weighted assets.
         4. Include ONLY 45% of the net unrealized appreciation on equity securities available for sale.
      2. **Step 8 –** Divide bank’s Total Capital by Risk-Weighted Assets [pg. 265]
         1. **Total Risk Based Capital Ratio = (Tier 1 Capital + Tier 2 Capital / Risk**-**Weighted Assets)**
         2. Separately, if you wanted to calculate a bank’s **Tier 1 Capital ratio** it is simply: **Tier 1 Capital Ratio = (Tier 1 Capital / Risk-Weighted Assets)**

**PROMPT CORRECTIVE ACTION** (pg. 279)

1. §38 of Federal Deposit Insurance Act - 12 USC §1831o: **Purpose-** is to resolve the problems of insured deposit insurance institutions at the **least long-term loss** to the Deposit Insurance Fund.
2. Perverse Incentives Created by Deposit Insurance:
   1. Bank owners - with deposits being insured, the owners are willing to take bigger risks (so long as there is not much capital at stake) to reap higher profits, while the greater risks are borne by the deposit insurance system.
   2. Regulators – incentive to hold back (forbear) and overextend; it’s easier to not do anything and just defer problems to the next guy.
      1. Now, if a bank fails, the regulators are reviewed by the OIG (Office of the Inspector General)
      2. Some regulators don’t want that criticism
      3. Some focus more on “bad” banks; good banks get more of a pass.
3. §18310: Five Categories of Banks according to Capital:
   1. Pg. 279

|  |  |  |  |
| --- | --- | --- | --- |
| **Classification** | **Leverage Ratio** | **Tier 1 R.B. Capital Ratio** | **Total R.B. Capital Ratio** |
| **Well Capitalized** | ≥5% | ≥6% | ≥10% |
| **Adequately Capitalized** | ≥4% | ≥4% | ≥8% |
| **Undercapitalized** | <4% | <4% | <8% |
| **Significantly Undercapitalized** | <3% | <3% | <6% |
| **Critically Undercapitalized** | <2% | N/A | N/A |

* 1. You must meet all of a category’s criteria to get into the good categories, but only need one bad characteristic to get into the bad categories.
  2. If it would result in *undercapitalization* a bank may NOT:
     1. Pay dividends to shareholders
     2. Pay management fees to any individual or company *controlling* the institution.

1. **Undercapitalized Bank** [starts on pg 286, 287, 288 – read and review these pages.]
   1. Bank must submit a **capital restoration plan**
      1. Controlling companies (BHCs) must *guarantee* that the bank will comply with the plan .
      2. Can increase capital by:
         1. Selling stock
         2. Selling off encumbered assets
         3. Selling 50% or 100% risk loans for more than what you had to carry it for on the balance sheet.
      3. Plan must be approved by federal regulator
         1. Plan cannot be approved if it would increase risk (ANY KIND of risk: credit risk, interest rate risk, etc.).
         2. Plan cannot be approved unless it is likely to succeed.
      4. Without an approved plan: (pg. 288-89)
         1. no increase in assets from quarter to quarter
         2. no acquisitions
         3. no new branches
         4. no new lines of business
         5. *Grounds for receivership* (non-approval is grounds ALONE to be shut down)
   2. **Significantly Undercapitalized Bank** (starts on pg. 289)
      1. Presumptive Safeguards (mandatory rule, subject to regulatory exception)
         1. Must recapitalize or sell
         2. Cannot pay more than the prevailing rate of interest
         3. Limits on the bank’s ability to shift assets between affiliated (sister) banks
      2. Discretionary Safeguards (may also apply to **Undercapitalized**)
         1. Restrict affiliate transactions
         2. Restrict asset growth
         3. Restrict risky activities
         4. Require new board election
         5. Remove officers – WITHOUT being required to prove wrong-doing
         6. And – ANY OTHER ACTION consistent with prompt corrective action.
   3. **Critically Undercapitalized Bank** (pg.291)
      1. Payment on Subordinated debt prohibited after 60 days
      2. Conservatorship, receivership, or other action required within 90 days
   4. Why have these directives if banks almost always close after issuance?
      1. Helps regulators have control over the shut-down process.
      2. Makes it look likes banks had a chance to fix that they couldn’t fulfill/meet
   5. Regulators can **downgrade** a bank’s classification for certain things (C.A.M.E.L.S.) which include:
      1. Capital Adequacy
      2. Asset Quality
      3. Management
      4. Earnings
      5. Liquidity
      6. Sensitivity to Market Risk
   6. **Regulator’s Requirements** (what regulator is required to do)
      1. Must take timely, effective action to prevent loss to the insurance fund
      2. If insured depository institution causes a “material loss” to the fund, the agency’s inspector general must prepare a report evaluating the supervision.

**PRUDENTIAL RULES** (pg. 296)

1. **Loans to One Borrower**
   1. **§84a’s Two Basic Rules:**
      1. A national bank’s loans to one borrower cannot exceed 15% of bank capital
      2. The bank may loan additional amounts, up to 10% of bank’s capital, if the *additional amounts* are *fully secured* by *readily marketable collateral* having a market value at least equal to the amount of funds outstanding (so may loan up to 25% of bank’s capital).
         1. **Readily Marketable Collateral:** financial instruments and buillion; promptly sellable under market conditions; daily valuation quote available.
   2. §84(d)2: **Aggregate Loans to Different Borrowers if:**
      1. Loan is for the *direct benefit* of another, OR
      2. A *common enterprise* exists between the borrowers
      3. A common enterprise exists under any of four types of circumstances (pg. 297)
         1. Same source of repayment (and neither borrower has another source of income adequate both to repay the loan and to meet the borrower’s other obligations)
         2. Common control (if one borrower is controlled by, or under common control with the other, and substantial financial interdependence exists between the borrowers [i.e. one borrower gets half of its gross receipts or gross expenditures from the other borrower])
         3. Acquisition of the same business (if the borrowers are borrowing to acquire the same business, and will own more than 50% voting power in that business)
         4. OCC decides based on facts and circumstances of particular transactions that a common enterprise exists
   3. **Exceptions from Lending Limits** (pg.297-298)
      1. Loans to a government entity (if general obligation)
      2. Loans secured by a govt general obligation bond
      3. Loans secured by a segregated deposit in same bank
      4. OCC approved emergency loans to other banks
      5. Syndicated loans (IF sold without recourse and participants share risk pro rate)
      6. Drawing on uncollected funds that are in the normal process of collection (checking accounts)
      7. Renewing or restructuring a loan
      8. Advancing money to pay insurance, taxes, etc. (if made to protect bank’s interest in the collateral)
      9. Financing the sale of the bank’s own assets (if bank is no worse off)
   4. **Nonconforming Loans** pg. 298 – this is a loan that complied with bank’s lending limits when made, but for one of following five reasons no longer does:
      1. Bank must take “reasonable efforts” to correct first four:
         1. Bank’s capital has declined
         2. Separate borrowers have subsequently merged or formed a common enterprise
         3. Bank has merged with another lender
         4. Lending limit or capital rules have changed
         5. Value of the Collateral has declined
            1. If this is the reason, the decline in value of collateral, **the bank must correct within 30 days** (diff than “reasonable efforts” standard of the first four)**.**
   5. **Interbank Liabilities** pg. 302-03 continued
      1. **[segue-note** fed funds are interbank loans of money kept on reserve at a Federal Reserve bank. The fed funds rate is the avg rate at which these monies are loaned by bank’s to each other**]**
      2. **FDICIA** – limits on Interbank Exposure
         1. Banks must have written policies and procedures to prevent overexposure to any US depository institution or foreign bank (in rule’s nomenclature, any “correspondents”) from becoming excessive considering the correspondent’s condition
         2. The bank/institution must periodically review the financial condition of correspondents to which it has significant exposure.
         3. The bank must establish “internal limits” which limit the exposure bank has to correspondents
         4. Bank must monitor exposure to correspondent to insure that transactions with it generally do not exceed the bank’s internal limits.
         5. An insured bank’s **interday credit exposure** to a correspondent cannot exceed 25% of the institutions capital unless the institution can demonstrate that the correspondent is at least adequately capitalized.
   6. **Insider Lending** pg.304-06
      1. 12 USC §375 and Regulation O
      2. Restrictions on extending credit to the bank’s executive officers, directors, & principal shareholders (collectively, “insiders”)
      3. **Ten Rules on Lending to Insiders** (5 Basic Rules, 5 Supplemental Rules) pg.304-305
         1. **5 Basic Rules**
            1. Prohibits preferential terms

Loan must be on substantially the same terms as other non-insiders (rate, term, etc.)

Normal risk of repayment

Normal credit underwriting procedures

* + - * 1. Requires prior board approval for extensions of credit to a single person exceeding the LESSER of:

The GREATER of $25,000 or 5% of bank capital (so generally, 5% of bank capital), **OR**

$500,000

* + - * 1. Limits total extensions of credit to any one insider - cannot exceed the national limits on loans to one borrower – even IF you could get approval

Cannot use state limits if they are higher

* + - * 1. Limits aggregate extensions of credit to ALL insiders

100% of capital, OR

200% of capital for some small, adequately capitalized banks to attract directors

* + - * 1. Restricts overdrafts by executive officers and directors, except pursuant to a written preauthorized overdraft LOC or transfer from another account
      1. **5 Supplemental rules**
         1. “Related Interests” – aggregated with insider

Business ventures controlled by insider are treated as extensions of credit to the insider

* + - * 1. Insiders of bank affiliates treated as bank insiders

But, an affiliate’s directors and officers are NOT treated as insiders IF:

The affiliate does not control the bank and constitutes less than 10% of the holding company’s consolidated assets

The bank’s board of directors formally excludes those persons from participating in major policymaking functions of the bank, and

They do not participate in such functions.

* + - * 1. An insider cannot knowingly receive a preferential loan (preferential loans violate §375b)

Regulators can punish insider AND the bank even if only the insider, and not the bank, knew.

* + - * 1. Correspondent banks cannot extend credit on preferential terms to each others’ insiders
        2. Special restrictions for executive officers, including

Imposing more restrictive lending limits, and

Requiring the bank to reserve the right to demand immediate repayment of all extensions of credit to an officer if the officer’s total borrowings from all banks (even unrelated) exceeds the amount the bank itself could lend the officer.

**DEPOSIT INSURANCE** (pg. 309)

**INTRODUCTION**

1. Deregulation of Deposit Interest Rates
   1. Banks can basically pay whatever rate of interest they want
   2. HOWEVER, banks generally can’t pay interest on corporate checking accounts

**BASICS OF FEDERAL DEPOSIT INSURANCE**

1. **Insurance Coverage –** currently covers $250,000 per depositor per bank in each of the following categories of legal ownership (§1821(a))
   1. single accounts – accounts owned by one person
   2. qualifying retirement accounts (IRAs)
   3. joint accounts – each person has signed the signature card and has equal rights to make withdrawals
   4. Revocable trust accounts
   5. Irrevocable trust accounts
   6. Employee benefit plan accounts
   7. Corporation, partnership, or unincorporated association accounts
   8. Government accounts
2. **Definition of “Deposit”**
   1. Includes checking accounts, savings accounts, NOW accounts, money market deposit accounts, and certificates of deposit
   2. Does NOT include money invested in stocks, bonds, mutual funds, life insurance policies, annuities, etc.
   3. FDIC v. Philadelphia Gear
   4. a standby letter of credit backed by a contingent promissory note is NOT a deposit for purpose of federal deposit insurance
   5. 12 USC 1831(l)1 – **deposit-** the unpaid balance of *money or its equivalent* received or held by a bank in the *usual course of business*…which is evidenced by a…letter of credit..on which the bank is *primarily liable…*issued in exchange for…a promissory note *upon which the person obtaining such credit is primarily liable*
3. **Brokered Deposits** pg. 325
   1. Well-Capitalized banks may solicit, accept, renew, or roll over any brokered deposit without restriction
   2. Adequately Capitalized banks may not accept new, renew, or roll over brokered deposits without a waiver from the FDIC
   3. Undercapitalized banks may not deal with brokered deposits
4. **Reforming Federal Deposit Insurance** pg.326 until end of chapter
   1. See 3-3 notes on Dodd-Frank.
   2. Dodd-Frank (Insurance Premiums)
      1. Pre **Dodd-Frank**: assessments based on domestic deposits
      2. Post **Dodd-Frank:** assessments based on total assets (minus) tangible equity
      3. Rate is assessed based on capital classification and CAMELS rating

**CONSUMER PROTECTION**

**USURY**

1. State Rules
   1. state rules vary quite a bit
   2. typically limits on the amount of interest that can be charged
   3. **usury –** charging interest above the legal rate
   4. most states, including Texas, *exclude merchants* from general usury laws; they allow a “time-price differential) –pg. 336 i.e. if merchants charge one amount for cash purchase immediately, and another for a purchase over time, the increased cost (from credit extension) is not subject to usury laws.
2. **Usury Limits on National Banks** –pg. 337
   1. 12 USC §85
      1. If the state has an interest rate limit, than the greater of:
         1. State general rate where the bank is located, except where a different rate is set for state banks, OR
         2. 1% + the discount rate
      2. If not interest rate limit is set by state law, then the greater of:
      3. 7%, or
      4. 1% + the discount rate
   2. Tiffany v. Natl Bank of Missouri – pg. 338 (national bank loaned at 9%; state limited state-chartered banks to 8% and other lenders to 10%; weird situation)
      1. National banks enjoy **most favored lender** status under state law
      2. They may take advantage of the highest rate allowed to lender under state law, even if state-chartered banks are restricted to lower rates
   3. Marquette National Bank of Minnesota v. First Omaha Service Co. (Nebraska bank solicits Minnesota credit card holders; Nebraska had more favorable usury law than Minnesota)
      1. Ct: a bank is located in the state where it is chartered; NOT where the borrowers are, or where the transaction takes place.
   4. Smiley v. Citibank South Dakota (late fees charged on credit cards)
      1. Late fees are *the same as interest!* Under §85
      2. Court gave Chevron deference to OCC regulation defining interest under §85.
   5. **Penalty for Usury**
      1. Forfeiture of ALL interest due under the contract
      2. If interest has been paid, penalty is twice the interest paid
      3. Two-year statute of limitations
   6. **State Bank Usury Limits**
      1. If a national bank (relying on the NBA) can charge more than a state federally insured (under state law) then, the state insured bank may charge the higher of:
         1. 1% + discount rate, OR
         2. The rate allowed by the laws of the state where the bank is located
   7. Texas Usury Laws
      1. Texas Constitution – 10% unless statute sets the rate higher
      2. Statutory structure exceedingly complex.
      3. Usury laws apply to commercial loans
      4. “draconian” penalties
      5. 4 year statute of limitations

**ANTI-DISCRIMINATION**

1. Equal Credit Opportunity Act (ECOA)pg. 354
   1. It is unlawful for a creditor to discriminate:
      1. Based on race, color, religion, national origin, sex, marital status, or age;
      2. Because the applicant’s income is derived from public assistance, or
      3. Because the applicant has exercised rights under the ECOA
   2. However, a creditor MAY:
      1. Have a program to benefit an economically disadvantaged class
      2. Ask about marital status (for homestead purposes)
      3. Ask about age
   3. Procedural Requirements
      1. Make credit decisions within 30 days (so you can’t effectively deny a person by never making a credit decision)
      2. Provide specific reasons for adverse actions
      3. Provide appraisal report for residential property if requested by applicant
   4. Federal reserve Board’s **Regulation B**
      1. May NOT make assumptions or use aggregate statistics relating to the likelihood that any category of persons will have interrupted income due to childbearing or childrearing
      2. May NOT consider lack of telephone listing
      3. MAY consider immigration status
      4. MAY consider state property laws
   5. ECOA Enforcement
      1. The primary federal banking regulator for bank with federal regulation
      2. Federal Trade Commission for non-banks
      3. Department of Justice if there is a pattern or practice of violating the law
      4. Aggrieved credit applicants may file civil actions
   6. Fair Housing Act (FHA)
      1. It shall be unlawful for any person or other entity whose business includes engaging in residential real estate related transactions, to discriminate against any person, because of race, color, religion, sex, handicap, familial status, or national origin. (notice, age is missing from these reqmts, unlike ECOA list)
      2. **Enforcement –** 
         1. Federal banking regulators must refer potential violations to HUD
         2. “Aggrieved person” may file complaint with HUD
         3. HUD investigates complaints and own suspicions
         4. DOJ brings suit for a “pattern or practice of violations”
         5. “Aggrieved person” may also file civil complaints
      3. Evidence of ECOA and FHA Violations
         1. Intentional Discrimination
         2. Disparate Treatment (pretext)
         3. Disparate Impact (ECOA uses this)
   7. Home Mortgage Disclosure Act
      1. Requires certain financial institutions (and others) to collect and report data about mortgage loans and mortgage loan applications
      2. Implemented through Regulation C
      3. Source of information for regulatory and other legal action

**COMMUNITY REINVESTMENT** pg. 357

1. **Community Reinvestment Act** (12 USC §2901-2906): Regulated financial institutions have a continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered
2. **Regulator’s Duties**
   1. Encourage financial institutions to *meet local credit needs* in a manner consistent with safe and sound operation
   2. *Regularly assess* institutions **CRA** compliance.
   3. *Consider CRA record when evaluating mergers, new branches, etc.*
3. No real enforcement action, ***except*** that it’s considered in application for new branches, mergers, etc. (prob acquisitions too)
4. Who must comply with CRA?
   1. National Banks
   2. National Thrifts
   3. Federally-insured state banks
   4. Federally-insured state thrifts
   5. NOT credit unions
5. CRA Tests (Regulation BB) (NOTE: depository institution defines its own assessment area)

**APPLICABILITY OF DIFF CRA TESTS TO BANKS DEPENDING ON SIZE**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Lending**  **Test** | **Investment**  **Test** | **Service**  **Test** | **Comm. Dev.**  **Test** |
| Large Banks > $1.09 B | X | X | X | X |
| Intermediate $0.274 - $1.098 B | X \* |  |  | X |
| Small Banks | X \* |  |  |  |

* 1. (Large Bank) Lending Test
     1. Considers home mortgage, small business, small farm, and consumer loans in the assessment area
     2. Geographic Distribution of these loans
     3. Borrower Characteristics, such as the size or income of the business
     4. Income Levels
     5. Bank’s community development lending, including number and amount of community development loans
     6. Innovative or Flexible Lending practices used by the bank to address credit needs of low or moderate income individuals
     7. Different from the lending test for small (and intermediate?) banks
  2. Investment Test
     1. Considers record of meeting credit needs through qualified investments that benefit assessment areas or broader areas that include the assessment area (activities considered under lending or service tests cannot be considered here)
        1. Comptroller considers the
           1. Dollar amount of qualified investments
           2. The responsiveness of qualified investments to credit and community development needs
           3. Degree to which the qualified investments are not routinely provided by private investors
        2. **Qualified Investment –** cannot be claimed by any other institution: includes, donating or selling on favorable terms, making available on a rent free basis a branch of the bank that is located in minority neighborhood to a minority depository institution, women’s depository institution, etc.
  3. Service Test – evaluates bank’s record of helping to meet the credit needs of its assessment areas by analyzing both the availability and effectiveness of a bank’s systems **for delivering retail banking services** and the extent and innovativeness of its community development services.
     1. Distribution of banking branches across diff income areas
     2. Record of opening and closing branches
     3. Effectiveness of alternative banking services (ATMs, telephone/computer banking etc.)
     4. Range of services provided in diff income areas
     5. Degree to which services in diff income areas are tailored to meet those customer’s needs
     6. Loan production in low and moderate income areas serving loan and moderate income individuals
  4. SPECIAL- Community Development Test –**ONLY applies to** wholesale and limited purposes banks b/c these institutions may otherwise find it hard to comply with broader rules
     1. Number and amount of community development loans
     2. Number and amount of qualified investments
     3. Extent of community development services
     4. Responsiveness to development lending, investments, and services
  5. **Small Bank** **Lending Test** (less than $250 million in assets)
     1. Loan-to-Deposit Ratio (usually > 70% is good)
     2. Percentage of loans in assessment area
     3. Record of lending to and engaging in other lending-related activities for borrowers of different income levels and for businesses and farms of different sizes
     4. Geographic distributions of its loans
     5. Record of responding to written complaints about its performance
  6. Bank may also propose their own “strategic plan”
  7. Regulators assign rating to each category, 5 different ranks:
     1. Outstanding
     2. High satisfactory
     3. Low satisfactory
     4. Needs to improve
     5. Substantial noncompliance
  8. For **Small Banks** and **Limited Purpose Banks** 4 rankings apply: (pg. 360)
     1. Outstanding
     2. Satisfactory
     3. Needs to improve
     4. Substantial noncompliance

**PREDATORY LENDING AND THE SUBPRIME MORTGAGE CRISIS** –pg. 370 and following pages

1. Sub-prime Lending – real estate loans made to people with poor credit scores
2. Predatory Lending - a subset of subprime lending; loans deemed to be harmful or unsuitable to borrowers.
   1. High fees
   2. Balloon payments
   3. Negative amortization
   4. Flipping
   5. Asset-based lending
   6. Packing of unnecessary fees and insurance
   7. Fraudulent or deceptive practices
3. Home Ownership and Equity Protection Act (HOEPA) –pg.377-78
   1. Fed is entitled to regulate subprime mortgages that either:
      1. have interest rates far in excess of Treasury rates (between 8%-12% spread trigger), OR
      2. have total fees and points greater than 8% or $451
   2. HOEPA specifies contractual limits on these loans:
      1. Prepayment penalties only permissible for first 5 years
      2. Balloon payments only after first five years
      3. No pattern or practice of asset-based lending
      4. Short disclosure required three days before loan is closed
      5. Three-day recission period
4. Calomiris Article, What to Do, and What not to Do, About “Predatory Lending” – pg. 380
   1. Subprime loans extended primarily by non-depository institutions that are NOT subject to examinations
   2. Proposed reforms:
      1. Disclosure and Counseling
         1. Mandatory disclosure statement *alerting risk of subprime loans*
         2. Make counseling available AND require lenders to notify of this
         3. Impose accuracy standard on Good Faith estimate
         4. Expanding penalties on lender for inadequate disclosure
         5. Increase time for notice of intent to foreclose to give homeowners time to find alternative financing
         6. Notice of high probability of foreclosure for loans where monthly payments exceed 50% of income
      2. Credit History Reporting
         1. Require lenders not to *selectively* report information to credit bureaus
      3. Single Premium Insurance – lump sum, rather than monthly, insurance
         1. Lenders should be required to fully amortize the cost of the insurance over the period of coverage (usually 5 years) rather than over the 30 year term of the loan
         2. Clearly disclose that credit insurance is optional and that other terms aren’t dependent on obtaining it
         3. Allow borrowers to cancel with refund within 30 days
      4. Limits on Flipping
         1. **Prohibit refinancing** by lender within 12 months unless it’s in borrower’s interest
         2. Borrower’s safe harbors (allowed if):
            1. Provides new money or debt consolidation
            2. Reduces monthly payments by minimum amount
            3. Reduces the duration of the loan
      5. Limits on refinancing of Subsidized Government or Not-for-Profit Loans
         1. Some lenders have tricked borrowers into refinancing OUT OF these subsidized loans into higher rate loans (assholes)
      6. Prohibition of Some Contractual Features
         1. Payable on demand clauses; call provisions
      7. Require lender to Offer Loans *without Prepayment Penalties*
         1. To show the difference in cost
   3. Don’t Regulate Pricing (Usury) – limits on price restrict supply
   4. Suitability Standards similar to security industry? –pg. 393 top (just that dude’s idea)

**THE SECONDARY MARKET AND SECURITIZATION**

1. **Secondary Mortgage Market** (reading was assigned, not in book)
   1. Some banks did straight sales of its loans, while others sold with buy-back provisions (idea is to get origination fees)
   2. Government creates a secondary mortgage market with Fannie Mare because no one wanted to buy mortgages on the secondary market (back in the day)
   3. Eventually, private investors started buying in the 1970’s
   4. **Fannie Mae and Freddie Mac**
      1. Fannie Mae was originally made to buy FHA loans
         1. Loans had to meet FRE and FNM standards
      2. How do they make money?
         1. Sell the packaged mortgages at a premium because they guarantee (the G Fee) the payments on the mortgage-backed securities (bonds)
            1. Take 15-25 bps off of coupon rate of MBS
         2. Issue MBSs
         3. Buy and Hold loans from originators
      3. Government Sponsored Enterprises (GSEs)
         1. Once government owned, then privatized, now government owned again
         2. Regulated by the Office of Federal Housing Agency
         3. No federal or state incomes taxes paid (!!!)
         4. Eligible for low-cost government loans
         5. Implicit backing of the federal government (HUGE)
         6. Not a government agency subject to the 5th Amendment
2. **Securitization**
   1. Oversecuritization – a credit enhancement technique
      1. Put 125 loans into a 100 loan pool to give some leeway for loan failures
   2. Ginnie Mae – guarantee company for Fannie and Freddie
   3. FHA and VA also guarantee mortgage payments
   4. Banks can securitize their own loans
   5. Collateralized Mortgage Obligation CMO – pool of mortgages
   6. Collateralized Debt Obligation CDO – pool of mortgage-backed securities
3. **Structured Investment Vehicles** (SIVs, aka SPVs – special purpose vehicles/entities)
   1. Used to shift liabilities off-balance sheet
   2. Regulators like these because risk is shifted away from depositors
      1. Indeed, also referred to as “bankruptcy remote entities”
   3. People were buying MBSs from SPVs because they didn’t want to be subjected to operating risks of banks
   4. Problems were these:
      1. Banks sold MBSs to SPVs with buy-back provisions
         1. Thus, bank still had exposure to it if security failed and buy-back provision was triggered
      2. Banks were providing credit and liquidity enhancements on SPV-sold MBSs
4. **Predatory Structured Finance**
   1. The Dark Side of Securitization – the securitization and its remoteness from the original loan leads to predatory lending
   2. Maybe the problem is that the risk isn’t transparent throughout the entire process
   3. The real risk lies where the originators know that the loan is too risky, but also know that someone will but it from them
      1. Which, because of the huge demand for MBSs at the time, they knew there was a market for the loans they were originating (until shit hit the bricks, and there wasn’t)
5. Possible Reform
   1. Borrowers (1) -> Originators (2) -> Pool (3) - > Investors (4)
   2. Reform at Borrower-Level
      1. Requirements for mortgage brokers to prevent bad originations
      2. Restructure loans or refinance (govt step in)
      3. Added disclosures from/to borrower
      4. Try to prevent foreclosures/give subsidies to buyers
      5. Keep interest rates low – that way ARMs don’t increase (Federal reserve tool)
      6. Fed pushes more money into economy (increases flow of credit)
   3. Reform at Originator Level
      1. Get rid of secondary market and make banks service their own loans
      2. On the other hand, give Fannie and Freddie more money to buy more mortgages to keep the money flowing
         1. Ick, not good idea here in my opinion.
   4. Reform the Rating Agencies
      1. Fucking understatement.
      2. Discuss their role on exam.
   5. Shift some liability for predatory lending to ultimate investor (problematic)
      1. The lender should have been reading the prospectus for the bonds they were purchasing though. Not smart.

**LENDER LIABILITY**  pg. 401-416

1. Lender liability – refers to a grab-bag of legal principles by which lenders can become liable for misconduct toward their borrowers.
   1. Ex. Contractual duties of good faith and fair dealing under state law
2. Brown v Avemco Investment Corp. – (due on lease provision in loan)
   1. Avemco isn’t really a bank
   2. Loan had due-on-lease provision; lease plane; lessees offered to purchase plan; Avemco repossessed the plane after nonpayment of accelerated portion
   3. Due-on-sale clause is OKAY, but UCC §1-304 imposes duty of good faith on the performance or enforcement of every contract or duty within the Code
      1. Due on lease here not okay
   4. Court would've liked to see some negotiation to show good faith (there was not negotiation)
   5. Not likely a winner, but more likely in a time where things are bad.
3. Connor v. Great Western S&L (homeowners sue lender for vicarious liability)
   1. Although court found that lender wasn’t a joint venture, the lender WAS liable to the homeowners because of the extraordinary control that the lender placed on the process
   2. However, the bank was held to be negligent by breaching the duty to the homeowners to exercise reasonable care to protect them from damages caused by major structural defects
   3. Joint venture argument is best
4. Kham v. Nate’s Shoes v. First Bank (bankruptcy judge equitably subordinates a bank’s loan)
   1. Equitable subordination – under BR Code §510(c) because bank refused to lend additional money, even though it had priority and was secured
   2. Court holds that the *subordination* ***was not proper*** – the contract allowed for termination
5. Lender Liability in the Future
   1. Depends on how public feels about banks (depends on economic environment, i.e. are there lots of foreclosures?)
   2. Maybe at the time banks were being held liable the banks had failed and didn’t have proper defenses (couldn’t pay attorneys)

**AFFLIATIONS** (start on pg. 425-436)

**RESTRICTIONS ON BANK’S TRANSACTIONS WITH AFFLIATES** (PG. 427)

1. 12 USC §1841(k) **affiliate –** an entity that controls the bank (holding company), is controlled by the bank (subsidiary), or is under common control with the bank, and every other company controlled by the holding company (holding company affiliate of the bank). Pg.425
   1. Control is 25% or more of the voting power in aggregate
2. Basic Policy Decisions
   1. Allowing banks to affiliate with other companies
   2. Allowing banks to have dealings with these companies; and
   3. Seeking to maintain a meaningful economic separation between banks and other types of affiliates
3. Problems with Affiliate Transaction
   1. Lack of Competition is a problem because there are barriers to entry into the banking industry (with charter system); want access to credit!
   2. “subsidy leakage” – don’t want the subsidy provided by the FDIC insurance to be leaked into affiliates (e.g. mortgage lender affiliates)
4. **Section 23A Covered Transactions –**
   1. Applies (it’s a **“covered transaction”) when** a bank (§371c(b)7):
      1. Extends credit to, or for the benefit of, an affiliate
      2. Issues a guarantee, including a standby letter of credit, for the benefit of an affiliate
      3. Purchases an asset from an affiliate
      4. Accepts securities issued by an affiliate as collateral for an extension of credit to *anyone* including someone with no connection to the bank
      5. Invests in securities issued by an affiliate
   2. **Four Main Rules of Section 23A** when it is a covered transaction:
      1. total covered transactions with *any single* affiliate cannot exceed 10% of the bank’s capital (use same capital as risk-based capital ratio – Reg W.)
      2. total covered transactions with *all* affiliates, *in the aggregate*, cannot exceed 20% of the bank’s capital (excluding transactions secured by US Treasury securities)
      3. Extensions of credit (loans), letters of credit, and guarantees must be *fully secured* with *qualifying collateral*
         1. 100% Collateral – US government securities and bankers’ acceptances
         2. 110% Collateral (must be 110% collateralized) – state and municipal securities
         3. 120% Collateral (must be 120% collateralized) – debt instruments not in 100% or 110% categories (private company debt)
         4. 130% (must be 130% collateralized) –stocks, leases, or other real or personal property, mortgages, and loans
         5. *Securities of an affiliate* and *low-quality assets* are NOT acceptable as collateral
      4. Cannot purchase a *low-quality asset* from an affiliate.
   3. **Exemptions from Covered Transactions rules of §23A**
      1. **Sister-Bank Exemption**
         1. At least 80% common control of the sister bank
         2. No exemption from the low-quality asset rule
         3. Undercapitalized bank may NOT use this rule
      2. Transactions Secured by US govt securities or a segregated, earmarked deposit account.
      3. Purchasing assets having readily-identifiable, publicly available market prices, AT market price
      4. Purchasing loans, without recourse, from affiliated banks, subject to the low-quality asset prohibition
      5. Repurchasing a loan originated by the bank and sold to the affiliate under a recourse or repurchase agreement.
      6. Giving immediate credit for items (checks) submitted for collection in the ordinary course of business
      7. Making deposits in an affiliated bank in the ordinary course of correspondent banking business
      8. Investing in bank service corporations, which engage in such activities as holding title to bank premises, conducting a safe deposit business, and providing services to the holding company and its banks.
   4. **Subsidiaries get Special Treatment**
      1. **Operating Subsidiary**
         1. Engages only in activities that a national bank can conduct directly
         2. Four main rules DO NOT apply to the bank’s transaction with the operating subsidiary; the operating sub is treated as if it is a part of the parent!
         3. HOWEVER, the rules DO apply to the operating subsidiary’s transactions with OTHER BANK AFFILIATES as if the operating subsidiary was the bank itself! (i.e. operating subsidiaries transactions with other affiliates are treated as if they were the bank for calculating limitations)
      2. **Financial Subsidiary**
         1. Engages in one or more activities that a national bank CANNOT do (e.g. underwriting corporate securities, etc.)
         2. **10% of capital rule does NOT apply**; however **ALL OTHER RULES still apply!**
            1. Thus, **20% rule STILL APPLIES** (and the others)
5. **Section 23B**
   1. **Four Main Rules of §23B**
      1. **Arm’s Length Rule-** bank must deal with affiliate on markets terms (arms length transaction)
         1. Terms must be substantially similar to, or at least as favorable as those prevailing at the time in comparable transactions with non-affiliates; OR
         2. If no comparable transactions, then the bank must deal with the affiliate in terms that “in good faith” would apply to non-affiliates (a fallback rule)
      2. **Fiduciary Rule** – bank cannot, as fiduciary, purchase securities or assets from an affiliate, *except as permitted:*
         1. Under the instrument creating the fiduciary relationship
         2. By court order, or
         3. By the law of the jurisdiction
      3. **Underwriter Rule-** bank cannot, as a fiduciary, purchase certain securities while an affiliate is a principal underwriter for those securities
         1. **Exception-** where bank’s board approved purchase before initially offered to public for sale
      4. **Corporate Structure Rule-** *neither the bank, nor its affiliates*, can publish any advertisement – or make any agreement – “stating or suggesting that the bank shall in any way be liable for the obligations of its affiliates”

**BANK HOLDING COMPANIES** pg.437 [you should read this assignment]

1. Definitions
   1. **Bank Holding Company –** a *company* having *control* over a bank or over a bank holding company §1841(a)1
   2. **Company-** any corporation, partnership, business trust, association, or similar organization, or any other trust, unless, by its terms, it must terminate within 25 years. §1841b
   3. **Control-**
      1. If a company owns, controls or has power to vote 25% or more of any class of the bank’s voting securities
      2. Company controls, in any manner, the election of a majority of the bank’s directors
      3. If the Federal Reserve determines, after a notice and hearing, that such company, directly or indirectly, exercises a controlling influence over the management or policies of the bank
      4. Summary
         1. > 25% voting = control
         2. 5%-25% = may be control
         3. < 5% = rebuttable presumption of No Control
   4. **Bank –** 
      1. Any FDIC insured bank, OR
      2. Any institution that both accepts deposits that the depositors may withdraw by check or similar means AND engages in the business of making commercial loans
      3. BUT NOT thrifts, credit unions, branches of foreign banks, or industrial banks
2. **Prior Approval Requirements**
   1. No company may become a BHC without Federal Reserve approval
   2. AN *existing* BHC needs prior approval before:
      1. Acquiring control of additional banks
      2. Acquiring more than 5% of a bank’s voting shares
      3. Acquiring substantially all of a bank’s assets, OR
      4. Merging with another BHC
3. **Activity Restrictions** 
   1. Bank Holding Company Act limits a BHC to-
      1. Banking
      2. Managing and controlling banks and authorized subsidiaries
      3. Activities that the Federal Reserve Board had, before Gramm-Leach-Bliley Act, determined to be “*so closely related to banking as to be a proper incident thereto*” §4(c)8 Activities must also be *reasonably expected to produce benefits to the public*.
   2. Two years allowed for BHC to divest itself of impermissible activities
   3. Federal reserve may extend by up to three years
   4. Thus- may conduct impermissible activity for up to 5 years, which is enough time for you to get the law changed.
4. **Other Regulation and Reporting:** BHC’s are:
   1. Subject to regular examinations
   2. Subject to capital requirements
   3. Federal Reserve Board can require non-duplicative reports on:
      1. BHC’s financial condition
      2. BHC’s systems for monitoring and controlling risk
      3. Transaction with Depository Institution Subsidiaries
   4. FRB has enforcement authority

**FINANCIAL HOLDING COMPANIES** pg. 465 start

1. **Introduction**
   1. Created by the Gramm-Leach-Bliley Act
   2. BHCs can ELECT to be treated as financial holding companies (FHCs) IF they qualify.
      1. Nowadays, most do want to be treated as an FHC.
   3. FHCs may engage in a *broader range* of activities than BHCs.
   4. A BHC qualifying as a FHC may engage, directly, or through subsidiaries, in “financial activities” AND in activities “incidental” or “complementary” to financial activities.
      1. Much broader range of activities contemplated here.
2. **Eligibility**
   1. To qualify as an FHC, a BHC must meet the following 3 Criteria (12 USC §1843(l)1-2, §2903(c)1
      1. EACH of the BHC’s subsidiary FDIC insured depository institutions must be well-capitalized and well-managed.
      2. EACH of those institutions must have at least a satisfactory examination rating under the CRA (Community Reinvestment Act)
      3. BHC must file a declaration with the FRB (Fed Reserve Bd.) [basically just an election on BHCs part]
         1. Also, now NO application and NO prior approval needed; just notify the Fed within 30 days after the event.
3. **Permissible Activities**
   1. May engage in activities that the Federal Reserve Board has determined to be (see pg. 468)
      1. “financial in nature” – nine classes of activities §1843(k)4
         1. Lending money, transferring money, exchanging money, investing money for others, transferring securities, or safeguarding money or securities
         2. Underwriting, brokering, or selling any kind of insurance, guarantee, or indemnity.
         3. Providing financial, investment, or economic advice, including acting as investment adviser to an investment company (i.e. managing a mutual fund)
         4. Securitizing loans or other assets that a bank could hold directly
         5. Underwriting, dealing in, or making a market in securities
         6. Engaging in any activity that the FRB had, by regulation or order before the GLB Act, determined to be closely related to banking under §4c(8)
         7. Engaging in the US in any activity that a BHC may engage in outside the US and that the Fed had approved
         8. Merchant banking
         9. Investing in any entity through an insurance company in the ordinary course of the insurance company’s business
      2. “incidental to financial activity” OR
      3. “complementary to a financial activity” AND “posing no substantial risk to the safety and soundness of depository institutions or financial system generally. (pg. 470)
         1. Hugely broad standard.
         2. Fed has broad statutory discretion to define nonfinancial activities as complementary to financial activities
4. **Merchant Banking –** private equity investment, investments in securities not publicly traded or marketed.

**THRIFT HOLDING COMPANIES / S&L HOLDING COMPANIES** pg.475

1. **Thrift Holding Companies –** a company (other than a BHC registered with Federal Reserve Board) having control over a savings association or control over a company that controls a savings association
2. Savings Association – a federal savings association, federal savings bank, or state savings and loan association; it also includes a state-chartered cooperative bank if the FDIC does not regulate that institution as a state bank.
3. **Multiple Thrift Holding Company** – controls more than one thrift institution
   1. Activities of MTHC strictly limited by SL Holding Company Act
      1. Can own and operate thrift premises
      2. Perform management services for its thrifts
      3. Manage or liquidate assets for its thrifts
      4. Act as an insurance agent, or as a trustee under deeds of trust, or as an escrow
      5. Engage in activities that the FRB has by regulation found permissible for BHCs under §4c of the BHC Act (see BHC above if you need more info)
         1. Closely related to banking
         2. Public interest
      6. Engage in other activities authorized for thrift holding companies as of 1987
4. **Unitary Thrift Holding Company –** controls only a single thrift, not counting thrifts acquired when they had failed or were about to fail
   1. **No restrictions** if meet ***qualified thrift lender* test**(65% of portfolio in qualifying assets) – pg. 476
      1. Qualifying Assets include:
         1. Home mortgages
         2. Home equity loans
         3. MBS
         4. Education loans
         5. Small business loans
   2. OTS administered SL Holding Company Act, but now no longer exists.
      1. Its powers are listed on pg. 476
   3. **NOTE: on page 478 good breakdown of BHC v. FHC v. UTHCs.** See that graph if you need help.

**POLICY – on pg 479-480 there is a debate over separating banking and commerce.**

* See arguments for and against beginning on pg. 480. (reread this area if you have time. It’s like 4 pages)

**SUBSIDIARIES OF BANKS** pg. 485 (read this if you have time too, post going through outline)

1. **Subsidiary** – a company engaged in nonbanking activities that is controlled by a bank
2. **Whether the BHC Act’s Activities restrictions Apply to Subsidiaries of Banks**
   1. Merchants National – 2nd Circuit held that the BHC Act does not restrict the activities of BHCs subsidiary *banks*, but the court did not decide whether it limited subsidiaries of those BHC subsidiary banks
   2. Citicorp v. Bd of Governors of the Federal Reserve System – Citigroup established life insurance subsidiary through a subsidiary bank (Citibank Delaware) to take advantage of state allowing more insurance activities
      1. BHC Act activity restrictions *may* apply to subsidiaries of subsidiary banks of BHCs
      2. **Ct ruled that Fed lacked authority to restrict activities of subsidiaries of banks.**
3. **Subsidiaries Under Current Law**
   1. **Operating Subsidiaries of Natl Banks –** engage only in activities that a national bank can engage in directly
   2. **Operating Subs of State Banks -** can engage in (as a principal) activities *impermissible* for a subsidiary of a national bank ONLY if
      * 1. The state bank is adequately capitalized AND
        2. The FDIC has found that the activity poses no significant threat to the deposit insurance fund.
   3. **Financial Subsidiaries –** 
      1. **Of national banks may engage in –**ANY financial activity OTHER THAN insurance underwriting, issuing annuities, and merchant banking (real estate development also expressly off limits)[so, can engage in any financial activity national bank can engage in, except for the above limits]
         1. **BUT –** **Six Restrictions and Requirements apply:**
            1. The bank must remain well capitalized and well managed and have a satisfactory CRA rating
            2. Bank must deduct from its regulatory capital every dollar of the bank’s equity investment in financial sub and remain well-capitalized even after deduction
            3. Bank’s transactions with financial sub must comply with §23A and §23B
            4. Aggregate total assets of all financial subs of the bank cannot exceed the lesser of $50 billion or 45% of the banks consolidated total assets.
            5. Bank must prepare alternative financial statements – in addition to regular ones – that do Not consolidate the bank’s assets, liabilities, and earnings with those of the bank
            6. If parent bank is among 50 largest insured banks, it must have outstanding unsecured debt rating of at least A.
            7. THESE 6 safeguards also apply to state member banks
         2. State Non-member Banks
            1. Weaker restrictions apply – top of pg. 491
      2. See pg 490 for more info

**EXAMINATIONS, ENFORCEMENT, AND FAILURES** pg. 627 start

**EXAMINATIONS AND MONITORING**

1. Background
   1. Large number of bank failures in the 1980’s
   2. Why did this breakdown occur?
      1. Examiners have imperfect tools for assessing bank’s safety and soundness and predicting future problems
      2. Structural changes in banking may have rendered examination less effective
      3. Too much reliance on off-site, computerized monitoring
      4. Large caseload of failed banks stressed the regulating force
      5. Activity restrictions were relaxed
      6. Some regulators practiced forbearance – tried to let banks get out of it on their own
   3. Answer to problem: **FIRREA**
      1. Regulatory crackdown
         1. The OCC was the “regulator from hell”
      2. DOJ White Collar Crime Task Force
      3. Funding fees paid by banks
         1. More competitive salaries for examiners
   4. Costs of Added Supervision
      1. Agency costs
      2. Credit crunch
         1. Slowing of the national economy?
         2. Deterring of innovation?
         3. Reducing credit availability to low income borrowers?
2. The Supervisory System
   1. Bank Examinations
      1. Compliance/Safety and Soundness Exam
         1. Once a year
         2. 18 months for small (, $500 million), and healthy banks
         3. State and Federal Exams can alternate years (so Fed can do once every two if state does intervening year)
      2. Specialized Exams (EDP, Trust, CRA)
      3. Examiners must have access to ALL records and employees
   2. Reporting Requirements
      1. Quarterly reports (Call Reports)
      2. Requested reports
      3. Pre-exam letters
      4. Annual independent audit (large banks)
   3. Who examines what?
      1. Each federal banking agency examines those entities for which it is the primary federal regulator.
      2. OCC examines national banks
      3. Federal reserve Board examines BHCs, state member banks,
         1. May also examine national banks
      4. FDIC examines state non-member banks
         1. FDIC may also examine any FDIC insured depository institution if the FDIC’s board finds that it’s necessary to ascertain the bank’s condition for insurance protection purposes
      5. OTS examined thrifts and their holding companies
      6. NCUA examines credit unions
      7. State banking regulators examine banks as they charter.
   4. **Uniform Financial Institution Rating System (UFIRS)**
      1. **CAMELS –** these ratings, whether component or composite, take account of a bank’s size, complexity, types of business, and risk profile.
      2. PAGE 634-635, each of these categories are described in detail. ALSO, page 636 has breakdown of what composite scores mean in Table form. MOREOVER, **pg. 633 has breakdown of Component and Composite Ratings**
         1. **Capital Adequacy** – examiners assess
            1. Extent to which the bank has capital commensurate with the risks it faces, and
            2. Management’s ability to “identify, measure, monitor, and control” those risk.

Thus a bank may need increased capital to offset weakness in risk management.

Examiners consider loan loss reserves, access to capital, plans and prospects for growth

* + - 1. **Asset Quality –** 
         1. denotes the soundness of the bank’s assets (including loans, securities, other investments, and property acquired by foreclosure, and off-balance sheet transactions, all viewed in light of management’s ability to identify, measure, monitor, and control credit risk.
         2. Stated negatively, asset quality refers to existing and potential credit risk.
         3. Examiners weigh:

Any risk affecting the value or marketability of the bank’s assets, including risk of default by borrowers, securities issuers, and others.

Scrutinize banks lending and investment standards, internal controls, and risk-identification and loan-administration practices.

Consider extent to which bank’s asset holdings diversify or concentrate credit risk

* + - 1. **Management** (probably most important/highly weighted – also kind of vague)
         1. This rating reflects ability of bank’s board and senior officers “in their roles, to identify, measure, monitor, and control” risks of banks activities and to assure the bank’s safe, sound, and efficient operation in compliance with applicable laws.
         2. Directors – should provide clear guidance regarding acceptable risk exposure levels, and ensure that appropriate policies, procedures, and practices have been established
         3. Officers – bear responsibility for translating board’s goals, objectives, and risk limits into prudent operating standards.
         4. **Good management-** “active oversight by the Board and management; competent personnel’ adequate policies, processes, controls taking into consideration size and sophistication of the bank; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems.
      2. **Earnings**
         1. Examiners focus on size, trend, and sustainability of the earnings, as well as the adequacy of budgeting systems, forecasting processes, and other management information systems.
         2. Examiners look for things that could undermine future earnings:

Excessive interest rate risk

Excessive or poorly managed credit risk

Poorly managed exposure to other risks

Weak control of expenses

Undue reliance on extraordinary gains, nonrecurring events or favorable tax effects

Poorly executed or ill-advised business strategies

* + - 1. **Liquidity**
         1. Examiners scrutinize bank’s fund management’s practices and compare banks cash needs with its ability to raise cash in a timely manner by selling assets or borrowing from outside sources.
      2. **Sensitivity to Market Risk**
         1. Denotes the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can reduce a bank’s earnings or market value.
         2. Primarily involves interest rate risk for most banks.
    1. How it’s measured:
       1. 1 is the BEST rating, 5 is the WORST
       2. Each category is rated, then a composite rating is determined based off of the collection of those ratings.
       3. The **composite is NOT an average**; the management category is probably the most highly weighted.
       4. **Component –** Strong, Satisfactory, Less than Satisfactory, Deficient, Critically Deficient
       5. **Composite –** sound in every respect, fundamentally sound, some cause for concern, unsafe and unsound, extremely unsafe and unsound
    2. **Disclosure of Ratings**
       1. Disclosed to bank mgmt
       2. Mgmt may share with directors, officers, attorneys and auditors.
       3. No disclosure of exam through FOIA (free. Of info act)
       4. Limited privilege (limited disclosure in litigation)
    3. If Bank disagrees with ratings
       1. Exit interview
       2. Follow-up information
       3. Regional office review
       4. Ombudsman
       5. Enforcement action; agency submits order
       6. Bank consents, OR hearing before ALJ if they do not
       7. Agency reviews ALJs recommendation
       8. Bank appeals to court; which court usually defers to agency, since Chevron deference and APA’s “arbitrary and capricious” standard.
          1. **Note-** generally a bank will consent, because they don’t want to piss their regulator off more.

**ENFORCEMENT** starts on pg.642

1. **Types of Enforcement –**
   1. Conditional Approvals
   2. Written Agreement
   3. Cease-and-Desist Orders
   4. Suspension, Removal, Prohibition of Personnel
   5. Civil Money Penalties
   6. Termination of Insurance
   7. Civil Litigation
   8. Criminal Prosecution
   9. Conservatorship and Receivership (bank failure)
2. **Institution Affiliated Parties - §1818** enforcement statute applies to banks AND “institution-affiliated parties,” which include:
   1. Any director, officer, employee, or controlling-shareholder (other than a BHC) of an FDIC insured depository institution, any agent of such a bank, or a person acquiring control of such a bank
   2. Any shareholder (other than a BHC), consultant, joint venture partner, and any other person as determined by the appropriate federal banking agency who participates in the conduct of the bank’s affairs
   3. Any independent contractor (incl attorneys, appraiser, or accountant)
      1. **Must knowingly or recklessly** (negligence, unlike for the “a.” and “b.” categories, is not enough for these guys) participate in:
         1. Violation of any law or regulation
         2. Breach of fiduciary duty or
         3. Any unsafe or unsound practice
         4. Must also have caused (or be likely to cause
            1. A significant adverse effect on the bank, OR
            2. More than a minimal financial loss to the bank

**Types of Enforcement in more Detail:**

1. **Conditional Approvals**
   1. What triggers conditional approvals?
      1. Acquiring a bank
      2. Engaging in new activities
      3. Opening a new branch
   2. Regulators can impose a broad set of conditions
   3. If a bank violates, it may be followed by a cease-and-desist order, or a civil money penalty.
2. **Written Agreements**
   1. Not enforceable by a court
   2. Can be a basis for a future cease-and-desist or civil penalty
   3. Mostly safety and soundness issues (holding more capital)
   4. Also for money laundering
3. **Cease and Desist Orders**
   1. Two basic grounds:
      1. Unsafe and unsound practice, or
      2. Violation of a statute, regulation, a condition imposed in a writing or by an agency, or violation of a written agreement
   2. **Unsafe or Unsound Practice** – “any action, or lack of action, which is *contrary to the generally accepted standards of prudent operation*, the possible consequences of which, if continued, would be *abnormal risk of loss* or damage to an institution, its shareholders, or the deposit insurance fund.”
   3. **Procedure** –
      1. Notice of charges
      2. Hearing before an ALJ
      3. Decision about whether to issue order and what it should contain
4. **Suspension, Removal, and Prohibition** (of directors or officers)
   1. To remove or prohibit, **must establish three things**:
      1. **Misconduct** 
         1. Violated statute, regulation, or written agreement, or
         2. Unsafe or unsound practice, or
         3. Breach of fiduciary duty
      2. **Effect**
         1. Actual or probable financial damage, or
         2. Actual or probable prejudice to depositors, or
         3. Benefit to the actor
      3. **Culpability**
         1. Personal dishonesty, or
         2. Willful or continuing disregard for safety and soundness
   2. Kim v OTS (CEO charged for bad loans he voted for)
      1. Court held he was NOT culpable because he had no evil intent or recklessness
      2. Some sort of scienter/recklessness is required
      3. Lots of discretion in regulators decision
   3. FDIC v. Meyer (Meyer is forced out of job by FDIC)
      1. If FDIC takes over as a receiver, they can fire employees or management
      2. Meyer alleged 5th amendment
      3. To bring a 5th Amend claim, use a Bivens-type claim:
         1. The Constitution implies a cause of action for money damages against federal agents who violate certain rights
      4. Qualified Immunity – govt officials performing discretionary functions generally are shielded from liability from civil damages if their conduct does not clearly violate
      5. **No Bivens-type action against federal agencies!**
   4. Summary of Control over Officers and Directors
      1. Enforcement powers (suspension, removal, prohibition) of §1818
      2. Prompt corrective action (§1831o) if its significantly undercapitalized bank (see around pg. 665)
      3. FDIC has power as employer after seizing bank
5. **Civil Money Penalties (CMPs)**
   1. **1st Tier – Minor Violations**
      1. Violation of statute, regulation, C&D order, written agreement, or written condition
      2. Maximum fine of $5,000 per day for the duration of the violation
   2. **2nd Tier – More Serious Violations**
      1. **Must show one of three types of misconduct**
         1. First tier violation
         2. Recklessly engaging in unsafe or unsound practice, or
         3. breaching a fiduciary duty
      2. **must ALSO show that misconduct involved certain pattern or effect**
         1. part of a pattern of misconduct
         2. caused/likely to cause more than a minimal loss;
         3. pecuniary gain or other benefit to actor
      3. Maximum Fine - $25,000 per day
   3. **3rd Tier – Very Serious Violation** 
      1. Must prove that person knowingly committed a 2nd tier misconduct/violation
      2. Must also prove that the person knowingly or recklessly caused:
         1. A substantial loss to the institution; or
         2. A substantial pecuniary gain or other benefit to the actor
      3. Maximum Fine - $1 million per day
6. **FDIC’s Backup Enforcement Authority**
   1. FDIC recommends other banking agency take enforcement action
   2. If problem remains unsolved, FDIC board must find:
      1. Unsafe or unsound condition,
      2. Unsafe or unsound practices, or
      3. Conduct poses a substantial risk to the insurance fund
7. **Terminating or Suspending Deposit Insurance**
   1. FDIC may terminate or suspend for any of these grounds:
      1. Unsafe or unsound to continue operation
      2. Institution or its directors have engaged in an unsafe or unsound practice
      3. Institution or its directors have violated statute, regs, C&D, written condition, or written agreement
   2. Existing deposits retain insurance for at least 6 months after the order takes effect to reduce the likelihood of a run
8. **Civil Litigation**
   1. Derivative suits on behalf of the shareholders
   2. Breach of fiduciary duty suits against directors (want to get to director’s insurance!)
9. **Criminal Penalties**
   1. Bribing bank examiners
   2. Taking kickbacks for loans
   3. Embezzling money
   4. Falsifying bank books
   5. Money laundering
   6. Obstructing a criminal investigation of a bank or customers
   7. Obstructing examination of a bank
   8. Making a false statement to influence a credit decision
   9. Bank fraud

**BANK FAILURES** pg. 693-707, and pg.729-737

1. Introduction
   1. Bank failures are NOT covered by the Bankruptcy Code
      1. However, BHCs and affiliates are covered
   2. General Bank failure Proceeding
      1. Appoint a receiver marshal the bank’s assets
      2. Pay claims in order of priority
   3. Who closes a financial institution?
      1. The chartering agency (state or federal)
      2. The FDIC
      3. The OTS for state thrifts & NCUA for state credit unions
      4. The institution may close itself (not likely prob)
   4. Grounds for Receivership pg. 700
      1. Bank has obligations exceeding its assets
      2. Bank cannot meet obligations in normal course of business
      3. Unsafe or unsound condition to conduct business
      4. Critically undercapitalized or otherwise has insufficient capital
      5. The bank is undercapitalized and has
         1. No reasonable prospect of becoming adequately capitalized
         2. Failure to recapitalize when ordered to do so under the Prompt Corrective Action statute
         3. Fails to submit a timely and acceptable capital restoration plan, OR
         4. Materially fails to implement a capital restoration plan
      6. Bank substantially dissipates assets or earnings through a violation of statute or reg or thru unsafe/unsound practice
      7. Conceals records or assets; refuses to produce them in exam
      8. Willfully violates a cease and desist order
      9. Money laundering crimes
      10. Loses FDIC insurance
      11. Bank consents to closing/receivership (or conservatorship)
   5. Due Process when Closing
      1. Normally done without notice or hearing
         1. Insufficient capital gives management incentives to take extra risks (dispose of assets to favored creditors, bet remaining assets on risky venture, take remaining assets for personal use etc)
         2. Could trigger a run on the bank
      2. DOES require a prompt post-seizure hearing
2. Appointing a Receiver
   1. Franklin Savings v Director of OTS
      1. The scope of review is ordinarily limited to the agency record before the director at the time he made his decision to appoint a conservator (“upon the merits”)
      2. Standard of Review – an appointment decision may only be set aside if the decision is “arbitrary, capricious, or an abuse of discretion, or otherwise not in accordance with the law”
      3. 12 USC §1464(d)2(B) – director has discretion to appoint conservator ex parte and without notice; Court shall decide upon the merits, whether to dismiss such action or direct the director to remove such conservator.
3. Resolution Procedures pg.729
   1. Open Bank Assistance – give money through loans or capital infusion to keep the bank liquid
   2. Conservatorship – agency operates bank as a going-concern and bank entity still exists
   3. Receivership- **resolution options** –
      1. Straight liquidation (deposit payoff) – FDIC liquidates bank’s assets and pays the banks liabilities (either as whole or piecemeal)
      2. Insured deposit transfer – FDIC pays a healthy bank to assume the failed bank’s insured deposits
      3. Purchase and assumption transactions (with loss agreements) – FDIC arranges for an acquirer to purchase some or all of the failed bank’s assets and assume some or all of the failed bank’s liabilities
      4. Bridge banks and new banks –
         1. Bridge bank to carry on failed bank’s business until they find an acquirer
   4. FDIC must wind up bank consistent with **least cost resolution requirement**
      1. **12 USC §1823(c)4-** FDIC must adopt resolution method “least costly to deposit insurance fund”
      2. To identify it, fdic must “evaluate alternatives on a present-value basis, using a realistic discount rate and document the evaluation and the assumptions on which it is based.
      3. Systemic Risk exception- may wind down in manner other than least costly if resolution of particular bank would have serious adverse effects on economic conditions or financial stability (more info on pg.731-32)
4. Systemic Risk – pg. 732 [just an article about “what is systemic risk”]
   1. Cascades
   2. Contagion
   3. Asset Implosions

**Go Buckeyes!**