Delaware Banker
The Quarterly Publication of the Delaware Bankers Association

Proposed Financial Institution Regulatory Reforms

Repair or Complete Remodeling?

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In response to the current economic crisis and near failure of the financial system, President Barack Obama and the members of his administration (the "Administration") have proposed sweeping regulatory reforms of the financial services industry.[1] The Administration's numerous proposals (the "Proposals"), set forth in a white paper released to the public on June 17, 2009, target weaknesses and gaps that the Administration perceives in the current regulatory structure with a five-pronged approach: 1) promoting the robust supervision and regulation of financial firms; 2) establishing comprehensive supervision of financial markets; 3) protecting consumers and investors from financial abuse; 4) providing the government with the tools it needs to manage financial crises; and 5) raising international regulatory standards and improving international cooperation.[2]

The Proposals read like a wish list of federal financial legislation, covering areas as diverse as consumer protection, charter options, insurance, securitization, derivatives, hedge funds, futures, systemic risk, capital standards, consolidated supervision, crisis management, accounting standards and international cooperation. Some proposals promise to be more hotly contested than others, but legislation based on the Administration's Proposals is already being considered in the U.S. House of Representatives.[3] Some of these proposed reforms are likely to have a significant impact on Delaware banks and trust companies. This article discusses certain aspects of the Administration's Proposals that are likely to have a significant effect on the Delaware banking community.

Elimination of the Federal Thrift Charter

One of the more controversial proposals of the Administration is the elimination of the federal thrift charter. Under the Administration's proposal, all current federal savings institutions would be required to convert to other types of financial institutions.[4] The federal thrift charter is actively utilized by Delaware financial institutions, for both banking and trust activities.

An overarching goal of the Administration's Proposals is to reduce or eliminate charter arbitrage opportunities. The Administration believes that the original goal of the federal thrift charter, which was created during the Great Depression to ensure the availability of residential mortgage credit, is no longer necessary. In addition, the Administration seeks to abolish existing exceptions to the Bank Holding Company Act of 1956 to prevent parent companies of federally insured trust companies from being regulated as bank holding companies.[5] These trust companies would mostly include federal thrift trust banks, as the Office of Thrift Supervision generally requires federal savings associations that engage only in trust or other fiduciary activities to obtain federal deposit insurance.[6] National banks would remain intact under the Proposals, but a new National Bank Supervisor would be created with supervisory responsibility for all federally chartered depository institutions.[7]

Uniform Financial Services Regulation

As part of the overarching principle of the Administration's Proposals to eliminate opportunities for arbitrage within the regulatory systems, the Administration's Proposals reflect the concept that all financial regulation should be synthesized and coordinated, such that all financial institutions are subject to the same supervisory and regulatory standards.[8] To further reduce arbitrage opportunities between remaining bank charter opportunities and supervisors, in addition to the elimination of the federal thrift charter, the Administration proposes to reduce the substantive regulatory and supervisory policy differences that apply to national and state banks. This reflects an intention to increasingly federalize bank regulatory law, unless states adopt more uniform regulation.

For instance, the Administration has submitted proposed legislation to Congress creating a central Consumer Financial Protection Agency (the "CFPA") with sole federal authority to adopt and enforce uniform consumer protection regulations that act as a regulatory floor.[9] The Financial Services Committee of the U.S. House of Representatives is already considering legislation for the creation of a CFPA.[10]

Under the Administration's Proposals, states would be able to adopt more restrictive consumer protection laws than regulations promulgated by the CFPA, and such states laws would apply to all charter types. This suggests the end of federal preemption of state consumer protection laws with respect to federally chartered financial institutions such as national banks. States would also have the ability to enforce both state and federal consumer protection laws and regulations against institutions of all charter types. However, any state law or regulation that is less restrictive or otherwise inconsistent with the federal regulations promulgated by the CFPA would be preempted. Although the content of consumer regulation is not defined in the Proposals or the draft CFPA legislation prepared by the Administration, indications are that it would cover items far broader than recent federal credit card and mortgage legislation, and perhaps extend to "contract terms", which potentially could include usury rates.[11]

Consolidated Bank Holding Company Regulation

The Proposals set forth a fundamental adjustment in the concepts of bank holding company regulation throughout the hierarchy of a banking organization. Under the Proposals, regulation would focus more heavily on the safety and soundness of the banking organization as a whole and the risks the banking organization may pose to the financial system. This suggests that any specific activities of a bank subsidiary or a nonbank subsidiary within a bank holding company structure would be analyzed not only under specific legal authority as it applies to that entity and that activity, but that greater consideration must be given to what effect the activity would have on the affiliated banking organization as whole and on the broader financial system. Even greater consolidated regulatory scrutiny would apply to the largest financial firms, or those that are so interconnected to the financial system that their failure could pose a threat to its stability, regardless of whether such financial firms own an insured depository institution.

Eliminating Restrictions on Interstate Branching

To further promote uniform rules for banks, the Administration seeks to remove restrictions on interstate branching that states were permitted to impose on out-of-state banks as part of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal").[12] In particular, under Riegle-Neal, a state can effectively (i) prohibit an out-of-state bank from establishing de novo branches within the state, (ii) require an out-of-state bank or bank holding company to acquire an entire bank rather than just a single branch within such state in an acquisition, and (iii) require that banks located within such state exist for up to five years before the bank or any of its branches can be

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acquired by an out-of-state bank or bank holding company. All of these permissible restrictions would be eliminated under the Administration's Proposals.

Delaware law currently does not permit out-of-state banks to branch de novo into Delaware. Additionally, Delaware law does not permit an out-of-state bank or bank holding company to acquire by merger or acquisition a single branch of a bank; it requires the acquisition of an entire bank which must have been in existence for at least five years. These restrictions have the effect of increasing the barriers to entry into the Delaware banking market. As a result, the Administration's proposal to remove these restrictions would have the effect of increasing competition among banks in Delaware.

On the other hand, Delaware's restrictions on interstate branching also have the effect of restricting the ability of Delaware banks to branch into other states. For example, many states that permit de novo branching only permit it on a reciprocal basis (i.e., Delaware banks are only permitted to branch de novo into such other state if that other state's banks can branch de novo into Delaware). The federal preemption of state interstate branching restrictions would allow Delaware banks to expand more easily into other states. Additionally, Delaware's interstate branching restrictions are one aspect of Delaware law that can cause Delaware to be a comparatively less attractive location for the types of banks that require the flexibility to branch nationwide. The Administration's proposal to eliminate these branching restrictions, in and of itself, could have the effect of increasing the attractiveness of Delaware as a jurisdiction in which to headquarter these types of banks.[13]

Credit Card Banks

Currently, institutions that are federally insured but engage solely in credit card operations and do not accept deposits of less than $100,000 can qualify for an exception from the definition of "bank" in the Bank Holding Company Act.[14] As a result, companies that own these banks are not necessarily regulated as bank holding companies. As with federally insured limited purpose trust banks, the Administration is proposing to eliminate this exception to the Bank Holding Company Act for credit card banks, such that any company owning a credit card bank would be regulated as a bank holding company.[15] These companies would be given five years to conform to the activity restrictions imposed by the Bank Holding Company Act.

This exception to the Bank Holding Company Act for credit card banks was popular at one time among retailers issuing private label credit cards, with some issuers operating credit card banks in Delaware. The issuance of private label credit cards by retailers through proprietary credit card banks has significantly decreased in recent years, with the vast majority of retailer cards now being issued by the private labeling programs of third party banks. Imposing burdensome bank holding company regulation and activity restrictions on retailers issuing these cards through proprietary credit card banks would further drive this business to third party banks.

Securitization Markets

The Administration's Proposals would affect the securitization markets in several ways — and perhaps in ways that serve to breathe new life back into the markets. First, the Administration is proposing a requirement that originators or sponsors retain an economic interest in at least 5% of the credit risk of securitized credit exposures, with the inability to hedge or otherwise transfer such risk. Regulators would have the authority, however, to adjust these requirements and specify the form of risk retention consistent with safety and soundness principles.

The Proposals also call for increased transparency of information in securitization transactions, with the general goal of ensuring that participants completely understand the transaction and the particular assets and risks associated with a particular securitization. Such transparency would include the disclosure of loan-level data, organized by broker or originator. Further, the Administration proposes to strengthen the regulation of credit rating agencies to provide investors with clearer ratings information that, among other things, identifies the risks being assessed, permits comparison across products and credit ratings, and differentiates the risks of structured credit products from the risks of unstructured debt. The Proposals also call for the alignment of compensation paid to securitization participants, including linking compensation to the long-term performance of assets.

Conclusion

Given the significant disruptions we have seen in the financial system as a result of the current economic crisis, there is little doubt that some changes in that system are inevitable. The Administration has proposed diverse and fundamental restructuring of banking regulation as we know it. Many of these proposals, which call for more and uniform regulation of banks across federal and state regulatory regimes, could have a significant impact on the financial industry in Delaware. In the near future, it will become clear which of these proposals will gain the momentum to move forward to change the regulation of financial institutions, and it is important that the members of the Delaware banking community understand how these changes may affect their business.

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Notes:

1 *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, available at http://www.financialstability.gov/roadtostability/regulatoryreform.html.

2 Timothy Geithner (Secretary, Dept. of the Treasury), "Testimony on the Administration's Proposal to Modernize the Financial Regulatory System before the Senate Committee on Banking, Housing, and Urban Affairs," (June 18, 2009).

3 See, e.g., Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong., 1st sess. (2009).

4 See *Financial Regulatory Reform*, at 32-33. Under the legislative language proposed by the Administration, each federal savings association would be given six months after the enactment of the legislation to notify the newly-formed National Bank Supervisor of its new charter choice. See "Federal Depository Institutions Supervision and Regulation Improvements Act of 2009," available at http://treasury.gov/press/releases/reports/titleiii_natlbanksupervisor_072309.pdf. Representative Barney Frank, Chairman of the Financial Services Committee of the U.S. House of Representatives, among others, is an advocate to retain the thrift charter, although he advocates the supervision of both thrifts and national banks under a single, new federal regulator. See, Jessica Holzer, *U.S. Thrift Charter May Be Hard to Kill*, Wall St. J., June 25, 2009, available at http://online.wsj.com/article/BT-CO-20090625-706073.html.

5 See "Bank Holding Company and Depository Institution Regulatory Improvements Act of 2009," available at http://treasury.gov/press/releases/reports/title%20vi%20bhca%20amndts%20%200722%20fnl.pdf.

6 See Home Owners Loan Act, 12 U.S.C. § 1464 (n) (2008). The Office of the Comptroller of the Currency does not require national trust banks chartered under its authority to obtain federal deposit insurance, and most do not. See 12 U.S.C. § 1813 (a)(2)(A) (2009) (exempting trusts from the definition of banks that are automatically insured by the Federal Deposit Insurance Corporation).

7 See "Federal Depository Institutions Supervision and Regulation Improvements Act of 2009," available at http://treasury.gov/press/releases/reports/titleiii_natlbanksupervisor_072309.pdf.

8 *Financial Regulatory Reform*, at 5-6, 19 & 33.

9 See "Consumer Financial Protection Agency Act of 2009," available at http://www.financialstability.gov/docs/CFPA-Act.pdf.

10 See Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong., 1st sess. (2009).

11 In particular, the Proposals question whether mandatory arbitration clauses in agreements governing consumer financial services, which are common, should be restricted or banned entirely. See *Financial Regulatory Reform*, at 62.

12 Pub. L. No. 103-328, 108 Stat. 2338 (Sept. 29, 1994).

13 There are many other considerations relevant to choosing the best jurisdiction in which to locate a bank. Additionally, some of these considerations, such as perceived home state advantages, may become less important to this analysis if state banking and consumer regulation is increasingly harmonized, either through federal legislation that preempts state law or the adoption of uniform laws by the states.

14 See 12 U.S.C. § 1841 (c)(2)(F) (2009).

15 See "Bank Holding Company and Depository Institution Regulatory Improvements Act of 2009," available at http://treasury.gov/press/releases/reports/title%20vi%20bhca%20amndts%20%200722%20fnl.pdf.