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Legal Counsel to the
Financial Services Industry

The Dual Banking System

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Course Overview

- Background – A brief history of banking regulation
- Key banking terminology
- “Dual banking system” concept
- Federal and state supervisory structures for regulating financial institutions
  - Current
  - Future state

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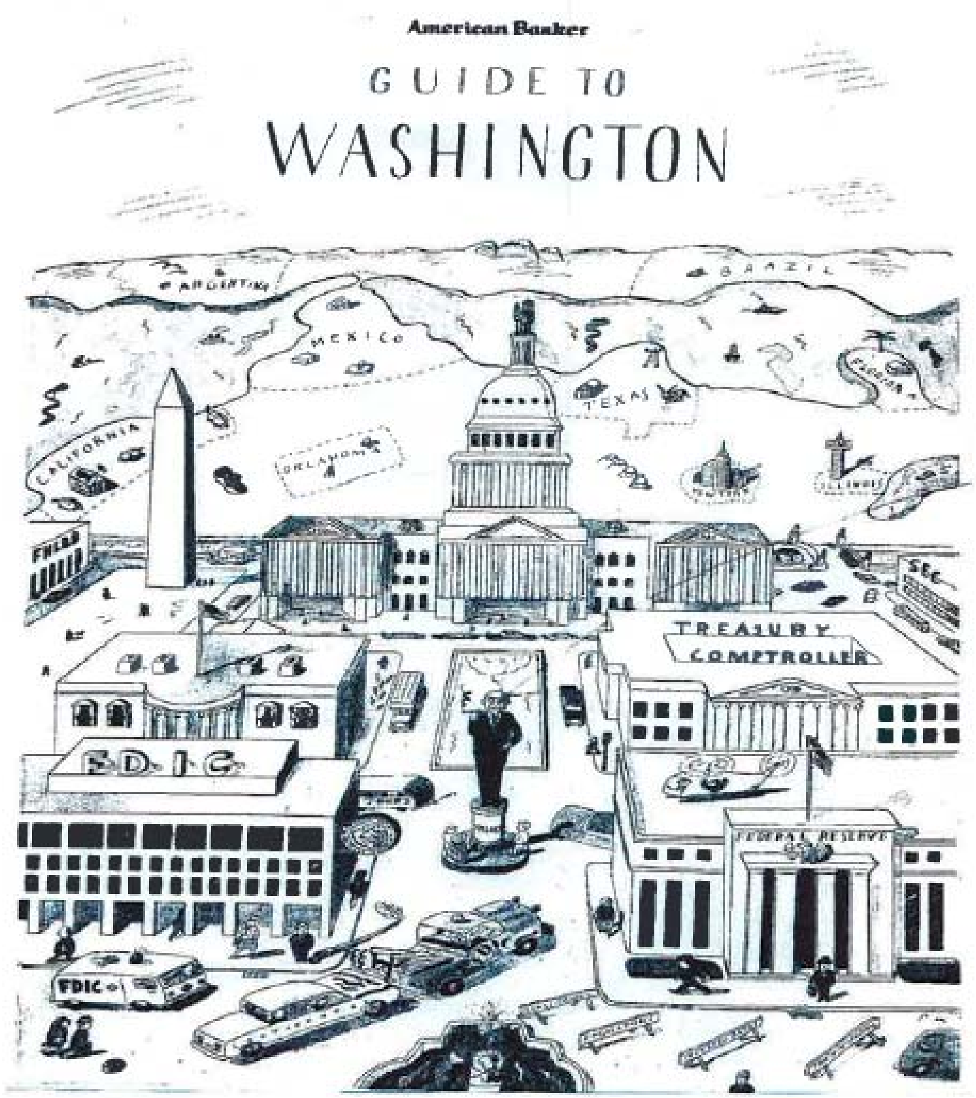
Background

- A safe and sound banking system is key to the health of the U.S. economy and financial markets.
- In the mid-19th through early 20th centuries, periodic financial panics led to failures of a large number of banks and subsequent disruptions in the U.S. banking system and economy.
- Due to the complexity of banking and the need for consumer protection, supervision and regulation of depository institutions and bank holding companies became necessary.
- Over the past century, banking has become highly regulated at both the federal and state level.
- The S&L crisis of the late 1980's and the economic meltdown of 2007-2008 led to even more significant banking legislation (FIRREA, FDICIA and the Dodd-Frank Act).

A "Bird's Eye" View of Washington



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Key Terminology

- **Depository institution** - any federal or state-chartered bank or savings association.
- **Insured depository institution** – any bank, savings association or credit union the deposits of which are insured by the FDIC.
- **Bank holding company** – any company (including a bank) that has direct or indirect control of a bank, including foreign banking organizations that own/control a U.S. bank or branch
- **Financial holding company** – a bank holding company that is permitted to engage in expanded powers under the Gramm-Leach-Bliley Act of 1999.

Key Terminology (cont.)

- **National banks** – Chartered and regulated by OCC; required by law to be members of the Federal Reserve System.
- **State member banks** – State-chartered commercial banks that have elected to become members of the Federal Reserve System.
- **State nonmember banks** – State-chartered commercial banks that do <u>not</u> elect to become members of the Federal Reserve System. Regulated by the FDIC.
- **Thrifts** – Federal or state-chartered; also known as savings associations, savings and loan associations, or savings banks. Original purpose of charter was to encourage consumer savings/home ownership.

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Key Terminology (cont.)

Regulation v. Supervision

Terms often used interchangeably, but refer to distinct and complementary activities:

Regulation

Development and issuance by authorized agencies of specific rules and regulations, under governing law, for the structure and conduct of banking business.

Supervision

Concerned primarily with "safety and soundness" of individual banks and bank holding companies. Involves general and continuous oversight to ensure that banks are operated prudently and in accordance with applicable laws and regulations.

Regulation v. Supervision

In ***supervising*** national banks, the federal banking agencies have the power to:

- Examine banks.
- Approve or deny applications for new charters, branches, capital or other changes in banking structure.
- Take enforcement actions against banks that do not comply with laws/regulations or that otherwise engage in unsafe or unsound banking practices.

<u>Examples</u>:

- Memoranda of understanding (MOUs)
- Cease and desist orders
- Civil money penalties
- Removal of officers and directors
- Termination of deposit insurance

Dual Banking System Concept

- By law, Congress has provided for the chartering, supervision and regulation of banking organizations at both the <u>federal</u> and <u>state</u> levels.
- Federal and state governmental bodies share responsibility for regulating and supervising depository institutions to ensure a safe and sound U.S. banking system.
- Bank organizers may choose a federal or state charter.
  - May create “forum” shopping
- Until the *Clearinghouse* case and the Dodd-Frank Act of 2010, federally chartered institutions enjoyed the privileges of federal preemption (preemption of state laws).

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Financial Institution Regulators: Current Structure

<u>Federal banking regulation and supervision</u>

Current Structure:

- Board of Governors of the Federal Reserve and the Federal Reserve System ("Fed" or "Federal Reserve")
- Federal Deposit Insurance Corporation ("FDIC")

Treasury Department bureaus:

- Office of the Comptroller of the Currency ("OCC")
- Office of Thrift Supervision ("OTS")

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Financial Institution Regulators: Current Structure (cont.)

State banking regulation and supervision

State chartered banks are regulated by banking commissioners/agencies within each of the 50 states.

Credit union regulation and supervision

National Credit Union Administration ("NCUA")

- Charters and supervises federal credit unions.
- Insures savings in federal and most state-chartered credit unions through the National Credit Union Share Insurance Fund ("NCUSIF").
- Similar in function to FDIC.

Federal Reserve System

Federal Reserve System was created by Congress in 1913 through the Federal Reserve Act.

- Board of Governors of the Federal Reserve Board; and
- 12 Federal Reserve Banks
  - Located in major cities (New York, Boston, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, St. Louis, Kansas City, Dallas and San Francisco)

* Functions as the “independent” central bank of the U.S.

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Federal Reserve System (cont.)

Supervision and Regulatory Functions

Primarily responsible for supervising and regulating financial holding companies, bank holding companies and state member banks.

Also supervises:

- Non-bank subsidiaries of bank holding companies
- U.S. branches and agencies of foreign banking organizations and their parent banks
- Edge Act and agreement corporations

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Federal Reserve System (cont.)

<u>Board of Governors' Responsibilities:</u>

- Formulates monetary policy
  - Sets reserve requirements and approves discount rates
  - Through Federal Open Market Committee, directs open market operations (buying/selling U.S. government securities), a primary instrument of monetary policy
- Primarily responsible for interpreting and enforcing consumer protection laws (e.g., ECOA and TILA) and issuing implementing regulations (Regs A-GG)
- Issues regulations governing foreign activities of U.S. banks and U.S. activities of foreign banks
- Oversees Federal Reserve Banks

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Federal Reserve System (cont.)

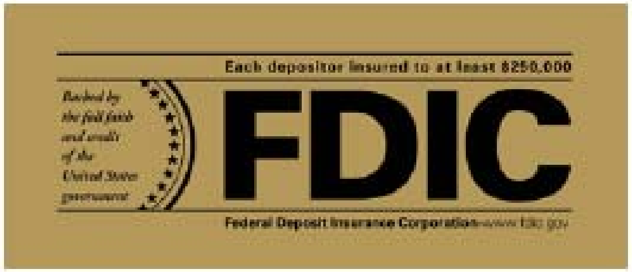
Federal Reserve Banks' Responsibilities:

- Distributes U.S. coin and currency
- Administers national payments mechanism
  - Check processing
  - ACH transactions
- Supervises and examines bank and bank/financial holding companies

Federal Deposit Insurance Corporation ("FDIC")

- Created by Congress through the Federal Deposit Insurance Act of 1933 in response to widespread bank failures of the Great Depression.
- Serves as an independent agency of the Federal government
- Preserves and promotes public confidence in the U.S. financial system by:
  - Insuring deposits in banks and thrifts up to $250,000;
  - Identifying, monitoring and addressing risks to the deposit insurance funds; and
  - Limiting the effect on the U.S. economy and financial system when a bank or thrift fails

FDIC (cont.)



- The FDIC is managed by a five-person Board of Directors, which meets monthly:
  - Chairman and Vice chairman, FDIC
  - Director (independent)
  - Comptroller of the Currency (OCC)
  - Director, OTS
- All are appointed by the President and confirmed by the Senate; no more than three may be from the same political party to ensure bipartisanship.
- Headquartered in Washington, D.C. with 8 regional offices

FDIC (cont.)

Responsibilities

- Insures monetary deposits at FDIC-insured depository institutions
  - Administers Deposit Insurance Fund (DIF)
  - Securities, mutual funds and similar types of investments are NOT insured by the FDIC or NCUA
- Supervises state nonmember banks (approx. 4,800)
  - "Back-up" enforcement authority for all other depository institutions
- Resolves failures of banks and thrifts
  - Most common option is to sell deposits and loans to another depository institution

Treasury Department Bureaus

- Office of the Comptroller of the Currency
- Office of Thrift Supervision

Office of the Comptroller of the Currency ("OCC")

- Established in 1863 as a bureau of the U.S. Dept. of Treasury under the National Bank Act.
- OCC is headed by the Comptroller of the Currency, who is appointed by the President, with advice and consent of the Senate, for a five-year term.
- Headquartered in Washington, D.C., with four district offices plus an office in London to supervise international activities of national banks.

Responsibilities:

- Charters, regulates and supervises all national banks (approximately 1500, incl. 45 large banks).
- Supervises 50 federal branches and agencies of foreign banks.

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Office of Thrift Supervision ("OTS")

- Established in 1989 as a bureau of the U.S. Dept. of Treasury.
  - Previously known as FHLBB/FSLIC, which was reorganized in response to S&L crisis.
- Headed by Director nominated by President with advice and consent of Senate.
- Headquartered in Washington, D.C. with four regional offices

Office of Thrift Supervision ("OTS")

Responsibilities

- Primary regulator and supervisor of all federally chartered thrifts, which include savings associations and savings banks.
- Shares with states the supervision of state-chartered thrifts.
- Also regulates and supervises savings and loan holding companies.

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Federal Financial Institutions Examination Council (“FFIEC”)

- Serves as “umbrella” organization for four federal banking agencies and NCUA.
- FFIEC was established in 1979 to prescribe uniform principles, standards and report forms for federal examination of depository institutions and to make recommendation to promote uniformity in the supervision of depository institutions.
- FFIEC was given statutory responsibilities by Housing and Community Development Act of 1980 to facilitate public access to HMDA data and aggregation of annual HMDA data.
- Increasingly important role as interagency initiatives and guidance proliferate.

Other Federal Regulators

- Dept. of Housing and Urban Development (“HUD”)
  - Enforces Fair Housing Act and RESPA
- Dept. of Justice (“DOJ”)
  - Federal banking agencies must refer “pattern and practice” violations of fair lending laws to DOJ
- Securities and Exchange Commission (“SEC”)
  - Regulates mortgage-backed securities (e.g., Reg AB)
- Federal Crimes Enforcement Network (“FinCEN”)
  - Treasury Dept. bureau; interprets and enforces anti-money laundering laws
- Federal Trade Commission (“FTC”)
  - Enforces federal unfair and deceptive trade practices law for non-banks

State Regulatory Agencies

- Each of the 50 states has its own banking department; typically led by a state Banking Commissioner.
- **Conference of State Bank Supervisors ("CSBS")**
  - Functions as an extension of each state banking department.
  - Advocates dual banking system and seeks to represent a unified voice on state regulation in Washington, D.C.
- CSBS works to:
  - Optimize the authority of individual states to determine the activities of their financial institutions.
  - Enhance the professionalism of state banking departments and their personnel.
  - Represent the interests of the state banking system to federal and state legislative and regulatory agencies.

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Sea Change: Dodd-Frank Wall Street Reform & Consumer Protection Act

In 2010, Congress enacted the Dodd-Frank Act, a broad and complex statute that creates a sweeping new financial services regulatory regime.

Six areas of legislative focus:

- New risk-based approach to financial services regulation
- New regulation of systemically risky institutions
- Increased bank supervision
- Increased focus on consumer protection
- Limits on bank investments and related activities
- Heightened regulation of mortgage lending

* Many rulemakings and studies required to fully implement Act.

Financial Institution Regulators: Future State

<u>Federal banking regulation and supervision</u>

Future Structure:

- FDIC
- Board of Governors of the Federal Reserve
  - Consumer Financial Protection Bureau, an independent bureau within the Federal Reserve

Treasury Department bureau:

- OCC
- [OTS abolished]

Financial Institution Regulators: Future State (cont.)

State banking regulation and supervision

Same as current; state chartered banks are regulated by banking commissioners/agencies within each of the 50 states.

Credit union regulation and supervision

- NCUA will continue to charter and supervise federal credit unions and administer the NCUSIF.
- All consumer financial protections functions of NCUA will be transferred to CFPB.

New Risk-Based Supervision

The federal banking agencies, and the Federal Reserve in particular, are given extensive new risk-based authorities under Dodd-Frank to:

- Monitor the systemic safety of the financial system and to take proactive steps to reduce/eliminate such threats.
- Impose strict controls on large bank holding companies with total consolidated assets of at least $50B (“large BHCs”) and systemically significant nonbanks supervised by the Fed (“significant nonbanks”) to limit risk.
- Take direct control of troubled financial companies that are considered systemically significant.

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New Regulation of Systemically Risky Institutions

Dodd-Frank also establishes several new entities and a statutory liquidation process to deal with systemically risky institutions:

- New Financial Stability Oversight Counsel established to monitor systemic financial risks.
  - Identify potential systemic threats
  - Direct regulatory agencies to take action
- Fed may impose increased capital and liquidity requirements on large BHCs and significant nonbanks.
- New process established for federal agencies to place large BHCs and significant nonbanks into an FDIC-operated receivership structure similar to the one that exists for banks.

Increased Bank Supervision

Dodd-Frank also restructures the supervision of holding companies and depository institutions in several ways:

- Eliminates OTS and reallocates S&L holding company supervision to the Fed, federal savings institution supervision to the OCC, and state savings institution supervision to the FDIC.
  - Thrift charter preserved; new charters may be issued by OCC
- Enhances Fed's ability to examine non-bank subsidiaries (e.g., mortgage affiliates) and allows other bank regulators to examine and take enforcement action against such entities.
- Directs federal banking agencies to develop capital requirements for both holding companies and depository institutions to address activities that pose risk to the financial system.

Focus on Consumer Protection: The New Consumer Financial Protection Bureau

Dodd-Frank establishes the Bureau of Consumer Financial Protection (otherwise known as the Consumer Financial Protection Bureau or CFPB)

- The CFPB will be housed within the Fed as an independent agency
- Director of CFPB will be appointed to a 5-year term by President and must be confirmed by the Senate
- Director will serve as member of the following:
  - Financial Stability Oversight Council
  - FDIC Board of Directors
  - FFIEC
- Director must appear before Congress semi-annually to report on activities of CFPB and state of consumer financial protection

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Focus on Consumer Protection: The New Consumer Financial Protection Bureau

- CFPB will assume responsibility for most federal consumer protection laws from the other federal banking agencies and NCUA (except the Community Reinvestment Act) as of July 21, 2011 ("Transfer Date")
- Will issue rules for federal consumer protection laws for all banks and non-banks engaged in financial services (with some exceptions)
  - Financial Stability Oversight Council will have authority to overrule a CFPB regulation in very limited circumstances

Consumer Financial Protection Bureau (cont.)

- CFPB will have authority to supervise, examine and take enforcement actions with respect to:
  - Depository institutions with more than $10B in assets; and
  - Nonbank mortgage industry participants and other CFPB-designated nonbanks
- CFPB will draft and issue new consumer protection rules, but the prudential (safety and soundness) federal bank regulatory agencies will retain primary examination and enforcement authority for depository institutions with $10B or less in assets

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Consumer Financial Protection Bureau (cont.)

- Dodd-Frank requires the CFPB to establish a new Office of Fair Lending & Equal Opportunity and several other departments
- The CFPB will have broad authority to curb practices it finds unfair, deceptive or abusive
  - "Abusive" standard may be broadly defined
  - Likely to increase litigation for financial institutions
- Federal preemption
  - Increases potential for state intervention in federally-chartered institutions operations by creating new procedural hurdles to preemption determinations;
  - Narrows circumstances in which preemption would apply; and
  - Provides statutory authority for state law enforcement authorities with respect to federally chartered depository

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Internet Resources

Federal bank regulatory agencies

Federal Reserve: www.federalreserve.gov

FDIC: www.fdic.gov

OCC: www.occ.treas.gov

OTS: www.ots.treas.gov

FFIEC: www.ffiec.gov

State banking agencies

Each state has its own website

Also see Conference of State Bank Supervisors (www.csbs.org)

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Conclusion

Q & A