# OUTLINE: Bank Regulation in a Time of Crisis

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##

## Remember

\*Check the statutory scheme:

1. Bank Powers under NBA
2. Fed Reserve Act 23A: affiliates and covered transactions rules
3. Prudential Rules: Insider Loans

### The Equation (Equity, Assets, Debt, Loans, Deposits, Reserves, Capital)

\*Equity = Assets – Debt

\*equity = amount by which a firm’s total assets (what firm owns) exceed the firm’s total liabilities (what the firm owes)

\*equity = what would remain if a firm paid off all of its creditors

\*Equity = Capital

\*Illiquid: Loans & Deposits: can be used to explain what a bank is: financial intermediaries

\*Liquid: Reserves & Capital: address the instability in banking. Reserves are for liquidity; Capital is for solvency problems.

### Model Bank Balance Sheet &

|  |  |  |
| --- | --- | --- |
|  | **Assets** | **Liabilities** |
|  | Loans: $10K(illiquid assets) | Deposits: $10K |
|  | Reserves: $1K(liquid assets) | Capital: $1K |

# Banks’ role in the Money Supply

\*NB: Gov’t controls money supply 2 ways: prefers monetary policy b/c reserve reqts clunky: hard to adjust, need to be monitored, etc.

### Money Supply

\*CONCEPT: gov’t increases liquidity by buying illiquid assets (T-bills) w/ liquid assets

1. Buy or sell U.S. Treasuries

2. Loan money to or accept repayment from banks

3. Reduce or increase reserve requirement

\****Formula: total money created = HPM/reserve ratio***

\*def *high-powered money*: when Fed adds reserves, it creates money at a multiple of the amount added

\*I.e., Fed loans $10k to Bank A (i.e., it buys Bank A’s stockpile of gov’t bonds); how much money does this create?

🡪Injection of $10,000 in HPM & reserve ratio of 10%, ∴ $10,000/0.1 = $100,000

🡪creates $100K but bank must keep $10K on hand, so injects $90k into markets

## Safety and Soundness

\*Types of risk: liquidity risk; interest rate risk; strategic/business risk; credit risk; operational risk; market risk

### Liquidity Risk: What’s Bad About Bank Runs

\*How bank runs spread

1. Interbank exposures: distress in bank 1 can spread to bank 2: 1 in distress calls in its loan on 2, now 2 is in distress!
2. Information comes out
3. Macro conditions

\*Ways to mitigate Bank Runs

1. Internal controls
2. Reserve requirements: Traditional; Basel III; Narrow banks (100 in deposits = 100 in reserves)
3. Suspension of withdrawals: Pursuant to notice; In violation of contract; Bank “holidays”
4. Liquidity provision; CB lending; CB open market operations
5. DI

### Reserve Requirements

\*def *Reserves*: “vault cash” or a balance at the fed

\****Reserve Requirement Formula***

\*0 to $10.7M: 0% req’t

\*$10.7M-55.2M: 3% req’t

\*$55.2M-plus: 10%

### \*NB: upper bound is $71M as of 12/29/11

\*def: *fed funds rate*: rate that banks charge one another for overnight, unsecured lending

\*If rate is 0, Fed can’t do anything: if too many excess reserves, no one wants to buy them!

\*2008: over $1T in reserves: Fed flooded the market with easy credit, banks just hoarded it: can lead a horse to water!

\*Solution: Compel banks to lend? Doesn’t work.

\*Solution: Quantitative Easing: flood credit in the market, even after rate is 0.

🡪Danger: inflation: reserves come off banks’ books into economy

🡪Solution: Fed can control inflation: can now pay interest on reserves at the fed: discourage banks from making loans by raising interest that it pays banks to hold reserves

\*Basel III: LCR: *Liquidity Coverage Ratio*: for 30 days of stress

\*Formula: (stock of high quality liquid assets) / (net cash outflows over a 30-day stress period) ≥ 100%

\*Level 1 high quality liquid assets (any %): e.g., cash; central bank reserves; marketable securities

\*Level 2 high quality liquid assets (up to 40%): expect a 15% haircut: only count 85% of their value

\*e.g., marketable securities; certain corporate bonds & covered bonds (i.e., regulated)

\*Net cash outflows = outflows – inflows

\*inflows: can only include if sure thing (e.g., mortgage is fully performing)

\*inflows limited to 75% of outflows: assume 25% drop in inflows

\*Basel III: NSFR: *Net Stable Funding Ratio* (for 1 year of stress) = ASF > RSF

\*goal: limit over-reliance on short-term wholesale funding during times of buoyant market liquidity

\*def: “*available stable funding*” (ASF): financing expected to be reliable sources of funds over a one-year stress period

\*a bank’s capital; preferred stock; etc.

\*def: “*required stable funding*” (RSF): illiquid assets: the % of bank’s assets that can *not* be monetised quickly

\*Narrow banks: a.k.a.: 100% reserve bank: only transaction accounts, no loans.

\*One corp. can have a narrow bank and a broad bank

\*E.g.: money market mutual fund (MMMF): 100% backed by its investments in money market, and allows transactions; $1T!

\*Q: How can a non-bank be run?

\*MMMF shares; unused credit lines; collateral calls (AIG); short-term debt (CP & repos: Bear Stearns)

# Deposit Insurance (DI)

### How to price DI?

1. Link it to the interest rate on sub debt: if interest rates on subordinated debt start to go up, it means it’s riskier
2. Link it to credit default swaps: Just a form of DI!
	1. BUT: procyclical: bank in a tailspin forced to pay higher DI will only enhance the tailspin.
3. Link it to private insurance
	1. Step 1: cap public DI at 95%, use private insurance for remaining 5%
	2. Step 2: Then price the 95% based on the 5%
	3. BUT: private insurance corps can fail to!

### The Canary in the Coal Mine Model: Who are good monitors: depositors vs. shareholders vs. debtholders?

1. Depositors: good monitors?
	1. Enforcement mechanism: bank run
	2. Cap deposits at risk beyond a certain amount (but easily circumvented: deposit at lots of banks)
	3. BUT: Small depositors are rationally ignorant: no reason to investigate
2. Subdebt holders: good monitors?
	1. Yes when approaching insolvency: only care about protecting principal and getting interest payments
	2. Bank capital very high: bad monitor, don’t care, nothing to gain or lose
	3. Bank capital getting low: good monitor: equity holder becomes risk preferring, subdebt holder becomes risk averse
	4. Bank capital very low: bad monitor: subdebt almost gone, holder has nothing to lose: becomes risk preferring!
3. Shareholders: good monitors?
	1. Enforcement mechanism: SH vote
	2. Bank capital very high: good monitor
	3. Bank capital getting low: bad monitor, become risk preferring
	4. Alternatives: SH vote on “Risk Appetite” plan; require SH approval for material increase in risk; tax bank shares when bank increases risk; Accessible Stock (pay par value for stock; bank fails; have to pay again!)
	5. Goal: increase incentives of SH to monitor managers make mgmt more risk averse (counter: probably already are!)
4. Accessible stock: good monitors
	1. def: asset that can become a liability
	2. Pro: good monitor both when capital is high (b/c equity) and when capital getting low (because risk of liability)

# Solvency Regulation (a.k.a. Capital Regulation)

\*def: “safety and soundness”: Safety: bank should not fail; Soundness: health, well managed

\*Ways to create safety and soundness via capital regulation: Liquidity Regulation; Solvency Regulation;

### What is “Capital”? Meanings of Capital

1. plant & equipment
2. all money or property that firm owns or uses; ~ total assets
3. legal capital: equity not available to pay dividends (par value per share)
4. net equity

### Capital Requirements

\*NB: debtholders always get full payment before equityholders get anything

\*def: preferred shares

1. liquidiation preference: holders get a specified payment per share before common SH get anything
2. dividend preference: right to receive a specified dividend before common SH get anything

\*def: convertible preferred shares: right to convert into preferred stock: makes sense if underdog is rising; potential for larger dividend

\*def: limited-life preferred shares: by maturity date, corp must redeem shares at predetermined amount

## Capital Regulation

\*def: *insolvency*: debt exceeds assets

\*def: *required capital ratio*: Is **C / A≥ R**?

\*How does capital deal with solvency problems?

1. It’s a cushion against insolvency
2. SH incentives: if banks have lots of capital, will be discouraged from being too risky
3. Risk incentives: capital requirements can function like reserve requirements

### Debt v. Capital

\*Debt: e.g. 30-year bond

\*Capital: e.g. common stock

\*Preferred stock? Looks like debt! Stated dividend ~ an interest rate; preference in insolvency.

\*Subordinated debt? Looks like capital! Subordinated to all other debt. (Regulators let banks treat it as capital.)

### Capital vs. Reserves

\*HYPO 1: Loans: 1B; Reserves 1M; Deposits: 800M; Capital 201M;

🡪Solvent? Yes, capital ratio is 20%. Liquid? No, liquidity ratio is 0.1%.

🡪TA: Bank in trouble, people will find out!

\*HYPO 2: Loans: 800M; Reserves 300M; Deposits: 1.3B; Capital: (200M)

🡪Solvent? No, negative capital! Liquid? Yes, liquidity ratio is 37.5%.

🡪TA: No one will find out, but *regulators* will close it.

\*Banks vs. industrial firms: Why are banks so thinly capitalized (industrial firm has high equity, bank has low capital)?

1. Bank has low variability in ROI: needs less cushion; industrial firm has great variability in ROI: needs more cushion
2. Type of debt: deposits not only a way of getting funds, but also a product line
3. DI makes depositors indifferent to amount of leverage
	1. industrial firm: as firm becomes more highly leveraged, cost of debt increases
	2. bank: as firm becomes more highly leveraged, cost of debt stays the same: depositors don’t care b/c FDIC
4. Depositors are disorganized and lack ability/incentive to protect themselves

\*Q: do we need to regulate capital?

\*Arg yes: bank has incentive to take on too much risk; bank would prefer to fund itself w/ debt than capital because:

🡪arg: capital more expensive: riskier than debt, capital holders demand a risk premium

🡪arg: capital more expensive: tax advantage: bank can deduct interest it pays to debt holders; (can’t deduct dividends)

## Basel II: Refining the Risk-Based Standards

\*NB: Both Basel I and Basel II are 8%

\*Crit Basel I: *regulatory arbitrage*: will encourage taking on high-risk, low-quality assets w/i any given category

🡪e.g., loans to Exxon and loans to startup have very different credit risk but treated the same: 100% risk weight comm loan

\*Crit Basel I: doesn’t take account of: securitization (“true sales” that are really just to subs); collateral; market risk (trading the assets, not holding them to maturity); operational risk; sophisticated interal risk mgmt tools

\*Basel II’s three pillars:

1. *Capital Ratio*: minimum capital req’ts: more nuanced calculation of credit risk, based on banks internal calculations
2. *Supervisory Review*: acknowledges that agencies enforce the rules and thus are part of the process
3. *Market Disclosure*: aims to inform market about banks’ capital adequacy in consistent framework that enhances comparability

### Types of Capital Risk Under Basel II

\*Pro: allows banks to use IRB

\*Pro: considers not just credit risk but also market, strategic and operational:

\*Credit: give loan to someone who defaults

\*Operational: unauthorized trading, embezzlement, suit in class action, fine for lying to regulators

\*Strategic: develop a 100 million dollar online system and then scrap it

\*Market Risk: “the risk of losses in on and off-balance-sheet positions arising from movements in market prices.”

\*How to measure: Credit Risk

1. *Credit ratings*: Basel II tries to solve Exxon/startup problem by using credit ratings; Dodd-Frank now prohibits
2. *Foundation IRB (internal ratings-based)*: Bank estimates probability of default loan by loan, gov’t supplies other variables
3. *Advanced IRB (internal ratings-based)*: ?????

\*How to measure: Operational Risk

\*Basic: (avg gross income for past 5y) x (0.15)

\*Standardized: (weighted avg of annual gross income across business lines for past 5y) x (0.15)

\*Advanced (IRB): use bank’s own internal assessment methodology if comprehensive and systematic

\*How to measure: Market Risk

\*def *market risk*: risk of losses (in both on- and off-balance sheet positions) arising from movements in market prices

\*def *trading book*: part of asset portfolio that bank uses to trade

\*Typical items in the trading book: bonds and stocks held for sale; swaps and options on securities, REPOs, commodities Ks

\*How to measure it?

1. Book Value (Basel I)
	1. crit: don’t need book value if efficient market values it more accurately; assets not being held to maturity
2. Mark to Market (Basel II: requires if possible)
	1. if can’t mark-to-market, mark to *model*: ~IRB
3. Include other risks: interest rate risk, forex risk, equity price risk, commodity price risk
	1. Permitted approaches: standardized; internal models (IRB)
	2. Crit of internal models; fox in charge of the henhouse!; just creates plausible deniability; if regulator can recognize “conceptually sound” model, should just create one
4. “Value at Risk” Model (VaR; Basel II requires)
	1. Need to model the distribution of performance of portfolio
	2. Basel II does not require a particular distribution, but does require VaR Model
	3. Crit: VaR accounted for bank’s risk appetite but failed to account for society’s risk aversion

\*NB: Volcker Rule (12 USC § 1851): Banks can’t prop trade; bank’s affiliate can prop trade (but they’ll be subject to Basel II)

### Basel II Pro & Con

\*Advantages of Basel II

\*better recognition of credit risk mitigation techniques

\*considers operational risk, uses supervisory review for other risks

\*incorporates historical data to make risk predictions more accurate

\*regulatory capital focused on measurement of credit, operational, and market risks

\*Free rides on the internal risk processes of banks

\*incorporates portfolio theory (considers riskiness of items in a firm’s portfolio related to one another)

\*Crit Basel II: just arbitrary! Instead:

\*Problem 1: Basel II failed and created complacency!

\*Indymac had 11% risk-adjusted capital and still failed!

\*TA: capital is a lagging indicator of problems at a bank, b/c bankers can manipulate their capital ratios

\*Problem 2: why 8%?

\*Problem 3: doesn’t address non-capital risks

\*Alternative:

1. strict leverate limit (4%)
2. eliminate: Risk-based capital req’t; tier 1 vs. tier 2 distinction; quantitative limits on counting sub debt as capital
3. require large banks to issue sub debt
4. require regulators to take prompt corrective action when yields on sub debt soar (*canary in the coal mine*)

## Basel III: Capital Standards

\*TA: minimum is up to 10.5%: “Capital conservation” buffer of 2.5%: common equity

\*Other changes: Re-introduced simple leverage ratio; new def of capital (rules out exotic capital); raised risk-weights on exposures to financial institutions; annual stress tests

### Procyclicality

\*Problem: Basel I & II are procyclical: it’s when banks are in trouble they need to raise capital and less able to do so!

\*Solution: regulators should identify bubbles early and raise capital requirements when times are rich, not lean

### MMMFs and Recapitalization

\*Advantage for insolvency: wholly financed by equity! Have no debts, can’t become insolvent.

\*Maybe require, ~narrow bank? “Any institution with more than X% in short-term instruments, have to be a MMMF”

### BHC and Recapitalization

\*Q: if sub is in trouble, can *parent* be induced (or required) to recapitalize it?

\*A: Non-banks: no, unless you pierce the corporate veil, parent is insulated from bankruptcy of subsidiary

\*A: Banks: yes, parent companies must be “source of financial strength” for banks (Dodd-Frank)

\*Q: if bank is in trouble, can *bank sibling* be induced (or required) to recapitalize the bank?

\*A: Banks: yes, if FDIC loses money in bank’s failure, bank’s sibling is on the hook (FDIA)

\*Q: if bank is in trouble, can *non-bank sibling* be induced (or required) to recapitalize the bank?

\*A: Banks: No.

## Enforcing Adequate Capital Requirements: Deterrence, Asset Sales, Recapitalization

1. Deterrence
	1. Punish mgmt of banks who fall short
	2. Won’t make bank solvent, but will deter bank manager if they know they’ll be unhappy
	3. How to make mgmt unhappy? Take away money (e.g. Jamie Dimon has $200M tied up in Chase); take away jobs (Ken Lewis); take away reputation (Dick Fuld); monetary penalties (Daniel Mudd of Fannie Mae, sued by SEC); prison (Keating)
	4. closing a bank is messy and creates transaction costs!
2. Forbearance
3. Asset Sales
	1. Concept: shrink assets on which you have to hold capital 🡪 sell assets, capital ratio goes up!
		1. 🡪opportunity for *regulatory capital arbitrage*
	2. Problem: must sell a lot of assets to have a real impact on your capital ratio!
	3. Problem: will be a fire sale, too many assets on the market
4. Recapitalization (***see more below***)
	1. When bank approaching capital limit, require bank to add on more capital
	2. Better to raise new equity than require new capital
	3. TA: better! Actually solves problem, as opposed to jailing a banker.

### Recapitalization: Where to get the money?

Insiders (Bank mgmt, Bank holding corp & affiliated companies)

Dodd-Frank “source of strength” provision: holding company must help out a sub in trouble

SH or creditors (rights offerings, cocos, assessments)

*subscription offer / rights offer*: offer to existing SH giving them the right to purchase new shares. Price always set lower than current value of stock. If don’t participate, you’ll be diluted. Crit: pretty coercive!

a.k.a., pre-emptive rights: SH get an option before general public

Pro: not-coercive b/c if you don’t want to buy in, you can just sell your shares

Con: reduced incentive to capitalize banks in the first place

*assessable stock*: corp can impose levies on SH for more funds. Used to be common! Issuer $20 stock for $5, keep going back to the well; sometimes >$20! NB: all stocks issued today are non-assessable stocks.

*contingent convertible bonds* (CoCos) (***see more below***)

Third parties: Value investors (long-term investors like Warren Buffett; Mitsubishi; sovereign wealth funds); Acquirers

Gov’t

capital injections—i.e. gov’t acts as value investor

TARP: initially meant to buy troubled assets, but became investor in banks: concerned about moral hazard of buying bad assets; bank would have had to service those assets; gov’t wanted bank to have more capital to make more loans

Treasury demands 5% dividend, up to 9% after 5y: gives banks incentives to buy the gov’t out

nationaliziation—i.e. gov’t acts as acquirer

Just don’t call it nationalization! FDIC takes over IndyMAC as “conservator”; UK gov’t nationalized Northern Rock!

 Open Bank Assistance: FDIC just gives money to the bank (very rare)

### Contingent Convertible Debt Requirements (article by Calomiris et al.): Better than the other Recapitalization options!

\*TAQ: What’s better? Issuing new common shares or converting debt into common shares?

\*Ex ante problem: risk mismeasurement and mismanagement

🡪over reliance on risk decisions taken at a low-level w/o consideration for macro-economic conditions

🡪herd mentality (instead of looking at adequacy of capital to absorb risks; reluctance to question fundamental assumptions about basis risks and hedges)

🡪disregard for the risk inherent in funding long-term assets with short-term liabilities

🡪tendency to override limits when they conflict with revenue goals

🡪inability to track exposures in complex framework

🡪failure to risk-adjust the price of internal transfers of funds and compensation

🡪Neither banks nor regulators can measure risk adequately!

🡪Regulators too reliant on IRB and too slow; action often delayed until losses can be proven beyond any reasonable doubt.

\*Ex post problem: failure to replace lost equity

🡪Current approach: banks understate risk ex ante, disguise loss ex post, avoid dilutive equity issues when needed most

🡪Banks can understate and disguise loss *because* b/c not *forced* to raise dilutive equity in the wake of losses.

🡪TA: After unrecognized losses occur, will be temptation to gamble for resurrection.

\*GOAL: provide incentive to take remedial measures to raise equity long before they face the risk of insolvency.

\*Objectives of CoCo proposals:

1. *bail-in*: CoCo trigger provides contingent cushion of common equity
2. *signaling*: price of CoCo indicates risk of default
	1. NB: trad’l sub debt serves this function, too but only if actually unprotected; in 2007, sub debt was bailed-out.
3. *equity-issuance*: if CoCo conversion pending, mgmt have incentive to issue new equity to avoid the conversion

\*Pros and cons

\*Pro: better than assessable stock b/c automatic

\*Pro: better than subscription offer because no need to induce SH to do something; no surprise

\*Pro: CoCos *might* not result in value loss to SH (as long as they don’t convert), but issuing new equity *definitely* does

\*Pro: Issuing new equity looks bad, but if mandated by regulation, doesn’t look as bad

\*Pro: “CoCos not only encourage timely replacement of lost capital and better mgmt of risk, also encourage banks to respond to increased risk with higher capital.”

\*I: What’s the trigger? (for converting debt into equity)

1. Accounting trigger: maybe risk-based capital (RBC)?
	1. Con: banks can game it (e.g. by selling off assets)
2. Price
	1. If trigger price above existing share price, large SH will *want* the trigger
	2. If trigger price below existing share price, large SH will not want trigger
	3. Pro: Good incentives for corporate governance
		1. Mgmt will fear conversion brings in a lot of new SH and pisses off the rest, will be pushed out of jobs
		2. So CoCos will liven up market for corporate control of banks – another market discipline device
	4. Con: stock price too volatile?
		1. Solution: quasi market value of equity ratio (QMVER) 🡪 market cat charted against equity ratio; must hit QMVER over a period of time, not just once
		2. Solution: CDS (but market too shallow)
3. Market-based trigger
	1. P/E ratio: harder to manipulate than price
4. Discretionary trigger
	1. e.g. OCC can decide if triggered

\*Arg: CoCos would never convert b/c mgmt has incentives to avoid conversion.

\*Arg mgmt won’t want to hit trigger: mgmt has large stake, don’t want to be diluted

\*Arg mgmt won’t want to hit trigger: mgmt doesn’t want to be pushed out

\*Arg yes: mgmt can trigger to bring in new SH who will vote for them

\*Arg holder of coco may want trigger so he becomes equity holder

\*Alt: just require much more equity! If banks got 50% of their financing from book equity, bank SH would pay the cost of understated risks gone wrong—not taxpayers.

\*BUT: Would not encourage proper risk mgmt by banks

\*BUT: would not produce banking system outcomes consistent with the public interest

­\*Arg: there are less-costly ways of lowering the risk of default at SIFIs! More efficient to have more debt.

\*Arg: “we propose that the amount of CoCos be set at 10% of book assets.”

\*Alt: Just use sub-debt? No, CoCos better because:

\*avoids issue of deciding whether to impose losses on subdebt holders after intervention; just become equity holders

\*subdebt holders get bailed out so no longer reflect risks; CoCos remain in the bank and suffer losses, so they more accurately reflect true risks.

\*if triggered, CoCos will better protect depositors/counterparties/senior debt b/c will cease to accrue interest 🡪 alleviate liquidity pressures

\*incentivize mgmt to replenish losses on a timely basis

\*not so pro-cyclical: incentivizes banks to build up capital when flush and reduce CoCo in recessions

### Prompt Corrective Action (PCA)

\*TA: way of enforcing capital requirements

\*How it works: regulators must take increasingly harsh measures as their capital gets lower and lower

\**undercapitalized*: must submit a cap restoration plan; BHC guarantees compliance; comply w/ restrictions on growth; approval for acquisitions of deposit facilities; submit to a receiver if fail to get recap plan approved or agency recap impossible

\**significantly undercapitalized*: must recapit immediately (merger or sale); limits on deposit interest rates; gov’t controls mgmt

\**critically undercapitalized*: must default on sub debt; submit to immediate appt of a receiver

\*RATI: meant to be a runaway truck off ramp

\*Pro: clear, explicit, gives notice, mitigates political incentives

\*Con: failed in 2008 (most banks were well capitalized anyway); creates complacency.

# Bank Failure

\*Three methods for dealing with bank failure

1. Pay Out of Insured Deposits: FDIC writes a check to all insured depositors (rare)
2. Purchase and Assumption (receivership): 3d party purchases assets & assumes liabilities
3. Conservatorship

## Receivership: A primer

1. Q: why would purchaser take on bank that, by definition, liabilities > assets?
	1. A: FDIC kicks in some money
	2. A: going concern value: purchaser willing to pay for good will
2. Pro: FDIC doesn’t have to manage the assets, as in a pay-out
3. Pro: stops a run: diminishes uncertainty, increases likelihood of prompt payment, and ensures equal treatment of all depositors
4. Pro: makes competing creditors act as a group, have a common interest in orderly resolution
5. Con: more complicated than paying out depositors
6. Con: very few possible bidders (b/c only “banks” can assume deposits)
	1. Solution: contingent license, only get license if win auction
7. Con: P&A bidding only open for a weekend (between closing and re-opening)
	1. Solution: preapproved bidders get 2-3 weeks notice
8. Con: not enough time to gather information about the bank for sale: if bank has failed, assets are probably not very good!
9. Con: The Winner’s Curse: winner of auction is likely to have overpaid
	1. Solutions: due diligence (FDIC encourages due diligence); loss-sharing (FDIC agrees to share losses); partial sales (buyer only buys the good assets, FDIC keeps the bad ones); put backs (if goes wrong, just return it to the FDIC)
	2. FDIC “superpowers”: purchaser can avoid certain obligations
		1. RULE: side agreements between bank & borrower not enforced after failure if hurt FDIC. *D’Oench, Duhme*.
		2. TA: E.g., bank buys bonds from securities firm, they tank, bank sells bonds back to securities firm and gets notes, side agreement promises not to enforce them so notes make bank balance sheet look better; then bank fails anyway! Now: that side agreement is *not enforceable against the FDIC*.
		3. FDIC will not recognize agreements that are not in writing, not contemporaneous, etc. 12 USC § 1823(e)(1).
10. NB: No Due Process: FDIC needs to act fast, so due process not required! *Fahey v. Mallonee* (SCOTUS 1947).
	1. NB: “upon the merits”: court can overturn FDIC only if was arbitrary/capricious. *Franklin v. OTS* (10th Cir. 1991).
	2. NB: bank’s lawsuit to remove receiver is the sole remedy; can’t enjoin FDIC from selling off assets. *Haralson*.

\*Bank closure: Insured deposits are paid (DI); assets are sold (FDIC as receiver); claimants are paid in order of priority :

* 1. Depositors (the FDIC!) 🡪 General unsecured creditors 🡪 subdebt 🡪 SH
	2. NB: depositors go first to avoid a run; protect DI fund; discourage “grow out of problem”

# Chartering & Change in Ownership

\*Why does the gov’t restrict entry?

\*Public interest! systemic importance of banks (TBTF); we can mitigate costs of failure by limiting entry. (OR: reg capture)

\*Less restrictive: 12 CFR 5.20(f): OCC default to approve new banks if reas chance of success and that will be S&S

\*Six steps (***see notes***)

## Buying a Bank

\*As a holding company: subject to Fed Reserve Board approval under BHCA

\*As an individual: subject to Change in Bank Control Act

\*Agency may disapprove M&A if: anticompetitive; jeopardy to bank, depositors or DI fund; concerns mgmt competence

\*NB: if group of friends acquire a bank: maybe each is an individual, or maybe de facto partnership (holding corp)

\*RULE: OCC’s denial of a national bank charter application is upheld unless it is arbitrary/capricious. *Pitts*.

# Bank Powers

\*Basics: Under a bank holding company:

\*bank: restricted to the business of banking (not a lot!)

\*affiliates: restricted to the financial business (a lot!)

\*Public interest explanation: don’t want them taking undue risks; banks as utilities (special privileges etc.)

\*Private interest explanation: lobbying by securities & insurance industries

\*Banks vs. Affiliates

\*Banks: restricted to the business of banking

\*Affiliates: restricted to the financial business

## National Bank Act: Enumerated Powers

\*NB:Any company controlled by a bank can’t engage in those activities either (25% or wholly owned?)

\*corporate powers; deposits; loans; incidental powers; real estate investments; investements in personal property; securities investments; trust powers; securities powers; insurance powers

\*Traditional banking powers (12 USC 24(7))

1. discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt
2. receiving deposits
	1. trad’l deposits
	2. custodial services (safe deposit box, securities acct, securities lending (hold for customers, then loan to short sellers))
	3. deposits w/ variable returns (looks like an index fund!)
	4. TA: interpret “take deposits” creatively, become an investment firm!
3. buying and selling exchange coin and bullion
4. loaning money on personal security (starts to look like equity investments (is it “interest” or is it a “dividend”))
	1. Fixed interest rate OK, Variable interest rate OK, swaps OK, loan secured by RE ok
5. obtaining, using and circulating notes

🡪TA: courts want to be faithful to statute but let banks evolve; delicate balance

🡪***MYA: shouldn’t worry; still barred from manufacturing; other barriers to banks getting too powerful, like AT***

## National Bank Act: Incidental Powers

\*~ neceassary and proper clause in Constitution

\*STAT: 12 USC § 24(7): Nat’l bank has power to exercise “all such incidental powers as necessary to carry on business of banking”

\*RULE: The “business of banking”?

\*A: maybe the five powers in 12 USC 24 (7) 🡪 too limited!

\*A: maybe those five powers are just examples 🡪 too broad!

\*A: *Nations Bank* footnote: business is *not limited* to the enumerated powers

\*RULE: Activities under “incidental powers”

1. RULE: must “reasonably be said to be convenient or useful in connection w/ the performance of one of the bank’s est’d activities in the exercise of its express powers.”
2. RULE: life-insurance type annuities: yes. *VALIC*.
3. RULE: travel agency services: no. *Arnold Tours*.
4. RULE: lease financing of personal property? Yes, *M&M leasing*, but no open end leases (bank retains residual ownership risk, gets car at end of lease)
5. RULE: act as “finder.” Yes. OCC letter.
6. RULE: analytical support, payments systems, websites for merchants. Yes. OCC letter.

## Real Estate

\*RULE: can’t buy and own real estate.

\*RATI: banks should keep capital flowing through the economy, not locked up in real property; don’t want banks too powerful; don’t want banks speculating. *Union Nat’l Bank v. Matthews*, 1878.

\*Exceptions (12 USC § 29)

1. foreclosure (include personal property like cars)
2. property offered to satisfy a debt; need not have secured the debt (DPC = “debt previously contracted”; REO= “RE owned”)
	1. e.g. mortgage loans: bank has legal title, mortgagor has equitable title (all rights of ownership)
3. premises: must be reasonably related to bank’s current & anticipated business needs
	1. RULE: can hold value up to 100% of capital (TAQ: what if bank’s real estate holdings go up in value?)
	2. RULE: CEO moving CA to NY? Buy new house in NY: yes. Buy old house in CA: temporariliy.
4. to promote the public welfare
5. make loans secured by real property

## Securities

### Q1: Can banks be dealers (buy and sell securities for its own accounts)?

\*RULE: No. Banks can own debt securities but not equity securities; the debt securities must be *marketable*.

\*def *investment securities*: debt (liab of issuer like bonds, debentures, CP) & equity (ownership interests in issuer)

\*EXCEPTION 1:*General Obligation*: nat’l bank can hold w/o limit

\*NB: def *general obligation*: legal obligation to repay the debt, like T-bills and munis: zero default risk!

\*NB: Bank can invest, underwrite, and deal

\*EXCEPTION 2: Investment grade private debt: nat’l bank can hold up to 10% of bank’s capital and surplus for any issuer

\*NB: very ltd power to invest in equity securities (subsidiaries, bank service companies (10%), small business investment corps (5%), agricultural co-ops, community development/public welfare entities)

\*Volcker Rule: 12 USC § 1851(h)(4)

\*TA: eliminates exception 2, now only exception 1

1. Bank & affiliates can’t prop trade (exempts t-bills; securities in connection w/ underwriting or market-making, to the extent that either does not exceed near term demands of clients, customers, or counterparties).

2. Bank & affiliates can’t have interest in a hedge fund or PE fund

### Q2: Can banks be brokers (buys and sell securities for client accounts)?

\*RULE: Off-balance sheet ok (e.g. bank earns fees but assets not on balance sheet)

1. trust & fiduciary services: need permission from OCC but then can act as trust; investment advisor; etc.
2. securities services: “without recourse, solely upon the order, and for the account of, customers”
	1. not *owning* securities, that’d be on balance sheet
	2. I.e., brokerage is ok!

\*STAT: Glass-Steagall: § 16 stops banks from acting like securities firms, § 21 stops securities firms from taking deposits

\*RULE: Banks can offer discount brokerage. *SIA v. OCC* (DCC 1987).

\*def *discount broker*: don’t offer investment advice

\*H: Not limited to brokering for existing customers, can solicit new ones, too.

### Q3: Can banks underwrite securities

\*def *underwriter*: salesman / intermediary between issuer and investors:

1. sells securities for an issuer in connection with a distribution to public investors
2. buys securities from the issuer with a view of distributing them to public investors

\*def *distribution*: process of selling securities so that they end up with public investors (as opposed to *private placement*)

\*RULE: bank “shall not underwrite any issue of securities or stock.” 12 USC § 24 (seventh).

\*ARG 1: It’s not a security.

\*RULE: “units of participation” in a mutual fund: yes, those are securities, bank can’t underwrite. *ICI*.

\*RATI: “subtle hazards” of bank underwriting: loss of confidence in fund will hurt confidence in the bank; investors might transfer confidence in bank to overconfidence in the fund; bank might make unwise loans to the fund or securities in the fund. Overrules OCC.

\*RULE: Commerical Paper: yes, that’s a security. *Banker’s Trust I* (SIA v. Fed, SCOTUS 1984)

\*ARG 2: It’s not underwriting

\*RULE: private placement not underwriting, only public offering is underwriting. *Banker’s Trust II* (SIA v. Fed, SCt 1986).

## Insurance Powers of National Banks

### Insurance Brokerage

\*RULE: nat’l banks can *deal* insurance in small towns (<5,000). 12 USC § 92; *Ludwig*.

\*BUT: nat’l banks can’t *underwrite* insurance under any circumstances.

\*RULE: fine for NY bank to buy location in small town, sell insurance nationwide from that location. OCC.

\*RULE: fine for bank to sell quasi-insurance products not labeled insurance: annuities, CDS, credit-life insurance.

\*def *annuity*: bank gives you an income stream for life; unlike life insurance, insures against risk that you’ll live too long.

\*RULE: banks can *not* sell general insurance to amish & farmers. OCC said OK, SCOTUS struck down.

### Insurance Underwriting

\*RULE: *financial guarantees*: no.

\*RULE: *SLOC*: not a guarantee, bank can issue it.. *Republic National Bank.*

\*def: *SLOC*: buyer can only draw on SLOC if customer defaults

\*RATI: Guarantee requires proving actual default; SLOC just requires showing documents. PROF: ridiculous!

\*RULE: *CDS*: bank can broker and issue. (def: *swap*: if there’s a default on the bond, bank will buy the bond (PROF: insurance!))

\*RULE: retirement CDs: no.

\*def: *retirement CDs*: make deposit; earn interest; at maturity, withdraw 2/3 with interest; remaining 1/3 pays out til death

\*RULE: Not allowed. Bank tried to disguise variable annuity as CD. *Blackfeet Nat’l Bank*.

## Prudential Rules: Loans to One Borrower & Insider Loans

### Loans to One Borrower

1. RULE: can’t bet it all on one horse; cap at 15% of capital, plus another 10% if secured (25% total). 12 USC § 84.
2. RULE: Must be secured by marketable collateral: stocks and bullion OK; art and diamonds are not.
3. RULE: consolidate if direct benefit or affiliate, bank can’t get around rule by loaning to family and friends.
4. CRIT: One borrower could have very different risks, whereas loans to 100 farmers will face same risks.

### Insider Loans

1. RULE: no loans by bank to insider (mgmt or BOD) or any related interest of an insider. 12 U.S.C. § 375b.
	1. def *insider*: D&O, principal SH (10%), related interest (some relatives, minor child, not others, adult child)
2. BUT: loan to insider is OK if:
	1. made on substantially the same terms, including interest rates and collateral, as loan to outsiders
	2. loan does not involve more than the normal risk of repayment or other unfavorable features; *and*
	3. adheres to regular credit underwriting procedures.
3. RULE: ban on “more than normal risk of repayment”: can’t price it in, just banned.

# Affiliations

# Affiliations: Bank Holding Companies

\*STAT: BHCA: subjects to regulation any company that owns a bank. Administered by Fed.

## Affiliates Rules

\*STAT: Fed Reserve Act §§ 23A, 23B: 12 USC 371c

\*TA: § 23A treats bank and operating sub as one unit, restrictions do not apply to transactions w/ operating sub; yes for financial sub

\*def *operating subsidiary*: acts like a bank

\*def *financial subsidiary*: does stuff that nat’l bank can’t (like underwrite corporate securities) (all restrictions except 10%)

### Section 23A

\*def *affiliate* (for § 23A): entity controls or is controlled by bank, or under common control (12 USC § 371c(b): definitions)

\*Bank’s parent: holding company

\*Bank’s grandparent: holding company

\*Bank’s sister: holding company affiliate

\*Bank’s son: subsidiary

\*Yes affiliate: bank & affiliate controlled by same people; have a sponsorship or advice K; if bank is investment advisor to a fund, fund is an affiliate

\*No affiliate: non-bank subs; company holding bank premises; safe deposit corp; acquiring a company from default on a debt

\*def *control*: three ways:

1. 25% or more of any class of voting shares
2. control over election of BOD
3. Fed says so

\*Def *covered transaction* (12 USC 371c(b)(7))

1. bank extends credit to affiliate (but OK if affiliate loans money *to* the bank)
2. bank invests in affiliate’s securities
3. bank purchases assets from affiliate as fiduciary (but OK if assets have a market price and are bought at that price)
4. bank accepts affiliate’s securities as collateral for extension of credit to 3d party
5. bank issues guarantee or SLOC for benefit of affiliate

\*NB: Following are *not* covered transactions: *T-bills*; *sister-bank exemption* (subject to Restriction 4), *Loans w/o recourse* (subject to Restriction 4), *Repos* (if bank originated a loan, sold to affiliate, can repo), *Checks and deposits* (checking acct w/ affiliate)

\*RULE: Not all covered transactions prohibited! a bank may engage in a covered transaction with an affiliate if:

1. *capital limit*: total covered transactions w/ any one affiliate can’t be >10% of capital
2. *capital limit*: total covered transactions w/ all affiliates combined can’t be >20% of capital
3. *collateral*: extensions of credit and SLOC must be secured with qualifying collateral, 100-130%
	1. 100% for Tbills; 110% for munis; 120% for other debt instruments; 130% for stock, leases, etc.
4. *low-quality assets*: can’t buy a low-quality asset from affiliate

\*RULE: *Advertising* (23B): can’t buy ads that say, “we stand behind our affiliate” 12 USC 371c-1(c)

## Bank Holding Company Basics

\*PROF: want affiliate to be able to do more than bank can do, but not too much more!

\*def *BHC*: company that controls a bank, or controls a company that controls a bank (i.e. parent or grandparent)

\*RULE: BHC can’t acquire control of a non-bank

\*def *company*: virtually all business entities; Q: how to avoid being a “company”?

\*A: expire w/i 25 years; individuals, certain family trusts, certain family partnerships, and gov’t corps

\*def *control*: three ways:

1. 25% or more of any class of voting shares
2. control over election of BOD
3. Fed says so (presumption: <5% is not control; will give informal guidance, not quite a no-action letter)

\*def *bank*: not just FDIC-insured banks but also (ii) any institution that accepts demand deposits/NOW *and* makes commercial loans

\*def: *industrial bank*:CEBA (1987) eliminated “nonbank banks,” but retained exception for *industrial bank*: no demand deposits; less then $100M. Now: no new charters for industrial banks, but anyone can buy an existing one.

## Restrictions on Nonbank Activities: Ownership Clause and Activities Clause

### Ownership of a Nonbank Sub

\*Ownership clause: can’t own a nonbank.

\*RULE: fine for BHCA-owned *state bank’s sub* to engage in non-bank activities if state law allows it. *Citicorp v. Fed* (aka *Citibank Delaware*, 2d Cir. 1991). TA: Ownership of a nonbank sub, sequel to *Merchants National* (below).

\*RULE: Bank can control a financial sub only if the sub engages only in activities that are *financial in nature or incidental to a financial activity* pursuant to subsection (b) of this section; and (ii) activities that are permitted for national banks to engage in directly. 12 USC § 24A(a)(2)(A)(i).

\*def *financial subsidiary*: can engage in financial activities that nat’l bank can’t (like underwrite corporate securities) plus anything incidental

\*BUT can’t underwrite insurance; issue annuities; develop real estate; merchant banking (unless auth from Fed & Treasury)

\*BUT: for calculating regulatory cap, must substract every dollar of equity in financial sub; total assets in financial subs must be <$50B or 45% of total assets

### Ownership of a Bank Sub Engaging in Nonbank Activities

\*Activities clause: bank subs can’t engage in nonbank activities.

\*RULE: fine for BHCA-owned *state bank* to engage in non-bank activities if state law allows it. Nat’l banks still can’t engage in non-bank activities. *IIIA v. Fed* (aka *Merchants National*) (2d Cir. 1989)

\*RULE: can’t do anything not related to banking, with exceptions in 4c8: anything “closely related” & pub benefit is OK

\*RULE: § 4(c)(8) Test 1: *closely-related test*: related if “a proper incident” to banking.

\*RULE: § 4(c)(8) Test 2: *public benefit test*: bank must show that activity will produce greater convenience; increased competition; gains in efficeincy. Benefits must outweigh possible costs (concentration, decreased competition, COI, S&S).

\*RULE: activities that are closely related

1. making, acquiring, brokering, servicing loans and other extensions of credit
2. anything connected to #1: appraising, guaranteeing checks, collecting debts, managing assets, providing RE settlement services
3. leasing real and personal property (but no landlording)
4. thrift
5. trust
6. investment advice
7. securities broker; private placement; hedging; futures market-making
8. underwriting & dealing in T bills; dealing in forex, forward Ks, options, futures & bullion
9. consulting
10. courier services
11. insurance agent (if <5000)
12. community development
13. money orders, savings bonds and travelers’ checks
14. processing data
15. Others by admin order: admin services to mutual funds; owning shares in a securities exch; certifying digital signatures; providing employment histories for use in making credit decisions; cashing checks; notary public

\*BUT: That’s it! Still missing: underwrite insurance; underwrite securities; general commerce. For more, must become an FHC.

\*RULE: what kinds of connections qualify as “closely related” (*Nat’l Courier Assoc v. Fed* DCC 1975):

1. banks have provided the service in the past
2. banks provide similar services and so are well-equipped to do so
3. banks provide services that are integrally related

\*RULE: AT concerns come under the public benefit test, not the closely related test. *Data Processing Orgs v. Fed* (DCC 1984).

### Bank Holding Company Regulation: Notice, Reporting & Examinations

see notes

\*RFICD: risk management; financial condition; impact: can BHC impact its nonbank subs?; composite: overall eval of BHC; depository institutions: overall eval of sub by its primary regulator

# Affiliations: Financial Holding Companies

\*RULE: FHC is a BHC that meets special rules (really easy to satisfy). Gramm-Leach-Bliley.

1. each FDIC sub must be well-capitalized and well-managed (the “M” in CAMELS)
2. satisfactory exam under CRA
3. file declaration of intent to become FHC

\*RULE: An FHC may engage in financial activities (plus anything “incidental” or “complementary”)

\*BUT: as long as no “substantial risk to S&S of depository institutions or the financial system generally”

\*RULE: either FHC or a sub can engage in financial activities

\*RULE: corp that becomes an FHC can *continue* nonfinancial activities indefinitely

\****RULE: FHC can own nonbank subs, but the FHC’s bank subs are still controlled by NBA: no non-banking activities.***

\*NB: insider loan prohibitions still apply to covered transactions among affiliates w/i the FHC

\*RULE: “Financial” Activities under G-L-B:

1. *Securities Powers*: Lend/transfer/exchange $; invest $ for others; transfer securities; safeguard $ or securities
2. *Insurance Powers*: Underwriting, brokering, or selling any kind of insurance, guarantee or indemnity
3. *Advice*: financial/investment/economic, including managing a mutual fund portfolio
4. *ABS*: Securitizing loans or other assets a bank could hold directly
5. *Securities Powers*: Underwriting/dealing/market-making of securities
6. *Grandfather*: Anything “closely related” (grandfathers in stuff Fed approved under BHCA)
7. *Int’l Playing Field*: Can do domestically anything Fed previously said was OK abroad (mgmt consulting, travel agency, etc.)
8. *Merchant Banking (PE)* : Acquiring shares in a nonbank OK if conditions (see below).
9. Investing through an insurance company (similar limits as merchant banking)

\*RULE: These are quasi-financial:

1. Lending/transferring etc. assets other than money or securities
2. Providing device for transferring financial assets
3. Arranging/effecting/facilitating financial transactions for 3d parties

\*RULE: Reasons why Fed can change definition of “financial”

1. Purpose of the statutes (G-L-B; BHC Act; Nat’l Bank Act)
2. Anticipated changes in market for FHCs
3. Anticipated changes in technology
4. Whether service is “necessary or appropriate” for FHC to compete

## FHCs: Merchant Banking and The “Wall” Between Banking and Commerce

\*RULE: FHC cannot engage in nonfinancial activities.

\*Exception: *grandfathering*: corp that becomes an FHC can *continue* nonfinancial activities indefinitely

\*Exception: *incidental and complementary*.

\*TA: really broad! Almost everything is “financial,” “incidental” or “complementary”

### Merchant Banking Under G-L-B

\*def *merchant banking*: buying and holding corporate shares for which no public market currently exists

\*Four main categories

1. Leveraged Buyouts (LBOs): i.e. borrowing money against firm’s assets, paying it back w/ firm’s future earnings
2. Ventural Capital: investing in early stage companies
3. Investing in privately-held, middle-market companies
4. Investing in firms in “financial distress”

\*Characterstics of PE investments

\*Risky: equity has low priority claim on cash flow; investment is illiquid & long term; targets tend to be risky

\*Investors: tend to be pension plans, endowments, foundations, corporations, wealthy individuals

\*Role of financial services firms: agents & underwriters (raise funds for portfolio companies); advise on M&A; intermediaries (manage PE partnerships and investments for others); direct investors

\*RULE: under merchant banking exception, FHC can own shares in or control nonfinancial corps

\*RULE: *merchant banking exception*: bank can buy a nonbank if:

1. acquired as part of a bona fide underwriting/merchant banking/i banking (BUT: It’s “financial” because purpose is to own, make money and resell? That’s all securities!)
2. shares are held by a “securities affiliate,” not FDIC sub (BUT: put it in a sub!!)
3. shares are held for a while (gets around Volcker rule?) (BUT: just say holding until price is right)
4. BHC does not routinely manage or operate the company except as to get reasonable ROI (OK to manage until good price)

\*Agency restrictions (Fed & Treasury)

1. Can’t hold for 10y (directly) or 15y (through a PE fund)
2. No D&O overlap, unless portfolio corp has own mgmt (but can name entire BOD)
3. FHC can’t supervise or work for portfolio corp, unless necessary to avoid operating loss
4. FHC can’t restrict portfolio corp’s routine business decisions, but can require FHC approval for *non*routine decisions
5. FHC must document its involvement

### Insurance Company Investments Under G-L-B

\*RULE: Ins co can own/control nonfinancial corp if in ordinary course of business; comply w/ state law; no routine mgmt

# Dual Banking System

\*Arg: dual banking is good: by having a “marketplace” of regulation, businesses won’t be trapped w/ a bad regulator

\*Arg: state regulation no longer necessary: feds handle DI; deposit market is an interstate market;

\*Proposal: make re-chartering easy; let states charter all banks; let banks branch freely across state lines; limit federal role to DI

\*Possible con: race to the bottom

\*Possible con: unifying advantage of national rule only works if pre-emption

# Consumer Protection and Basic Financial Services

\*CFPB: new home for all the formerly scattered consumer laws (Fed, OCC, FDIC, DOJ, FTC, etc.)

## Usury

\*RULE: “interest” includes late payment fees. *Smiley v. Citibank (SD)* (SCOTUS 1996). PROF: not “reasonable,” stretches *Chevron*.

### Usury for National Banks

\*STAT: Usury limits for nat’l banks: 12 USC § 85: three options

1. H: Banks can charge general st usury rate; but if state-chartered banks can charge more, nat’l banks can, too. *Tiffany*.
2. 1% above discount rate on 90-day CP in Fed district where bank is located (*very low, will never apply*)
3. 7% if no interest rate is fixed by state law

\*RULE: bank is “located” in the state where it’s chartered: can charge that rate nationwide *Marquette Bank* (SCOTUS 1978).

### Usury for State-Chartered Banks

\*RULE: State bank in A can charge state A max in state B. DIDA, 12 USC § 1831d.

\*RULE: “there is no such thing as a state-law claim of usury against a nat’l bank.” *Beneficial Nat’l Bank v. Andersen* (2003).

\*RULE: DIDA (§1831d) does not pre-empt; can make usury claim against state-chartered bank. *Thomas v. U.S. BNA* (8th Cir. 2009).

# Consumer Protection Statutes

## Equal Credit Opportunity (ECOA)

\*STAT: ECOA: can’t discriminate in provision of credit on basis of race/color/religion/nat’l origin/sex/marital status/age/welfare/or as retaliation for exercising rights under Consumer Credit Protection Act. 15 USC §§1691-1691f.

\*Two issues: what can bank ask about and what can bank do with that info? 15 USC 1691(b). E.g. can’t ask about race/religion at all; can ask about marital status, age, welfare status for enumerated reasons

\*RULE: “creditor” is someone who regularly extends credit (loan to your sister does not make you a creditor).

\*RULE: ok to discrimiante on basis of citizenship. *Bhandari* (5th Cir. 1989).

\*RULE *effects test*: require a showing of “pattern or practice.”

\*RULE: ok to favor particular classes of people if can show no disparate impact on a protected class and maybe prove intent to make credit more available to people who have historically been under-served

### Redlining

\*def *redlining*: drawing a line around a territory w/i which bank refuses to lend money

\*Arg good: doesn’t violate ECOA to discrimiante based on geography

\*Arg bad: it’s just a proxy for race etc.

\**U.S. v. Chevy Chase Fed Savings* (consent decree DDC 1994)

\*bank promises to obtain a market share in black neighborhoods comparable to its share in white neighborhoods

\*bank promises to open ATMs and offices in black neighborhoods

\*NB: no showing of distinct discrimination, just a disparate impact

## Truth in Lending Act

\*goal: meaningful disclosure of credit terms

\*def *open-end transactions*: creditor reasonably contemplates repeated transactions (e.g. credit card balance)

\*must disclose finance charge, APR, annual fees and transaction charges, late fees, cash advance fees, etc.

\*def *closed-end credit*: credit advanced to a customer for a one-time purchase

\*must disclose: identity of creditor, itemized description of amount financed, total finance charge if loan is repaid at minimum rate, APR, payment schedule, total sales price, prepayment penalties, late fees, etc.

## Lender Liability

\*RULE: *good faith*: can accelerate a loan only a shield, not a sword. *Brown v. Avemco* (9th Cir. 1979)

\*RATI: require good faith b/c of “impossibility of drafting a K covering every possible contingency.” Fischel.

\*UCC 1-208: accelleration term “at will" or "when he deems himself insecure" implies a good faith req’t of insecurity.

\*RULE: if lender is too involved or in control of a construction project, court may impute liability. *Great Western S&L* (Cal. 1968)

\*NB: highly disfavored.

\*RULE: good faith doesn’t matter; “inequitable conduct” requires breach + advantage-taking; bank’s refusal to bail out a client w/o being supersecured does not make it a fiduciary. *Kham & Nate’s Shoes v. First Bank* (7th Cir. 1990, Easterbrook).

## Community Reinvestment Act

\*Arg: part of the public utility view of banks

\*Ranks: outstanding, satisfactory, needs to improve, substantial noncompliance

\*PROF arg: CRA does more harm than good

# Pre-Emption

\*Q: How to quantify damage of non-monetary harm, like TILA violation?

1. statutory damages, e.g. $1,000/ violation.
2. fee-shifting (one-way ratchet).
3. class action.

\*Q: Class Action works too well! Solution?

1. Limit recoveries: e.g., Fair Debt Collection Practices Act
2. Superiority requirement: CA must be best way to resolve the problem. *Leysoto*.
3. Class action waiver clause.
4. Mandatory arbitration clause. FAA: 9 USC §2. (Combine it with class action waiver: waive class wide arbitration.)

\*RULE: “state laws that obstruct/impair/condition bank’s powers” do not apply to nat’l banks. *Barnett Bank*.

\*RULE: ***state laws can be preempted only if*** state law would have discriminatory effect (harms nat’l bank to benefit state banks); significant interference w/ nat’l bank’s powers (*Barnett Bank*); or is otherwise preempted. *Dodd-Frank*.

\*NB: fed law often neither pre-empts nor preserves, but just declares std for determining pre-emption: e.g. state law not inconsistent w/ fed law if it affords greater protection than fed law. 15 USC 1692n.

\*RULE: *Leysoto* (SD Fla 2009): no harm alleged; D had only $40K in assets but statutory damages of $4.6-46M. H: class not certified b/c other procedues superior for resolving.

\*RULE: mandatory waiver of class wide arbitration is acceptable, FAA pre-empts state ban on unconscionable K clauses. *AT&T Mobility v. Concepcion*.