



# **ARCHITECTURE OF THE BANK CHARTER & BANKING REGULATION**

## **AN OVERVIEW**

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# What Does DFI Regulate?

- **Division of Banks**
  - State-chartered commercial and savings banks
  - Alien bank branches
  - Bank holding companies
  - Non-depository trust companies
- **Division of Credit Unions**
  - State-chartered credit unions
- **Division of Consumer Services**
  - Consumer loan companies
  - Mortgage brokers
  - Mortgage loan servicers
  - Check cashers and sellers
  - Payday lender
  - Escrow Agents
  - Money transmitters
- **Division of Securities**
  - Broker-dealers
  - Registered investment advisers
  - Private placement registration/exemption
  - Business Opportunities/Franchises
  - Investment schemes



# Scope of Division of Banks Regulation



- **58 State-Chartered Commercial & Savings Banks**
  - Total Deposits as of 6/30/11: \$38,397,668,000
  - Total Assets as of 6/30/11: \$43,166,484,000
  - Excluding Alien Bank Branches
- **2 Alien Bank Branches**
- **40+ Bank Holding Companies**
- **8 Non-Depository Trust Companies**

# The Dual Banking System

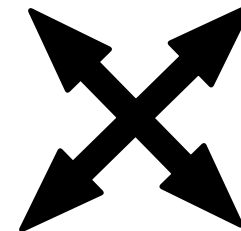
- From the beginning, there have been advocates of **centralized vs. state-chartered banking**.
- This dynamic tension has evolved into the **dual banking system** that we have today.
- This is an example of **federalism** at work.



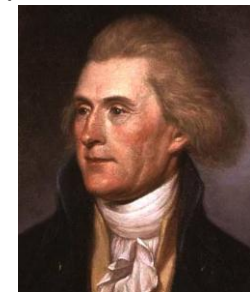
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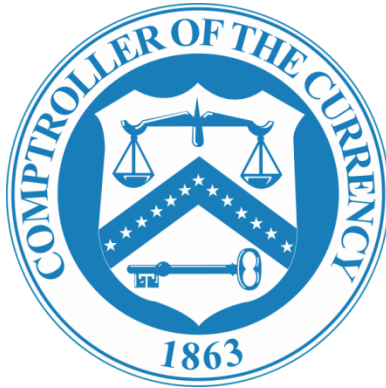
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# Federal vs. State Charters



- There are **national banks** regulated by the **OCC** under the **National Bank Act of 1863**.
- There are **federal S&Ls** now (because of Dodd-Frank Act) regulated by the **OCC** under the **Home Owners Loan Act of 1933**.
- **Washington State bank and savings bank charters** are regulated by **DFI** under **Title 30 RCW** and **Title 32 RCW**.

# The Role of the Federal Reserve

- **Federal Reserve controls the nation's money supply by:**
  - Purchase and sale of U.S. Treasury Bonds
  - Raising or lowering discount rates
  - Controlling the printing of money
- **The Fed also makes a lot of rules concerning the way the banking system behaves.**
  - Rules of corporate governance such as insider transactions (Regulation O)
  - CAVEAT: Rules of consumer protection have been transferred to CFPB under Dodd-Frank Act.
- **The FRB regulates bank holding companies under the Bank Holding Company Act.**
- **This is done jointly with DFI by examination of Fed members.**



# The Role of the FDIC



- Insures deposits.
- In cooperation with DFI, regulates state-chartered banks and savings banks who are not Fed members.
- Acts as receiver and resolution authority for failed banks.

# Fed Membership

- Who may apply?
  - Any bank **incorporated by special law of any State**
  - Any bank **organized under the general laws of a state or U.S.**
  - Any bank incorporated in District of Columbia
  - [**Federal Reserve Act, §9 (12 U.S.C. §321)**]
- Advantages:
  - Don't have 3 regulators examining them – just 2.
  - Anecdotally, Fed examination is perceived differently.





# The Fed as Central Banker



- **12 District Federal Reserve Banks**
- **Washington State is in the jurisdiction of the Federal Reserve Bank of San Francisco**

- **Prevent panics**
  - Elasticity of currency
  - Check clearing system
  - Lender of last resort
- **As the banker's bank, it helps to assure the safety and efficiency of the payments system.**
- **As the government's bank, or fiscal agent, the Fed processes a variety of financial transactions involving trillions of dollars.**
- **You don't have to be a Fed member to borrow from the Fed.**

# Fed Funds

- **Federal funds are the reserve balances (also called federal reserve accounts) that private banks keep at their local Federal Reserve Bank, such as the Federal Reserve Bank of San Francisco.**
- **This is a mechanism for private banks to lend funds to one another.**
- **Monetary policy works by influencing how much interest the private banks charge each other for the lending of these funds.**
- **Federal reserve accounts contain federal reserve credit, which can be converted into federal reserve notes.**

# Federal Home Loan Bank System

- **GSEs regulated by FHFA.**
- **Cooperatives owned and governed by their members –banks, thrifts, credit unions and insurance companies.**
- **Assist and enhance the financing of housing and community development.**
- **Access to low cost secured borrowings (advances) funded by FHLBanks from the issuance of discount notes or term debt – consolidated obligations (COs).**



# DFI as Primary Authority



- A bank must have federal deposit insurance.
- However, DFI (and not the FDIC) is the chartering (granting) authority for state-chartered banks.
- Unless FDIC makes the rare move of appointing itself receiver, only DFI can close a failed bank.
- FDIC has only appointed itself receiver 3 times in its history and never with a state-chartered bank.
- FDIC does have to weigh in, however, on changes in “control” of a bank and additional branching.

# Joint Examination Authority

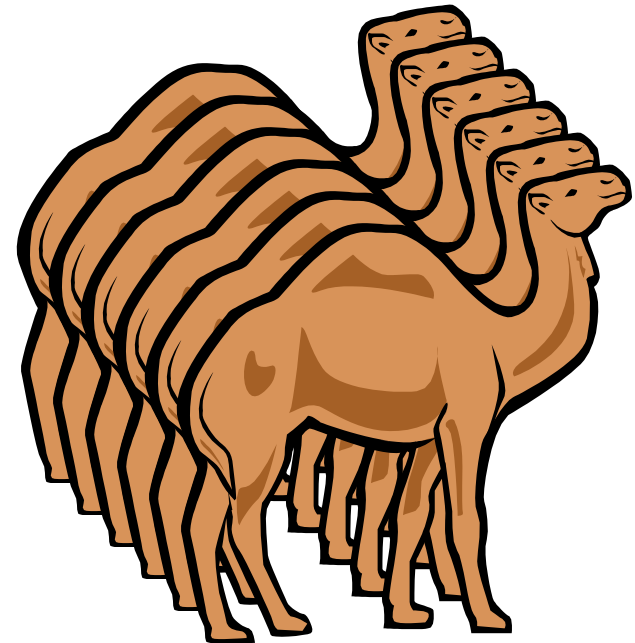


- **Joint examination agreement between FDIC and DFI**
- **Joint examination agreement between FRB and DFI.**
- **Joint Examinations:**
  - **FDIC/DFI: Safety & Soundness Exam (including IT security)**
  - **FDIC/DFI: Bank Secrecy Act & PATRIOT Act compliance**
  - **FRB/DFI: Safety & Soundness Exam (Fed Members)**
- **Delegated To FDIC:**
  - **Consumer Protection Exam**
  - **Community Reinvestment Act (CRA) Exam**
- **Joint examinations every 12 to 18 months.**
- **Visitations of problem banks more frequently.**

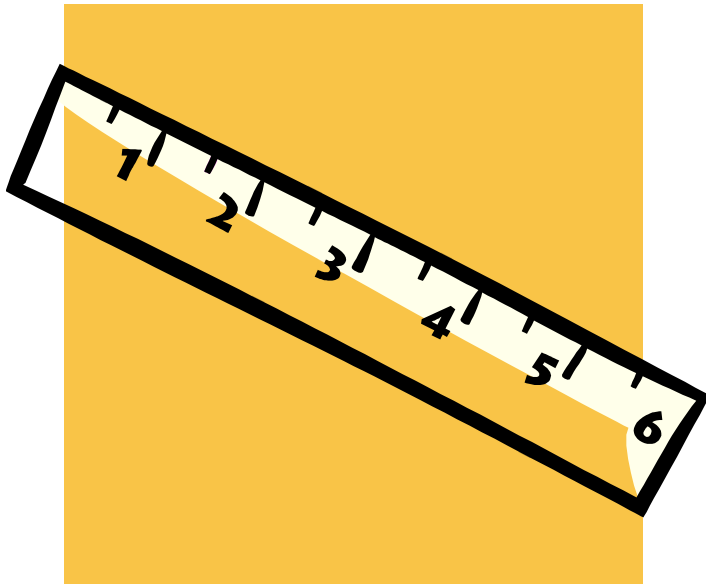
# CAMELS:

## The 6 Measures of Safety & Soundness

- **C**apital
- **A**sset Quality
- **M**anagement Quality
- **E**arnings
- **L**iquidity
- **S**ecurity (IT)



# CAMELS Ratings (Individual & Composite)



1. **Strong**
2. **Satisfactory**
3. **Needs Improvement**
4. **Deficient**
5. **Critically Deficient**

# Bank Health Math - 1

- **Tier 1 Capital** = Core equity capital (usually paid-in stock)
- **Total Capital** = Tier 1 Capital plus reserves and subordinated debt
- **Tangible Equity Ratio** = Tangible Equity (Cash on Hand) ÷ Total Assets
- **Leverage Ratio** = Tier 1 Capital ÷ Total Assets
- **Total Risk-Based Capital Ratio** = Total Capital ÷ Risk-Weighted Assets





# Bank Health Math - 2



- **Liquidity Ratio** or acid test (ability to repay short-term creditors) = liquid assets ÷ total assets.
- Another measure of a bank's liquidity is the **Loan-to-Deposit Ratio** = total loans ÷ total deposits.
  - In 2008, LTD ratios in the United States ranged from a low of 56% in Utah to a high of 170% in North Dakota.

# Bank Health Math - 3

- **Loan Loss Reserve** (an expense set aside as a reserve for bad loans).
  - Key measure of asset quality.
  - **Reserve Ratio** =  $\text{Loan Loss Reserves} \div \text{Gross Loans Average}$
  - Higher the reserve ratio, lower the quality of the portfolio
  - Also known as **Allowance for Loan & Lease Losses (ALLL)**.
- **Net Interest Margin** = interest income minus interest paid on deposits as a percentage of interest-earning assets.



# PCA Standards 1

- FDIC and DFI apply uniform *prompt corrective action (PCA) standards* in Title 12, Part 325 of the Code of Federal Regulations and authorized by Congress under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).



# PCA Standards 2

- **Well-Capitalized**
- **Adequately Capitalized**
- **Undercapitalized**
- **Significantly Undercapitalized**
- **Critically Undercapitalized**



# Well-Capitalized



- Bank significantly exceeds the required minimum levels of capital (both risk-based and leverage).
- Leverage Capital equals or exceeds 5%.
- Total Risk-Based Capital equals or exceeds 10%.
- This is the standard FDIC and DFI normally expect in good times.

# Adequately Capitalized

- Bank meets the required minimum levels of capital.
- Leverage capital is at least 4% but less than 5%.
- Total Risk-Based Capital is at least 8% but less than 10%.
- Must have FDIC waiver to accept brokered deposits (can't pay a rate greater than 75 basis points above market).



# Undercapitalized



- Bank fails to meet any required minimum level of capital.
- Leverage capital is at least 3% but below 4%.
- Total Risk-Based Capital is at least 6% but below 8%.
- Close monitoring of bank required.
- Capital restoration plan required.
- Limit growth and access to FRB's discount window.
- Regulatory approval is required for acquisitions, branching or entering new lines of business (not favored).

# Significantly Undercapitalized

- Bank is significantly below any required minimum level of capital.
- Leverage capital is below 3%.
- Total Risk-Based Capital is below 6%.
- Executive pay subject to approval.
- No payment of subordinated debt.
- Harsh remedial efforts and restrictions required, including raising equity capital, improving management, prohibiting brokered deposits, ending risky activities, etc.





# Critically Undercapitalized



- Bank fails to meet the “critical capital” level determined by regulators.
- Less than 2% Tangible Equity Capital.
- Bank has received a PCA Supervisory Directive from the FDIC that it must within 90 days obtain additional equity capital or be acquired, or else be subject to receivership.
- Usually receivership follows within 90 – 270 days of such determination.
- Bank is under the toughest restrictions at this point.

# Chartering a State Bank - 1

- **Paid-In Capital Amount**

- Location.
- Management.
- Population to be served.
- Economic characteristics.
- Proposed activities.
- Proposed operation.
- Other factors.
- RCW 30.08.010

- **Proposed Articles of Incorporation**

- RCW 30.0.020
- One incorporator sufficient
- At least 5 directors.



# Chartering a State Bank - 2



- **Notice of Intention to Organize a Bank**
  - RCW 30.08.010
  - WAC 208-528-990
- **Business Plan**
- **3-Year Financial Projection**

# Chartering a State Bank - 3

- **Contents of Business Plan**
  - **Ownership – Stock Structure**
  - **Niche Served**
  - **Marketing Plan**
  - **Proposed Management**
    - **Directors**
    - **Executive Officers**
    - **Background Checks/Fingerprints**
  - **Economic Analysis**
    - **Feasibility of markets.**
    - **Other viability issues.**
  - **Meeting Community Needs**
  - **Use of Information Technology**
  - **Outsourcing to Third Parties**
  - **Compliance with Federal/State Laws**



# Chartering a State Bank - 4



- **Investigation**
- **FDIC Approval**
  - **Condition of charter. RCW 30.08.060**
- **Conditions for Issuance of Certificate of Authority**
  - **Satisfactory Business Plan.**
  - **FDIC Approval.**
  - **Paid-in capital in the amount determined by the Director.**
  - **Requisite surplus or reserve fund has been accumulated or paid in cash.**
  - **Good faith compliance with law and conditions precedent.**

# **Contents of Applications**

## **Financial Condition & History**

- **Pro forma statement of condition – beginning.**
- **Details of bank facility to be occupied.**
- **Proposed investment in fixed assets (furniture and equipment).**
- **Relationships with sellers or lessors.**
- **Organization expenses.**

# **Contents of Applications**

## **Adequacy of Capital Structure**

- **Proposed allocations within total capital structure.**
  - Amount of paid-in common capital stock.
  - Amount of paid-in surplus.
  - Amount of paid-in undivided profits.
  - Amount of other segregations, including the organization or expense fund.
- **Minimum capital requirements determined by Director.**
  - Population of community to be served.
  - Ratio the projected net total capital structure will bear to the estimated volume of deposits at the end of each of the first three years of operations.
  - Detailed projection of earnings and expenses for each of the first three years of operations. Provision for loan loss reserves based upon the major types of lending demands the proposed bank expects to serve and total loans expected each of first three years..

# **Contents of Applications**

## **Character of Management**

- **A financial report and a biographical report for each officer and director.**
- **Report by each officer and director of the number of shares to be purchased, the total cost of such shares and details as to source and financing terms for such portion as not paid in cash.**
- **Initial subscribing shareholders and price per share.**
- **Financing terms for 5% or more shareholders.**
- **Committee membership.**
  - **Loan and/or executive committee.**
  - **Investment committee.**
  - **Audit committee.**
- **Principal correspondent bank.**
- **Surety bond coverage.**



# **Contents of Applications**

## **Estimate of Deposits**

- **Demand deposits.**
- **Savings passbook accounts.**
- **Other time deposits.**
- **Public funds.**
- **Recapitulation as to total demand and total time.**

# **Contents of Applications**

## **Convenience & Needs of Community**

- **Must show economic support and justification for the proposed bank.**
- **The community and "surrounding country" (the trade territory or market area) which the proposed bank will serve.**
- **Detail map showing competition.**
- **Subscribers residing in or closely identified with the area.**
- **The economic characteristics of the trade territory for the most recent five-year period:**
  - **Manufacturing & Other Industrial**
  - **Agricultural**
  - **Construction activity & housing starts**
  - **Retail and wholesale sales**
  - **School population**
  - **Census figures and projections**

# **Contents of Applications**

## **Consistency of Corporate Powers**

- **Articles of incorporation scrutinized.**
- **Bylaws scrutinized.**
- **Complete details of any proposed affiliate (such as a bank holding company).**