Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter, P.C.
ATTORNEYS at LAW
WASHINGTON, DC

A Policy Agenda for National Banks[*]

Jim Sivon

December, 2017

At some point in the next few weeks, the U.S. Senate is expected to consider a bipartisan bill that amends the Dodd-Frank Act and other federal banking laws in order to promote greater economic growth by reducing certain regulatory burdens. This article proposes four other changes in federal law aimed at enhancing the national bank charter.

Three of the features in this proposed policy agenda for national banks are taken from testimony presented to the Senate Banking Committee last year by then Acting Comptroller of the Currency Keith Noreika.[1] The fourth calls for operational and regulatory parity between subsidiaries of national banks and subsidiaries of financial holding companies. This latter proposal was considered, but rejected, by Congress almost 20 years ago. However, intervening events suggest that it is time to reconsider parity between national banks and financial holding companies.

Collectively, these four proposals would enhance the dynamism of the national bank charter so national banks can better meet the needs of a growing economy. They also would help state banks. The benefits of operational and regulatory parity between national banks and financial holding companies would flow automatically to state banks under existing state "wild card" and "parity" statutes. Also, two of the other proposals in this policy agenda logically should be extended to state banks. The four features of this policy agenda for national banks are outlined below.

Consolidated Supervision and Regulation for Traditional National Banks

Under current law, the Federal Reserve Board (Board) is the primary federal regulator for a state bank that is a member of the Federal Reserve System, and for the parent holding company of that bank. In contrast, national banks and their parent holding companies are subject to regulation by two federal agencies: the Office of the Comptroller of the Currency (OCC) regulates the national bank, and the Board regulates the holding company. For national banks, especially those in which the bank constitutes the majority of the

[*]The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1]Testimony of Keith A. Noreika, Acting Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 22, 2017.

assets of the holding company, this structure results in overlapping reporting requirements, examinations, and regulation.

In his testimony to the Senate Banking Committee, Acting Comptroller Noreika proposed that this overlap should be eliminated for national banks that constitute a substantial portion of the total assets of a holding company. More specifically, he suggested that the OCC should be the consolidated regulator for a national bank and its parent holding company if the national bank constitutes 90% or more of the total assets of the holding company. He also suggested that such consolidated federal regulation applies to any depository institution, not just national banks. In other words, a state bank that is not a member of the Federal Reserve System, and the parent holding company for that bank, could be subject to consolidated regulation by the Federal Deposit Insurance Corporation (FDIC), if the state bank met the 90% asset test.[2]

This change would not alter the Board's supervision and regulation of the nation's largest banking organizations. Since those companies operate large securities firms and other non-banking companies both in the U.S. and abroad, their subsidiary national banks would not meet the 90% asset test.

Consolidated Chartering for National Banks

When an organizing group seeks to charter a new national bank, the group must apply to the OCC for a charter and to the FDIC for deposit insurance. This two-step application process increases the costs of forming a new national bank, and effectively gives the FDIC a veto over new charters. As Acting Comptroller Noreika noted in his testimony, it was not always this way. Prior to 1991, the OCC could grant a charter to a new national bank and certify to the FDIC that it had reviewed the same statutory factors for deposit insurance coverage that the FDIC must consider in granting deposit insurance. Following a wave of bank failures in the early 1990s, Congress established the current two-step application process as an additional safeguard for the deposit insurance fund.

Today, in the post-Dodd-Frank regulatory environment, there are a variety of additional safeguards for the deposit insurance fund, including higher capital requirements. Moreover, the OCC is a member of the Board of Directors of the FDIC, and, as such, has an obligation to the integrity of the fund. Therefore, another feature of this policy agenda for national banks would be to return to the pre-1991 process for chartering national banks and granting deposit insurance to those banks.[3] This change also could help to reverse the slow-down in de novo chartering that has occurred since the financial crisis.

Modernize Corporate Governance Procedures for National Banks

National banks have some flexibility in selecting the law governing their corporate procedures, but only to the extent that those procedures are not inconsistent with governance procedures in federal law.[4] The third feature of this policy agenda for national banks would be to eliminate the governance procedures in the National Bank Act, and permit national banks the ability to fully adopt the corporate governance procedures of the state in which the bank has its main office, the Delaware General Corporation Law, or the Model Business Corporation Act. As Acting Comptroller Noreika stated in his testimony, this change would

[2]Similar consolidated federal supervision would apply to savings associations owned by holding companies.

[3]In his testimony to Congress, Acting Comptroller Noreika suggested that the OCC's deposit insurance certification could be subject to a "notice and disapproval" process under which the FDIC would be given a period of time (e.g., 30 days) to object to a certification, and if the FDIC did not issue an objection during that period the insurance would be deemed to be granted.

[4]Examples of inconsistent provisions noted in Acting Comptroller Noreika's testimony are requiring shareholder supermajorities, requiring notice to shareholders by publication and certified mail, requiring formal meetings, and requiring explicit shareholder votes.

place national banks on the same footing as bank holding companies and state banks.

In conjunction with this change, the OCC also should be encouraged to modernize its systems for disclosures related to securities issued by national banks.[5] The adoption of a disclosure system similar to the SEC's EDGAR system would improve investor knowledge and understanding of securities issued by national banks and thereby enhance the market for those securities.

Parity for Financial Subsidiaries of National Banks

In 1999, when Congress provided for the establishment of "financial holding companies" that could engage in a wide range of financial activities, it also provided for the establishment of "financial subsidiaries" of national banks. Financial subsidiaries of national banks, however, are subject to certain activity and operational limitations that do not apply to subsidiaries of financial holding companies. Another feature of any policy agenda for national banks should be to eliminate the activity and operational limitations on financial subsidiaries of national banks and give them parity with subsidiaries of financial holding companies.[6]

Unlike a subsidiary of a financial holding company, a financial subsidiary of a national bank may not engage in insurance underwriting (except to the extent permitted by the OCC for national banks before January 1, 1999) and may not engage in merchant banking activities through a securities or insurance affiliate. Also, unlike a financial holding company, a national bank must deduct its investment in a financial subsidiary from regulatory capital and may not consolidate its assets and liabilities with those of its financial subsidiaries. Furthermore, the aggregate consolidated total assets of all financial subsidiaries of the national bank cannot exceed the lesser of 45 percent of the consolidated total assets of the parent bank or $50 billion, and if the parent national bank is one of the 100 largest insured banks, the national bank must have at least one issue of outstanding debt that is rated in one of the three highest investment-grade rating categories.

These activity limitations and operational conditions were placed upon financial subsidiaries in order to limit a perceived "safety net subsidy" that flowed to national banks through deposit insurance, access to the Federal Reserve's discount window and Fedwire. In other words, they were designed to ensure that national banks did not enjoy an unfair competitive advantage over financial holding companies in providing financial products and services to businesses and consumers. The activity limitations and operational conditions also were imposed to reduce the risks incurred by a bank subsidiary from spilling over and harming a parent bank.

Both of these justifications for the activity limitations and operational conditions imposed on financial subsidiaries of national banks deserve to be revisited.

At the time, the existence and scope of the supposed safety net subsidy was the subject of analysis by staff at the Board and the OCC.[7] Board staff found a subsidy: "We conclude that limiting extension of the safety net subsidy should be a serious concern when designing strategies for expanding bank activities." The OCC staff, in contrast, found no basis for the subsidy: "First, banks do not benefit from any net subsidy. Second, even if there were a subsidy, it could be largely kept within the bank by establishing effective rules governing the transmission of funds among entities, rather than by limiting the activities of bank subsidiaries."

[5] Thanks to Jim Barresi of Squire Patton Boggs for this suggestion.

[6] I was involved in the industry effort in the 1990s to establish activity and operational parity between subsidiaries of national banks and subsidiaries of bank holding companies. That goal was promoted by the Support Group for Modern National Banking, which was managed by Carter Golembe. I served as a legal adviser and secretary to that Group.

[7] See "***Analysis of the Safety Net Subsidy Issue***", OCC Staff, April 1997, and "***The Subsidy Provided by the Federal Safety Net: Theory, Measurement and Containment***", Myron L. Kwast and S. Wayne Passmore, Federal Reserve Board, December 1997.

These opposing views reflected differing perspectives on the cost of bank regulation. The OCC staff argued that the costs of complying with applicable banking laws and regulations exceeded the benefits of the federal safety net. Board staff argued, in turn, that regulatory costs were leveling off, and possibly declining. In this post-Dodd-Frank regulatory environment, with materially higher capital, liquidity, and other prudential standards in place for national banks, it would seem that the costs of regulation do, in fact, exceed any subsidy that flows from the federal safety net. Apparently, these higher costs also have caused some banking organizations to eliminate their holding companies.

Claims of greater risk transference from a bank subsidiary to a parent bank than from a holding company subsidiary to an affiliated bank also have been challenged by recent events. The bank holding company structure did not provide any special insulation from risk in the run-up to the financial crisis, and during the crisis, most of the federal support provided to the banking industry was provided to holding companies.

Moreover, the potential for risk transference to a bank logically should be greater in a holding company structure than in a bank subsidiary structure. With various subsidiaries, including a bank, a holding company may have some incentive to favor one or more subsidiaries over the bank. In a bank subsidiary structure, the bank has no incentive to engage in transactions through subsidiaries that can harm the bank. Instead, the bank has every incentive for its subsidiaries to engage in transactions that can result in a steady stream of dividends up to the bank so it can be strong and profitable.

Conclusion

In sum, given Congressional interest in refining bank regulation, and given changes in personnel at the federal banking agencies and the Treasury, it may be timely for national banks to pursue a policy agenda that enhances the national bank charter.

Jim Sivon is a partner with the law firm of ***Barnett Sivon & Natter, P.C.****, Katie Wechsler is an associate with the law firm of* ***Barnett Sivon & Natter, P.C.***