Choice of Charters

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AUTHORED ARTICLE | Spring 2012

The Bankers' Statement – Spring 2012

Appeared in the Winter 2012 issue of *The Bankers' Statement*

One of the unique characteristics of the banking business is that bankers have choices when it comes to bank charters. Choices between federal and state bank and thrift charters and choices regarding Federal Reserve membership have historically involved differences not only in powers, obligations, governance and products, but which and how many regulators oversee the institution and the direct and indirect cost and expense involved in that oversight. The concept of a "dual charter" system has been in place for a long time, and provides for choice, diversification and decentralization of authority and oversight among state and federal regulatory agencies. As noted in the FFIEC Statement on Regulatory Conversions issued on July 7, 2009 (FIL-40-2009), "financial institutions may choose to operate under the state or federal charter that best accommodates their legitimate business and strategic needs."

With the demise of the Office of Thrift Supervision (OTS) resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) effective July 21, 2011, it may be especially timely for banks and thrifts to consider the best type of charter for the activities they presently conduct or anticipate conducting in the future based, as noted, on their "...legitimate business and strategic needs".

The Act transferred certain powers and duties of the OTS to other federal regulators effective July 21, 2011. As a result, the Office of the Comptroller of the Currency (OCC) now has supervisory and rulemaking authority over federal thrifts and the Federal Reserve now has supervisory authority over savings and loan holding companies. OTS authority with respect to state thrifts will transfer to the FDIC. The Act does not eliminate the federal thrift charter.

A significant degree of uncertainty remains with regard to this transition, especially with respect to post-transition implementation and post-transition regulatory oversight. Irrespective of the technical "rules of engagement", how thrifts perceive their treatment in the examination and enforcement process on a post-transition basis will provide a real indication of the actual impact on the operations of federal thrifts.

While the differences between charters may seem insignificant at first, they can and do result in different paths and operating environments for the institutions involved. Review and consideration of the most optimum operating charter for an institution should be a constant and continual item for board consideration.

There is now for all intents a virtual regulatory "moratorium" on de novo charters, and a formal "moratorium" on charter conversions was imposed by the FFIEC (FIL-40-2009) for proposals to convert charters when "... conversion requests are submitted while serious or material enforcement actions are pending ... ". Dodd-Frank formalized a prohibition on conversions, subject to certain limited exceptions, when an institution is subject to an enforcement action initiated by its primary federal regulator.

In all instances, institutions will encounter a de facto "moratorium" when the obvious intent is "regulatory arbitrage" reinforcing a "no place to hide" policy for troubled institutions.

With interstate branching available for most state and national banks and thrifts, choice of state charter and choice of state law can be an important factor in considering which state chartering authority provides the most receptive and advantageous chartering, powers, financial, supervisory and operating environment for an institution when state alternatives are available. Accessibility, ease and consistency in the relevant laws and regulations, regulatory cost, supervisory accessibility and other aspects of choice of which state to charter in can make a significant financial and operating difference to certain banks and thrifts, and further flexibility has come about as a result of the Act with regard to interstate branching. Those issues and others are some of the relevant factors as thrifts look to whether they will remain with the OCC or examine state charter considerations and alternatives.

An article in *The American Banker* (Editor at Large; October 26, 2011) points out that there is a significant trend of conversions from federal to state charters in the community bank segment that has become evident over the past two decades, which appears to perhaps be accelerating. The article cites concerns regarding a banker-perceived "one-size-fits-all" approach by the OCC, and a perceived greater understanding of local conditions by state regulators. The article also cites a perceived banker preference for Federal Reserve membership and supervision as opposed to non-member status for state banks (which results in the FDIC being the primary federal regulator for supervision and examination purposes). In terms of overall aggregate assets under supervision, however, the national bank charter clearly leads.

And in an era of diversifying risk following the collapse of the residential real estate market, institutions may wish to examine whether remaining subject to the limitations of the QTL test make sense for their future plans or whether they plan to offer a more diversified lending platform going forward. Presently, thrifts and savings banks are subject to strict percentage limitations on CRE and C&I lending. Thrifts converting to full bank charters and perhaps expanding the nature and risk profile of their loan portfolios with regard to CI and CRE lending must be prepared with experienced personnel and sufficient controls to identify and address the added risk and additional regulatory scrutiny they are likely to encounter. Branching and dividend/capital distribution rules also differ between the types of charters, as do permissible activities and permissible investments for the institution and subsidiary organizations.

Converting for the "right reason" is always the primary consideration. "Regulator shopping" doesn't fool anyone, especially the regulators. However, there are legitimate business and cost reasons to consider choice of charter, which can make a significant business difference to bankers and their shareholders. And sometimes, particularly after there have been significant and continuing relationship "issues", it may make sense to change to gain a fresh perspective.

Please note that, for Ohio-chartered institutions, the following is subject to a general caveat that Ohio state bank and thrift laws and regulations are presently undergoing a comprehensive review and analysis through a project initiated by the ODFI and industry representatives. Goals of the project include simplification of the Ohio banking code, enhancing access to capital and appropriate business opportunities for Ohio charters, and elimination of most if not all statutory differences between state bank, thrift, and savings bank charters consistent with safe and sound operations of the institutions. Natural and appropriate differences will likely remain with regard to organizational structures and governance rules between stock and mutual organizations, however certain complex and perhaps antiquated operating restrictions presently in place for thrifts and savings bank may be removed. In that light, there will likely be further important considerations for those currently in the thrift and/or savings bank business in the event that the statutory changes are adopted and implemented. The timeframe for finalization of the comprehensive recodification initiative is not definite at the present time.

So what's available now and what are the differences?

1. **State Member Banks**. The chartering entity for state member banks in Ohio is the Ohio Division of Financial Institutions (ODFI), a division of the Ohio Department of Commerce. Charles Dolezal, a long-time community banker, is the current superintendent of financial institutions, and Kevin Allard, a long-time chief examiner for the ODFI, is the current deputy superintendent for banks and thrifts. The ODFI charters and regulates Ohio-chartered banks, savings banks and thrifts, and has some input and examination authority for matters involving bank holding companies that control Ohio-chartered banks. It also charters and regulates state-chartered trust companies and has some regulatory authority with respect to out-of-state trust companies operating in Ohio. The OTS had some oversight for state thrifts and their holding companies as noted previously which has been transferred to other federal agencies as noted later.

State-chartered banks can be "members" of the Federal Reserve, which requires investment in Fed stock in an amount equal to 3% of capital with another 3% on call. The Fed stock investment presently returns a 6% dividend. Being a "member" of the Federal Reserve System provides that the FRB is the "primary federal regulator" for state member banks, although certain FDIC rules also apply because all Ohio banks and thrifts are required to be FDIC-insured. Therefore state member banks deal primarily with two bank regulatory agencies (one state and one federal) in their day-to-day business and examinations. Both the ODFI and their federal counterparts endeavor to coordinate examination processes to the greatest extent possible to attempt to minimize the burden on their institutions. Member institutions with holding companies have Fed supervision at both the bank and holding company levels.

In Ohio, it is worth noting that the ODFI combined bank and thrift examination staffs several years ago to provide uniform examination despite the underlying different types of charters. For the past seven years their examination staffs have been composed of a mix of both traditional thrift and traditional commercial examiners leading to a broader general understanding among all of the examiners with respect to the underlying business, operations and issues facing both types of charters.

Current law and regulation provides that the ODFI has important rule-making authority that can provide parity with OCC regulation and regulations of other states to provide competitive equality for Ohio-chartered financial institutions.

Generally, assessments by state regulators tend to be lower than their federal counterparts. In Ohio, annual assessments charged to state banks by the ODFI are presently around 40% of that charged to national banks by the OCC. Both have significant surcharges for 3, 4 and 5-rated institutions.

2. **State Non-Member Banks**. Basically the same applies to state non-member banks, except that their "primary federal regulator" for supervisory purposes is the FDIC. Most federal agencies strive for consistency in regulation through the FFIEC and other joint rule-making authorities. State non-member banks are examined by the ODFI and the FDIC. As with state member banks, the ODFI has limited authority to examine bank holding companies with regard to their interaction with Ohio state-chartered institutions irrespective of the home state of the holding company.
3. **National Banks.** The OCC is the chartering agency and "primary federal regulator" for national banks. National banks are "automatically" Fed member institutions by virtue of their charters. As a result, national banks are examined by a single federal agency. However, if a holding company is also involved, the Fed has examination responsibility for the holding company. As FDIC-insured institutions, however, certain FDIC rules also apply. One of the differences between national banks and state banks in the examination area is that the OCC can (and does) draw examination field staff from across the country that can sometimes result in more frequent changes in examination staff, which in turn can impact the ability of the examination staff to develop and retain an underlying knowledge and understanding of the particular institution, its management, customers, market and culture. Some argue that, as a result, the OCC has more of a "one-size-fits-all" approach, while others believe that the national scope provides a broad examination perspective so that OCC examiners can bring ideas and insights from other OCC districts to the banks they examine in Ohio.
4. **Federal Thrifts.** With responsibility for enforcement of OTS rules and regulations having shifted to the OCC, there remain some questions as to the impact of retaining a federal thrift charter or electing to convert to a federal thrift charter. The OCC has been conducting workshops across the country in an effort to quell concerns voiced by some federal thrifts regarding the impact of the new regulatory structure and OCC examinations. Until more time passes to determine the long-term effect of this significant change, the impact of converting to a federal thrift charter remains somewhat uncertain.
5. **State Thrifts**. State savings associations are presently regulated by the ODFI in Ohio and, after July 21, 2011, the FDIC. Interestingly, the Act provides for the transfer of supervisory authority, but not rulemaking authority, to the FDIC. Rulemaking authority has been transferred to the OCC. The outcome is uncertain at the present time.
6. **State Savings Banks.** State savings banks are somewhat unique charters that are a hybrid of state commercial bank and state thrift. Holding companies can be either bank holding companies or thrift holding companies, depending on the business conducted by the savings bank. Ohio savings banks presently have formulaic restrictions on lending activities and, like state thrifts, are subject to their own set of statutes under the Ohio Revised Code. Like state thrifts, their primary federal regulator has been changed from the OTS to the OCC. Whether it makes sense to continue state savings banks as a

separate charter given the changes in the industry oversight remains to be seen.

In Ohio, the impact of the pending recodification initiative presently underway may also have a profound impact on charter choices with regard to state thrifts and savings banks.

7. **Holding Companies.** As noted previously, bank holding companies and financial holding companies will continue to be regulated by the Federal Reserve, as will thrift holding companies following elimination of the OTS. Mutuals and mutual holding companies have special considerations when it comes to conversion alternatives, but it is presently unclear with respect to mutual charters and mutual holding companies what changes may evolve. Formation of holding companies may provide activity and investment alternatives for institutions, as well as tax advantages in Ohio.
8. **Ohio Parity Rules.** Under current Ohio law, and as anticipated under the pending recodification initiative, the superintendent has authority to grant Ohio-chartered institutions the same or similar rights, powers and privileges as federally chartered institutions, state-chartered institutions from other states doing business in Ohio, and other financial services providers.
9. **Trust Powers.** Both Ohio and the OCC provide for the ability of banks and thrifts to exercise trust powers directly and/or through joint ventures, and both provide for the establishment of pure trust companies. Special rules apply to state savings banks.
10. **Other Non-Bank Activities.** Both Ohio and the OCC provide for limited ability of banks and thrifts to act as agent in the sale of insurance and securities products and to engage in limited real estate activities. Certain non-bank activities conducted by state banks and thrifts are subject to approval by the FDIC. Non-bank activities are also subject to "subject-matter jurisdiction" oversight by appropriate non-bank regulators, such as the Ohio Department of Insurance for insurance matters and the SEC and FINRA for securities activities.

Changing Charters

Charter change considerations direct and indirect costs and expenses included in the conversion process, including legal and other professional fees, signage and stationary changes. Those considerations tend to be relatively minor, however, in light of considering what is the best charter alternative to accomplish the long-term goals of the institution.

Conversions can occur via a direct conversion process or through a conversion by merger. In all instances, the converting bank or thrift can expect a thorough "physical" by the proposed new chartering authority, in consultation with the current chartering authority, before acceptance.

A perceived disadvantage for federally chartered institutions considering converting to a state charter is that the bank will be examined by two agencies, the state and the Federal Reserve in the case of member banks, or the state and the FDIC in the case of non-member banks. However, institutions that have holding companies and choose Federal Reserve membership will still have only two regulators, the state and the Federal Reserve. In those instances, the Federal Reserve will substitute for the FDIC and the OCC/OTS in the event of a conversion, and the Federal Reserve is already involved due to the holding company relationship.

For institutions that currently operate, or intend to operate, on a multi-state basis, the concept of federal "preemption" of state laws that would otherwise serve to limit or constrain the institution in activities permitted for the institution, has a long history of being upheld for institutions with federal charters. Federal thrifts in particular have long enjoyed interstate branching rights. While state institutions have similar opportunities in some respects through their FDIC-insured status, the law is less clear for state institutions and the concept and enforceability of "preemption" has become even more unclear and uncertain under the Dodd-Frank financial reform legislation. Dodd-Frank also provides vulnerability to state attorneys general with regard to consumer enforcement irrespective of charter or size. To that end, the concept of "preemption" as a potential advantage for federally chartered institutions, and reason to select or preserve a federal charter, is somewhat unclear at the present time.

As noted previously, "functional" regulators, such as the SEC for securities activities and state insurance departments for insurance activities, will continue to have supervisory authority for certain non-bank activities under the Graham-Leach-Bliley Act, irrespective of charter.

Some argue that access to state regulators is more direct and readily available, and some argue that access to the nationwide experience and expertise of federal agencies and examiners provides a "value-added" opportunity based on broader supervisory activities in multiple states. Sometimes it boils down to personalities, although that is very rarely on its own a justifiable and viable reason to change charters. Being examined by only one regulator can provide certain perceived benefits (and burdens) for some institutions, while others would argue that having two examination "teams" can provide balance and a broader perspective. Others feel trapped and sometimes "whipsawed" when state and federal "partners" have differing positions about the same bank or the same credit. On the federal side, there is no question that in the present environment more decisions appear to be deferred to Washington or to regional offices when there is an important or serious judgment call with the federal agencies, especially in the case of troubled institutions.

In all instances, institutions considering a charter change must carefully weigh and consider these alternatives and the impact of the alternatives, and be certain to develop a viable business rationale to support their decision and document that process at the board level.

Conclusions

As with most such significant issues, while some of the considerations are similar there is no "one size fits all" in terms of the outcome. Institutions must consider which charter is right for their current and long-term strategic objectives, and which affords the institution and its constituencies the most favorable environment in which to operate and to reach their institutional goals. Converting institutions should expect a certain level of skepticism with regard to motivation if there are existing or pending problems (irrespective of whether there is an active enforcement action), and always a thorough examination by the new chartering agency before approval. Certainly direct cost is a factor, but so is accessibility, consistency, continuity, examiner quality and cooperation. Each charter type has positives and negatives, and while one type of charter may have been appropriate at the time it was first adopted, perhaps times and situations have changed or are likely to change, making it prudent to conduct an examination of whether a charter change may be appropriate and beneficial. Some have adopted certain charters because management and/or the board had familiarity with that type of charter, but the situation may have changed due to any number of factors from growth and stock liquidity issues to personality issues with the examination and oversight staffs.

Access to a dual-chartering system is preserved by the Dodd-Frank Act, although questions may arise with regard to whether a thrift charter, as a separate type of charter, remains relevant going forward. Certainly those institutions whose size and risk profile makes them "systemically important" will see a greater level of scrutiny, some of which may well find its way downward throughout the industry through the process of "regulatory creep" and the evolution of "best practices".

Institutions considering potential charter alternatives should meet with the relevant agencies and discuss their plans in order to obtain a good sense of whether the agency will be receptive to the conversion and in order to compare the proposed agency with its current agency. Appropriate experienced professional assistance should also be sought in order to examine the impact of the conversion on the institution and its affiliates, as well as to determine cost and timing implications. Careful and thorough consideration (and documentation) of the pros and cons of the various charter types should be undertaken by institutions and their boards in light of their current needs and business, and in light of their strategic direction, before deciding which charter best fits their business profile and strategic needs.