SUBJECT: Modifying provisions for regulating banks and trust companies

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 8 ayes —Averitt, Solomons, Denny, Grusendorf, Hopson, Marchant, Menendez, Wise

0 nays

1 absent — Pitts

WITNESSES: For — *Registered but did not testify:* Ann Graham and Michelle Roberts, Texas Bankers Association; Chris Williston, IBAT

Against — None

On — Randall S. James, Texas Department of Banking; *Registered but did not testify:* Everette Jobe, Texas Department of Banking

BACKGROUND: Finance Code, chapter 12 governs the structure and function of the Texas Department of Banking. Sec. 31 et seq., the Texas Banking Act, provides for regulation of state-chartered banks. Sec. 181 et seq., the Texas Trust Company Act, provides for regulation of trust companies.

DIGEST: CSHB 1768 would make various changes to the Finance Code regulating banks and trust companies.

Conflicts of interest. CSHB 1768 would replace the existing section of the Finance Code regarding conflicts of interest in the Department of Banking with language similar to the standard language in agency sunset legislation. However, this provision also would prohibit department employees who exercise discretionary decision-making authority with respect to a regulated person or entity from:

- purchasing assets of a department-regulated person or entity when the assets were being liquidated by a receiver, unless the purchase was through a public auction or with the permission of the receivership court;

- borrowing money from a regulated person or entity; or
- taking a financial interest in a regulated person or entity.

These rules would not apply to clerical or administrative employees, provided that the transaction did not violate any employment policies that the banking commissioner might adopt. The bill also would prohibit all classes of employees from obtaining a product or service from a person or entity regulated by the department on terms that were better than those offered to similarly situated members of the general public.

CSHB 1768 would create exceptions from the rules regarding borrowing from and holding a financial interest in a regulated person or entity. It would permit indebtedness to a regulated person or entity if the debt was permissible when it was incurred but later became impermissible under the conflict-of-interest rules, either because the person went to work for the department or because of some event (for example, a bank merger or sale of the loan) that the employee could not control. The employee could not participate in decisions concerning the person or entity to whom the employee owed the debt until the debt was repaid.

The bill would not prohibit an employee from holding a financial interest in a regulated entity or person if the interest arose through ownership of publicly traded shares of certain mutual funds. Nor would it prohibit an employee's family member who was employed by a regulated entity or person from receiving an equity interest in that employer as part of an employee-benefit plan designed solely to compensate employees for services rendered. Again, however, the Banking Department employee could not take part in decisions affecting the regulated person or entity while the interest was held.

CSHB 1768 would authorize the banking commissioner to establish employment policies to implement the conflict-of-interest provisions and would give the Finance Commission rulemaking authority to administer the provisions. The bill would delete the current criminal penalties for violating financial conflict-of-interest rules such as those above. Also, the bill would require department employees to swear that they had read not only the conflict-of-interest statutes, as in current law, but also the commissioner's policies and the commission's rules.

Examinations. Although generally state banks must be examined every 12 months, CSHB 1768 would allow the commissioner to conduct examinations every 18 months for banks with total assets of less than $250 million that had been judged well capitalized and well managed, were found to be in outstanding condition (or in good condition if the state bank had no more than $100 million in assets) at their last examination, were not the subject of an enforcement action, and had not undergone a change of control since the last examination.

The commissioner could postpone an examination by up to six months or could examine a bank more often than every 12 months if doing so would be more efficient. The bill would allow more frequent examinations if the commissioner thought it necessary to safeguard depositors, creditors, and other bank stakeholders.

Confidentiality and disclosure. CSHB 1768 would prevent the disclosure of information to the commissioner in an examination of a bank or trust company from serving as a waiver of the bank's or trust company's privilege in the information. It also would relocate provisions that protect the confidentiality of examination reports of banks and trust companies and would prohibit their disclosure, except as allowed under the Finance Code. The bill would maintain but relocate the provision that makes it a Class A misdemeanor (punishable by up to one year in jail and/or a maximum fine of $4,000) for the commissioner or a department officer or employee knowingly to disclose or permit access to bank or trust company information in violation of the Finance Code.

Requirements for charterers. CSHB 1768 would specify that people who were subject to a final removal or prohibition order of the commissioner could not serve on the board of a state-chartered bank or trust company. It would extend this bar to those who had been removed or barred from service by another state, federal, or foreign financial regulatory agency.

The bill would delete the requirement that the commissioner notify organizers or acquirers of a state-chartered bank or trust company that their charter or acquisition application was complete. It would expand the public notice and comment requirements by requiring organizers to disclose their

identities, and it would specify that the commissioner could require multiple public notices and order them printed in any publication or at any location.

Related-party transactions. CSHB 1768 would delete the Finance Code's prohibition against state banks leasing real property from a bank officer, manager, managing participant, principal shareholder, or participant or affiliate of the bank without the commissioner's prior written consent.

The bill also would amend the prohibitions against a bank making a loan for which the equities of an affiliate institution would serve as security. It would allow a bank to take such equities as security provided that the transaction complied with federal laws governing such transactions. Federal law allows such loans as long as they also are secured by certain very safe and liquid assets, such as U.S. Treasury-issued securities.

Closing a trust company. CSHB 1768 would require the commissioner to issue a written order of findings if the commissioner wanted to close a state trust company and to post that order at the entrance of the company's place of business. Filing a certified copy of the closing order with the Travis County district court also would be necessary to initiate a receivership.

Miscellaneous provisions. CSHB 1768 would make technical changes throughout the Finance Code to eliminate the implication that the banking commissioner could have only one deputy and that the Banking Department could have only one attorney. It also would authorize the commissioner to act through an agent, including by providing agents immunity from suits related to their duties, and would broaden references to laws the commissioner must administer and enforce, including by allowing the commissioner to convene a hearing regarding any matter in his jurisdiction, rather than simply on matters under certain subtitles and chapters of the Finance Code.

CSHB 1768 would preempt any other conflicting nonsubstantive changes made to the Finance Code made by the 77th Legislature.

This bill would take effect September 1, 2001, except that the effectiveness of alternative versions of the same nonsubstantive change would depend on whether the 77th Legislature enacts legislation relating to nonsubstantive additions to and correction in existing codes.

SUPPORTERS SAY:

CSHB 1768 would amend provisions of the Finance Code that have become obsolete or inconsistent because of recent changes in federal and state laws and in banking practices.

The changes that would allow leases between banks and bank insiders (such as managers) and loans secured by the stock of a bank affiliate would not threaten the safety of the banking industry. These changes are necessary to maintain consistency with the rules governing federally chartered banks. These types of transactions are and will remain issues in bank examinations, so this bill would not remove them from regulation.

Furthermore, the leases that the bill would permit still would have to made at fair-market terms for the bank. Likewise, loans secured by the stock of an affiliate are not especially risky investments, given the additional security requirements of the federal law that the bill would adopt. If, however, the rules were significantly more onerous for state banks, those banks might give up their state charters and choose federal regulation, thus harming the health of the state bank industry.

Similarly, extending the examination cycle for small, very sound banks would put the state system in line with the federal system and would not jeopardize the safety of the industry. Small banks, especially ones that meet the soundness requirements that this bill would impose, can be examined less often because they have less impact on the banking system as a whole. In fact, the rules for when an 18-month examination cycle could be used are already part of the department's policy.

The bill would make needed changes to the conflict-of-interest provisions, not only to conform to standard language for state agencies but to prevent the rules from inhibiting employment opportunities at the Banking Department. There is no reason to bar an employee who lacks discretionary authority over a regulated institution from all employment with the department because the employee owns interests in securities over which he or she has no

control, such as mutual funds or a spouse's employee stock-option plan. Such rules limit the number the people who can work for the department without increasing the integrity of the department's regulatory functions.

CSHB 1768 properly would delete the criminal penalties to which department officers and employees could be subject for financial conflicts of interest. Employees of other state regulatory agencies are not subject to similar penalties. Instead, the bill would leave discipline for such violations and other employment issues to be handled by the commissioner and the Finance Commission.

On the other hand, the bill would beef up some enforcement tools by closing a loophole in the law that prevents certain persons from being involved in the control or management of a bank or trust company. Current law does not prohibit a person under such an order from another jurisdiction from being involved in management or control of a Texas-chartered bank or trust company. Eliminating that loophole would protect the public.

The bill's provision that would prevent the disclosure of information to the department in an examination from waiving privilege in the information is necessary. Some courts have held that providing such information to the department does waive privileges such as attorney-client confidentiality in lawsuits between the examinee and third parties. Such a rule would impede examination by the department by providing a basis to resist disclosure of information.

The bill also would change the method for closing a trust company. Currently, the department posts notice of its intent to close. The bill would allow the commissioner to post a written notice with the department's findings justifying the closure. This would prevent potential "panics" by preventing a delay between the time the public learned of the institution's poor financial situation and the actual closing of the trust company.

OPPONENTS SAY:

The 18-month examination cycle that CSHB 1768 would allow for some small banks would be too long. It also might create a basis for banks that met those criteria to claim that they had a right to be examined no more than once every 18 months, regardless of whether the commissioner saw other reasons

for examining them more often. If the department already extends the cycle for selected banks on an ad hoc basis, this portion of the bill is unnecessary.

CSHB 1768 would eliminate criminal penalties for Banking Department employees who violated the financial conflict-of-interest rules. This could increase the public perception that the department was too close to the banking industry.

NOTES:

The committee substitute deleted some of the filed version's changes to Chapter 11 of the Finance Code that would be included in the Banking Department's sunset legislation. It also changed portions of the conflict-of-interest section to mirror the standard sunset language.

The substitute would provide more detailed guidelines than in the original bill for when the commissioner could inspect a bank on an 18-month cycle. It also would delete the authority that the original bill would have conferred on the commissioner to extend the examination cycle.

The substitute also removed the original bill's deletion of a provision making confidential information that the department obtained through an application to acquire a bank or trust company.

The companion bill, SB 1438 by Sibley, has been referred to the Senate Business and Commerce Committee.