1994

Commentary: State-Chartered Financial Institutions in the 1990s - A New Perspective

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Commentary: State-Chartered Financial Institutions in the 1990s–A New Perspective

By Alvin C. Harrell

I. Introduction

Effective June 30, 1994, Home Savings and Loan Association of Oklahoma City ("Home Savings" or "the association")[1] terminated its federal deposit insurance and began to operate as an uninsured state-chartered depository institution,[2] regulated and examined by the Oklahoma Banking Commission but not the Office of Thrift Supervision ("OTS") or the Federal Deposit Insur-

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Ed. note: The views expressed herein are solely those of the author and do not reflect the position of any organization with which he may be associated.

1. Home Savings is a state-chartered, capital stock savings and loan association with about $11 million in total assets. Your author is President and Chairman.

2. There is a six month phase-out period. All funds on deposit as of June 30, 1994 will continue to be insured, less subsequent withdrawals, until December 31, 1994.

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Name	Owner
Commercial Credit Plan, Inc.	Primerica Corporation
Everest National Corporation	General Electric Corporation
Fidelity Trust Company	Fidelity Investments
Governor Financial Company	Leucadia National Corporation
Great Western Thrift & Loan	Great Western Financial Corp.
IDS Deposit Corporation	IDS (American Express Company)
Merrill Lynch National Financial	Merrill Lynch & Co., Inc.
MountainWest Financial	NOVUS Credit Services, Inc. (Dean Witter)
Valley Loan Corporation	Private

Industrial Loan Corporation Charters Operative but Not in Use:

H&R Block, dba Companion Financial Corporation (Application being prepared)
Dreyfus Funds, Inc.
First Deposit Corporation (Capital Holding)
GMAC (General Motors)
PaineWebber Financial Corporation (PaineWebber, Inc.)
Sears Roebuck & Co.
United Services Automobile Association (USAA)

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ance Corporation ("FDIC").[3] Home Savings is now operating much like the uninsured building and loan associations that proliferated in this country until the system was federalized using deposit insurance during the 1930s.[4] Yet in the 1990s this relatively "deregulated"[5] operation represents an unusual banking strategy.[6] The purpose of this commentary is to briefly explain this perspective in the context of current banking trends. An article in a future issue will describe in more detail why and how the termination of deposit insurance was accomplished.

II. Background of the Decision to Terminate Deposit Insurance

Home Savings was not the first Oklahoma thrift to voluntarily terminate deposit insurance. Okmulgee Savings and Loan Association showed that it was possible by voluntarily terminating deposit insurance in early 1993.[7] Okmulgee Savings lost only about 30% of its deposits, demonstrating that termination of deposit insurance was a legally and operationally viable strategy. Home Savings was intrigued but did not immediately follow suit because (1) at that time, Home Savings was federally chartered and a federal association cannot drop deposit in-

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3. Like non-banking lenders, Home Savings will be subject to certain federal consumer laws and to enforcement of these laws by the Federal Trade Commission.

4. For a brief description of this traditional model, *see* Alvin C. Harrell, *Commentary on FIRREA: What Would George Bailey Think?*, 44 Consumer Fin. L. Q. Rep. 21 (1990).

5. The Oklahoma Savings and Loan Code authorizes certain activities prohibited for federally-chartered institutions, and in some respects provides greater operating flexibility in comparison to FDIC-insured institutions.

6. The Bank Rate Monitor described us as "Rebels in Oklahoma." *See also* Stacy Martin, *Okmulgee Thrift Owners Rebel, Cancel FDIC Coverage*, Sun. Okla., July 4, 1993, at 1 (describing termination of deposit insurance by Okmulgee Savings and Loan Association).

7. *See* Bill Atkinson, *Oklahoma Banker Drops FDIC Coverage*, Amer. Bank., Sept. 24, 1993, at 6; Stacy Martin, *Okmulgee Thrift Owners Rebel, Cancel FDIC Coverage*, *supra* note 6; Nancy Raiden Titus, *Okmulgee Thrift 1st Institution to Drop FDIC Insurance*, Okla. J. Rec., June 29, 1993, at 1.

the debtors proposed in their Chapter 11 plan to pay off a foreclosure judgment on their residence over a 20-year period, with interest.

In opposition to the plan, the mortgagee contended that since a Chapter 13 consumer debtor is precluded from satisfying a New Jersey foreclosure judgment in full through the life of a Chapter 13 plan, a consumer debtor should not be able to circumvent this prohibition in a Chapter 11 case.

Disagreeing with another New Jersey bankruptcy case which had accepted the mortgagee's argument, the court in *Kennedy* observed that unlike Chapter 13 in which Congress specifically proscribed modification of the rights of home mortgage lenders, there is no similar proscription in Chapter 11. Therefore, the court concluded that a Chapter 11 plan could be used to satisfy or modify a foreclosure judgment on a New Jersey residence. Nevertheless, the court rejected the debtors' proposed treatment of the mortgagee in their plan. According to the court, while the debtors could modify the mortgagee's right to immediate payment of its loan from the proceeds of the sale of the real estate, requiring the mortgagee to wait 20 years for payment in full of its claim would violate the Bankruptcy Code's requirement of "fair and equitable" treatment in Chapter 11.

XXX. Lid on New Jersey Fire Insurance

Effective November 1, 1993, the New Jersey Department of Banking adopted a new rule limiting the amount of fire insurance a mortgagee can require on New Jersey real property.

The rule applies to financial institutions and licensees. The rule provides that a lender may not require a borrower to obtain fire insurance in excess of the replacement value of the mortgaged property as a condition for granting the mortgage loan. Under existing New Jersey insurance laws, an insurance company may issue fire insurance policies to the extent of the actual cash value of the property at the time of loss, not to exceed replacement or repair cost.

As a result of the new rule, a lender making a loan in excess of the property's replacement cost may not require the borrower to obtain fire insurance in the amount of the loan. The rule leaves unclear whether lenders must monitor replacement value throughout the loan term.

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surance, and (2) Home Savings was fat and happy, comfortable with a status quo that was generating unprecedented earnings due to the very low deposit interest rates being paid by insured institutions.

Some time later it was learned that yet another Oklahoma thrift, this time a federal association, had voluntarily terminated deposit insurance by first converting to a state charter.[8] This institution, Globe Savings Bank of El Reno, did so as part of a voluntary liquidation plan and did not seek to continue in business as a savings and loan association; instead, Globe converted to an ordinary state-chartered corporation in order to preserve certain claims against the federal government relating to its acquisition of a failed thrift.[9] But the experience of Globe suggested the possibility that a federally chartered savings and loan might terminate deposit insurance by first converting to a state savings and loan charter.[10]

All that remained was an incentive to make the switch, something to disturb the association's satisfaction with the status quo. That incentive was provided by the Dallas Regional Office of the OTS ("Dallas OTS Regional Office").

III. The Dallas OTS Regional Office

For over 60 years Home Savings had been under the jurisdiction of the Topeka, Kansas OTS regional office (or its predecessor under the Federal Home Loan Bank Board). During that time Home Savings had never experienced a significant regulatory problem; its relationship with examiners and other supervisory personnel (even those reputed to be "difficult") always had been excellent. But in late 1992 Home Savings (along with other Oklahoma thrifts) was transferred to the jurisdiction of the Dallas OTS Regional Office. Within a few months the association's Board of Directors knew what it was like to feel the wrath of a regulatory agency whose authority and mandate apparently exceed its perception and judgment.[11] The association's Board of Directors ("the Board") became increasingly concerned that a small institution like Home Savings could not survive in such a hostile regulatory environment. The Board began to reconsider its options.

IV. Defensive Strategy or Creative Opportunity?

At first, termination of deposit insurance was considered as a defensive mea-

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8. Home Savings thus became the third Oklahoma thrift to voluntarily terminate deposit insurance, rather than the second as has been widely reported.

9. Banking lawyers initially advised Home Savings that it was not possible to terminate deposit insurance. Outside counsel also advised that a liquidation was not possible. This advice was disproved by the Globe transaction. Our thanks to Globe executives for sharing their experience and thereby making possible the Home Savings transaction.

10. This is largely dependent on state law, as discussed *infra*.

11. Washington D.C. banking attorneys with extensive regulatory experience have since reported to your author that the OTS Dallas Region is the worst in the country, though other reports from around the country suggest that the problems may be systemwide. *See e.g.*, Paul S. Nadler, *Common Sense: The Missing Factor In Far Too Many Bank Examinations*, Amer. Bank., April 13, 1993, at 8; Jim McTague, *Back-to-Back Exams At Community Bank Draw a Cry of Fowl*, Amer. Bank., Oct. 21, 1993, at 9; *infra* note 12.

2. In the court's view, the cost study must be performed before establishing the fee, not after being sued for purposes of justifying the fee.

3. Under *Garrett* and *Beasley*, the bank could recover its actual damages, measured as to late fees "by the period of time the money was wrongfully withheld plus the administrative costs reasonably related to collecting and accounting for a late payment."[61] Thus, the plaintiff class should have recovered an amount equal to the bank's late and overlimit fee revenue less its actual damages. In applying this standard, the *Hitz* court added the extra interest that accrued on late and overlimit balances to the amount of the late and overlimit fees imposed. From this sum, the court subtracted not only the administrative costs "reasonably related to collecting and accounting for" late and overlimit balances, but also the bank's cost of funds for the extension of credit for such balances. The plaintiff thus receives more in damages than under a traditional measure of damages in an amount equal to the amount by which the extra interest exceeds the cost of funds.

If the approach of the trial court in *Hitz* is endorsed by the appellate court, lenders may find it extremely difficult to defeat a claim for unlawful penalties California.

2. South Dakota

The South Dakota Attorney General addressed the issue of whether credit card late charges agreed to by a South Dakota bank and its customer are subject to the liquidated damages provision in S.D. Codified Laws Ann. section 53-9-5.[62] The South Dakota banking statute allows "other charges made in connection with" a credit card account to be charged in "an amount agreed to by the bank and the customer." Such fees are "deemed interest."[63]

The Attorney General determined that to the extent that section 51A-12-13 of the South Dakota statutes is contrary to section 53-9-5, the former is the more specific statute as to late charges and therefore controls. Accordingly, the Attorney General concluded that because credit card late charges are "interest," and not liquidated damages, section 53-9-5 does not apply to such charges.

VI. Conclusion

A number of issues in the area of interstate lending have yet to be resolved. The courts and federal regulators have generally adopted a broad view of the federal preemption of state law, but lenders should continue to watch for new developments in the courts.

As federal preemption gathers strength, plaintiffs are looking more to unconscionability and liquidated damages statutes or common law theories as bases for their claims. Lenders should be aware of these potential claims and also that no clear consensus of interpretation has yet emerged.

61. *Garrett, supra* note 47 at 741.

62. Op. Atty. Gen. S.D. No. 93-08, 1993 S.D. AG LEXIS 5 (Sept. 20, 1993).

63. S.D. Codified Laws Ann. § 51A-12-13.

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sure. During 1993 the Board concluded that the regulatory attitude of the OTS Dallas Regional Office, in conjunction with national regulatory trends, threatened the long-term viability of the institution.[12]

Sheshanoff recently reported that the average banking institution spends an amount equal to 59% of its annual income on regulatory compliance.[13] This is a striking figure considering that it likely includes large institutions capable of achieving economies of scale in order to reduce the compliance burden. It suggests that the compliance cost for smaller institutions is well above 59%. This was certainly true of Home Savings, which found itself spending $100-$200,000 per year, roughly 200-400% of its average annual income, on regulatory compliance.

Home Savings could afford this burden in 1993, due to the extraordinarily wide spread between its cost of funds and the yield on loans and investments. But that extraordinary spread was too good to last, and had already begun to decline by mid-1993. The Board of Directors faced the prospect of continually increasing regulatory costs[14] in the face of a declining yield spread, with the association caught in between and slowly bleeding to death. At some point the result was likely to be an unfavorable merger, or worse yet a regulatory takeover based on "inadequate management" or "inadequate earnings."[15] The Board was forced to confront the prospect of a

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12. *See supra* note 11. The post-FIRREA regulatory environment includes regulatory micro-management, credit allocation, and hair-trigger enforcement actions. *See, e.g.*, Harrell, Commentary: *Ten Banking Trends in the 1990s–A Sea Change for America*, 47 Consumer Fin. L. Q. Rep. 336 (1993). In the hands of an over-zealous regulatory agency this is a dangerous mix. The Board of Directors was forced to confront the fact that the regulatory agency created to assure the safety and soundness of thrift institutions had become a primary threat to the existence of small institutions like Home Savings. *See, e.g.*, William M. Isaac, *Overregulation May Drive Small Banks Over the Edge*, Amer. Bank., May 25, 1994, at 18; Robyn Meredith, *OTS Changes Focus of Enforcement Work to Healthy Thrifts*, Amer. Bank., May 2, 1994, at 3; Paul Nadler, *Ex-Regulator Sees Danger in "One-Size-Fits-All" Rules*, Amer. Bank., May 8, 1994; Fred R. Bleakley, *Tough Guys–"Regulators From Hell" Frighten Some Banks But Also Win Praise*, Wall St. J. April 27, 1993, at A1; Bert Ely, *It's Regulation that Makes Lending Unprofitable*, Amer. Bank., Oct. 14, 1993, at 19.

13. Undated letter to financial institutions from Sheshunoff Information Services, Inc., describing a 1992 survey. It seems likely that the figure is higher today.

14. *See, e.g.*, Claudia Cummins, *Fed's LaWare Sees Red Tape Struggle Growing for Banks*, Amer. Bank., June 14, 1994, at 1.

15. The attitude of the OTS Dallas Regional Office was not comforting in this regard, as will be detailed in a future issue.

row on the strength of their accounts at affordable rates will lose an important source of financing.

The increased risk to buyers of accounts from Tenth Circuit sellers will remain until the United States Court of Appeals for the Tenth Circuit repudiates the decision or all of the legislatures for states in the Tenth Circuit amend Article 9 to remove the basis for the decision. For other transactions, the risks could also increase. The court in *Octagon Gas is* not the first one to become confused and to conclude that a sale of an account is not a sale. In resolving the priority of a federal tax lien and an unperfected assignment of an account against the purchaser of the account, the District of Columbia Court of Appeals in *District of Columbia v. Thomas Funding Corp.*[80] dismissed the claim that the purchaser had priority over a tax lien under the Federal Tax Lien Act[81] as a "purchaser" under that Act. The court stated that "a purchaser of accounts rarely will qualify as a purchaser under the statute because a purchaser of accounts under District of Columbia law obtains a *security interest* in the accounts pursuant to Article 9 of the Uniform Commercial Code."[82] Fortunately, this statement is dictum. The purchaser had filed a defective financing statement and had only an unperfected interest within the meaning of the federal tax lien act. His interest was subordinate in any event, and the court's confusion did not affect the outcome. Nevertheless, if courts in other circuits were to pick up the language of *Octagon Gas* and *Thomas Funding Corp.*, then the effect on businesses (and their customers) that rely on selling accounts as a source of financing would be devastating.

Any party interested in assignments of accounts should be monitoring these developments and should be aware of the potential problems created by the unfortunate use of language in these cases.

80. 593 A.2d 1030 (D.C. 1991).

81. 26 U.S.C. § 6323(a) (1988)

82. 593 A.2d at 1037 (emphasis by the court).

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healthy institution being put out of business by the regulators.

Thus termination of deposit insurance was initially considered as a defensive measure, designed to preserve Home Savings as an independent institution. But it soon became apparent that Home Savings had a unique strategic opportunity to create a retail depository institution largely free of the constraints of federal banking regulation.

By saving $100-$200,000 annually in regulatory costs, Home Savings could afford to pay substantially higher deposit interest rates. In turn this would enable the association to help replace those deposits that would inevitably be lost when deposit insurance was terminated.[16] As many bankers are aware, it is normally uneconomical to raise deposit interest rates across the board, because the benefits of any new deposits will be outweighed by the dead weight of the increased costs on existing deposits (deposits that otherwise would have been retained at lower cost). There is, therefore, a strong disincentive that militates against a general increase in a bank's deposit interest rates. This is probably one reason why deposit interest rates have been slow to move upward during 1994. By "paying" for this increased cost of funds by reduced regulatory compliance costs, Home Savings was able to break out of this pattern.[17]

In turn the reduction in federal regulatory costs and elimination of severe regulatory constraints also offered the prospect of increased flexibility to lend and invest the new deposits at attractive rates of return.[18] Despite the current focus of federal banking regulation on social issues, it became apparent that Home Savings could provide superior service to its community, on both the lending and deposit sides of the ledger, without OTS regulation. In effect, a regulatory agency torn between supporting social obligations and safety/soundness was having a significantly adverse impact on both in the context of a small institution. The Board concluded that a strong and viable community banking institution, serving primarily its local area, could best survive outside the umbrella of federal banking regulation.[19] Freed of "one size fits all" federal regulation, Home Savings would have the flexibility to pursue diverse strategies and market niches, and to restrain operating costs, in ways not possible for a federally supervised institution. Ultimately, what started as a defensive measure permitted the pursuit of new strategic opportunities on both the deposit and lending sides of the ledger.

V. Institution-Related Factors

There were several factors, unusual if not unique to Home Savings, that made the decision to terminate deposit insurance possible and even compelling. Other institutions considering the same option may face a different and more difficult decision.

First, of course, is the question of the basic legal authority to operate without deposit insurance. In Oklahoma, as in other states, a newly-chartered bank or thrift is required to

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16. See paid advertisement in this issue for an example of the association's advertising campaign.

17. This was possible because Home Savings (like many other small institutions) had very high compliance costs relative to a low deposit base, so that the increased deposit costs could be offset by reduced compliance costs. Obviously the economics would be different for an institution with a larger deposit base and lower relative compliance costs.

18. This was the case not only because of reduced regulatory constraints outside the federal banking system, but because of the Board's increased willingness to lend once it was relieved of the threat of federal regulatory enforcement actions.

19. Similar observations have been made in other contexts. *See, e.g.*, Shannon Henry, *Ariz. Community Development Group Is Showing the Others How It's Done*, Amer. Bank., June 9, 1994, at 8; *see also infra* Part VI.

solved by the Article.[20] These studies led to written reports detailing these matters. Some reports were published in the bar association journal.[21] Each report furnished a basis for favorable testimony as to the suitability of the proposed law in the Oklahoma Legislature. The reports carefully specified, however, that they represented the collective views of the individual authors and not necessarily the view of any one author, the Oklahoma Bar Association, or any of its committees, officers or members. The legislation reported on was not part of the Oklahoma Bar Association legislation program, but rather was the legislative program of the Oklahoma Commissioners.

After the law passed, the report was revised by the bar committee to become an introductory or prefatory Oklahoma comment to the new statute which generally explained what the statute did and how prior law was changed. The report, as revised, was published by the printer of Oklahoma Statutes Annotated (West Publishing Company) when the annual supplement to Oklahoma Statutes Annotated was released. The Oklahoma Committee then drafted individual Oklahoma Comments for many UCC sections. The Oklahoma Comments were printed in addition to the Official Comments and the text of the statute itself,[22] and, together with those materials, provide significant guidance to Oklahoma practitioners about the new law. But more than this material eventuated because, as the bar committee conducted its study and prepared its report, it often was prompted by its intellectual curiosity to probe more deeply. As a result, it was able to prepare additional detailed comments to many specific sections indicating changes in that particular area of the law, as well as at times providing supplemental information to what was covered in the Official Comments. For example, the Oklahoma Comment to Revised Article 3 section 3-102 opined that the Official Comment to that section rejects the interpretation of the relationship between Articles 3 and 8 rendered in *Victory National Bank of Nowata v. Oklahoma State Bank, Vinita,*[23] which held, in a view peculiar to Oklahoma, that Article 8 of the Code, and not Article 3, is applicable to an ordinary certificate of deposit. For another example, the Oklahoma Comments to Revised UCC Article 3 sections 3-104, 3-105 and 3-106 discuss the impact of those sections of Revised Article 3 on Oklahoma cases decided under prior law. In fact, these efforts ultimately have prompted the participation of the Oklahoma Committee in providing input to the NCCUSL through studies of future revisions to the UCC while the NCCUSL is still completing the task of revision on the national level.[24] In the meantime, the Oklahoma Comments also represent a published resource that may have relevance in other states when parties confront issues similar to those addressed in the Oklahoma Comments.

IV. Conclusion

Uniform laws uniformly and rapidly enacted are the only alternative to a chaotic condition that benefits no one,[25] or to federal enactment which is the less desirable method to do the job.[26] To facilitate the uniform laws process, local studies leading to uniform enactment of the law through increased understanding of how it was formulated, and the soundness of the policy choices made, are essential. But evolution has demonstrated that these studies may have additional benefits for the process. They may develop increased local input into the process itself, and, if their results are put in written form and published, the resulting local comments or reports on the uniform law may not only assist the local practitioner but also lead to further insights and explanations of how the law operates. This may provide benefits on the national level as well as the state level. Hopefully this article will encourage the establishment or expansion of processes like those described in Oklahoma in other jurisdictions, so that practitioners from many jurisdictions will come to realize how much help in interpreting these laws may be found in local comments on them from their own as well as other jurisdictions.

20. These initial studies ultimately became Prefatory Comments in the Oklahoma Comments to the UCC Articles, published in the Oklahoma Statutes Annotated.

21. *See, e.g.*, Miller, Hudson and Speegle, *The Uniform Laws Committee-Part II*, 58 OBAJ 2157, at 2160-63 (1987), discussing Article 2A.

22. The statute publisher made a contribution to the Oklahoma Bar Association for the right to publish the Comments. The Bar Association in turn has contributed to the Uniform Law Foundation to support the work of the NCCUSL on the Uniform Commercial Code.

23. 520 P.2d 675 (Okla. 1973).

24. This effort involves Articles 2, 5, 8 and 9. This extended effort is not limited to Oklahoma. *See supra* note 17, concerning the work of the California Bar Association.

25. The conditions that led to the uniform laws movement are described in Armstrong, *supra* note 1, at 11-28. Indeed, it was when the early progress made in separate uniform commercial acts began to unravel that the Uniform Commercial Code received its impetus. Armstrong, *supra* note 1, at 53-78.

26. *See, e.g.*, Miller, *The Uniform Commercial Code: Will the Experiment Continue*, 43 Mercer L. Rev. 799, at 801-03 (1992) and Miller, *Is Karl's Kode Kaput?*, 26 Loyola of La. L. Rev. 703, at 705-06 (1993).

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have federal deposit insurance.[20] However, in Oklahoma certain thrifts which existed before federal deposit insurance was required under state law are "grandfathered" and may operate without federal insurance. There are very few thrifts left in Oklahoma from among those that were in business before deposit insurance was mandated. Of roughly 54 Oklahoma savings and loan associations

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20. Whether it is wise public policy to thereby grant a monopoly on banking to the federal government is another question, one that will be explored in a future issue. It would seem, however, that the state banking department or legislature of any state could facilitate the emergence of state-chartered uninsured depository institutions, should the political will exist.

onstrued by its use in a series of transactions. Result in values less than fair market value.

Where there are no published price guides the method for determining the value of repossessed goods could be determined by agreement of the parties in transactions other than consumer transactions. This could be done only if the method was reasonably calculated to result in a fair market value or if the fact that the specified method may not result in a fair market value is specifically acknowledged in the agreement, but agreed to by the debtor in exchange for another identified benefit of the bargain. The method used must not result in values which are significantly less than fair market value as demonstrated by their use in a series of transactions. The use of prices in a recognized market, such as the grain markets or stock exchange could be used in commercial transactions for goods sold in those markets. Where the secured party does actually sell the goods, the secured party could not use an alternative method of valuation for the repossessed goods which results in a value lower that the actual sales price.

5. Where the agreed upon method could be some form of consignment sale in which the consignee/seller has sufficient interest in the outcome of the sale that the consignee is motivated to efforts to obtain a higher price.

V. Summary and Conclusion

Currently the UCC provides that the price received for repossessed goods at a "commercially reasonable sale" conducted by the secured party is subtracted from the total debt as part of the determination of the deficiency owed by a consumer. Experience has shown that the use of that figure, at least as long as parameters of what is "commercially reasonable" are so flexible, results in unfairly high deficiencies. A new method to determine the credit against the deficiency for the value of the repossessed goods should be adopted. The use of a "fair market value" that is not linked to the sale of the goods would result in fairer deficiencies and could allow secured parties even more flexibility in their choice of the manner of disposal of repossessed goods.

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that were in business a decade ago, less than a dozen have survived. Perhaps only a handful of these would be eligible to terminate deposit insurance.

Second, Home Savings found itself with a very high ratio of liquidity to total deposits. By the time the decision was made to terminate deposit insurance, liquid assets approached 75% of deposits, and highly marketable FHA/VA loans exceeded the remaining 25% of deposits, so that readily marketable assets exceeded 100% of deposit liabilities. Home Savings could easily pay the withdrawal of every penny of its deposits if need be. In effect the association's portfolio of conventional loans was funded entirely by its capital and reserves.

As a result Home Savings was in an unusually good position to terminate deposit insurance, in that there was never any danger of an inability to fund withdrawals during the termination process. Moreover it seemed that there might be a brief window of opportunity, as during the Board's consideration of the termination of deposit insurance there was much discussion of possible Community Reinvestment Act ("CRA") regulatory changes, including a proposed minimum 60% loan-to-deposits ratio that may well become a benchmark for the industry.[21] If so, it is possible that an institution seeking to terminate deposit insurance might be unable to assemble sufficient liquidity to satisfy potential withdrawals without violating the CRA (which could then be a basis for denial of the request to terminate insurance). Of course an institution with a higher loan-to-deposit ratio could still terminate deposit insurance by arranging for a sale of loans as needed to fund potential withdrawals, but this would add an additional complication to an already challenging proposition.

Third, Home Savings enjoyed a very high capital-to-assets ratio, in the range of 20-25% (the ratio increased as modest withdrawals reduced liabilities following announcement of the termination). The risk-based capital ratio exceeded 140%. This meant that Home Savings could legitimately and effectively communicate to sophisticated potential investors that their deposits would be safe despite the lack of deposit insurance. While some customers are wedded to deposit insurance, seemingly to the exclusion of any other factor (including the rate of return on their investment), others are more willing to conduct a measured analysis of an institution's financial position. To the latter, Home Savings is able to offer an above-market rate of return without significant risk. Few institutions have capital ratios that will permit this kind of marketing strategy.[22]

Finally, the size of the association's deposit base was sufficiently small to be less than a dominating element in an evaluation of the institution's strategy. Far

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21. *See* Proposed Rule, Community Reinvestment Act Regulations, 58 Fed. Reg. 67466 (Dec. 31, 1993), and discussion *infra* at Part VI.

22. Home Savings currently has a "core" and "tangible" capital-to-assets ratio in excess of 25%, compared to 1.5% and 3.0% required by federal regulators. The risk-based capital ratio is in the range of 130-140%, compared to the 8% required by OTS and FDIC. For an illustration of the association's marketing strategy, *see* paid advertisement in this issue.

"ancillary" collateral when other collateral is also given;

- Additional penalties and remedies should be available to the consumer if a creditor wrongfully executes against a deposit account.

The fear among consumer advocates is that the unregulated use of deposit accounts as collateral could constitute a powerful "sledgehammer" for forcing concessions from consumers in the event of a dispute over a debt, allowing the creditor to "seize" the debtor's accounts, so as to force an immediate settlement of any claims or defenses the consumer may have on unfavorable terms.

The Article 9 Drafting Committee's task is to accommodate the concerns of both the banking industry and consumer groups, while producing a set of provisions which will provide meaningful improvement over the common law pledge.[20] In view of this challenge, the Drafting Committee may well conclude that there was a good reason for excluding deposit accounts from Article 9 to begin with.

20. The path may be narrow and treacherous. For example, as an evening's amusement, try to develop a workable definition of a "consumer deposit account."

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more important was the association's capital, and its unique lending position in the local community. In short, the Board concluded that the association would be worth more as a lean and efficient "deregulated" institution outside the federal banking system, even without half or more of its deposits, than as a conventional thrift slowly suffocating under the weight of federal regulation. Most other banking institutions would have a far greater investment in their deposit bases, and could less easily afford the risk of simply walking away from (or raising the cost of funds on) a significant part of that base.[23]

VI. The Regulatory Response

Recently there have been signs that the federal banking agencies recognize the stifling impact their oversight is having on regulated institutions, especially small ones.[24] They could hardly miss the point, as increasing numbers of federally chartered banks and thrifts embrace various strategies to escape or diminish direct federal oversight. Perhaps some day this will lead to real reform, if nothing else from an instinct of regulatory survival.

In the meantime, one of the primary challenges for financial institutions in the 1990s is to minimize the adverse effects of federal regulation. In addition to the Oklahoma thrifts that terminated deposit insurance, other noteworthy strategies include:

- A number of California institutions have given up their charters to become mortgage banks.[25]
- A number of national banks have converted to state charters in an effort to escape regulation by the Office of the Comptroller of the Currency.[26]
- There has been a flight from the OTS by thrifts converting to state savings banks, which in some states are regulated by the state and FDIC rather than the OTS.[27] In some states nearly half of the thrifts have engaged in this kind of "charter flip" over the past few years.
- The most common means of escape for community banking institutions is simply to sell out to a holding company or merge with a larger institution. Unlike Home Savings, most of the institutions choosing this path do not have the option to escape federal banking regulation and still remain independent. The result has been a significant decline in the number of community banking institutions, a trend reminiscent of the thrift industry after FIRREA.[28]

When FIRREA was enacted in 1989, there were roughly a dozen federally-insured community banks and thrifts headquartered in the association's local CRA community (the central corridor of south Oklahoma City). Today only one remains, and it is reported to be engaged in merger discussions with an outside bank holding company. This entire community banking system, developed over three quarters of a century, was essentially wiped out in five years after FIRREA.

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23. Of course such institutions could also realize significant gains by sale of that deposit base.

24. *See, e.g.*, Barbara A. Rehm, *Ludwig Vows Easier Exams For Smaller Banks by Fall*, Amer. Bank., June 17, 1994, at 1; Barbara A. Rehm, *Ludwig is Moving Beyond CRA to Focus on Revamping Exams*, Amer. Bank., April 7, 1994, at 1; Barbara A. Rehm, *Policymakers Renewing the Call For Overhaul of Bank Regulations*, Amer. Bank., Feb. 17, 1994, at 2; Shannon Henry, *OTS Revving Up to Slash Red Tape, Aide Says*, Amer. Bank., Dec. 2, 1993, at 8. Unfortunately the details don't always measure up to the rhetoric. *See, e.g.*, Claudia Cummins, *Fed's LaWare Sees Red Tape Struggle Growing for Banks*, Amer. Bank., June 14, 1994, at 1. Your author has reviewed the current regulatory relief measure being considered by Congress, and is very unimpressed.

25. *See, e.g.*, *Long Beach Selling Deposits to Become a Mortgage Bank*, Amer. Bank., July 6, 1994, at 8; James H. Soft, *American Liberty Drops Thrift Charter*, Amer. Bank., Feb. 8, 1994, at 16; Phil Roosevelt, *Hamilton Has a Growth Spurt After Shedding Thrift Charter*, Amer. Bank., Sept. 10, 1993, at 10; Terrence O'Hara, *Profitable Calif. Bank Quitting the Business Citing Overregulation*, Amer. Bank., Mar. 2, 1994, at 6. The largest thrift in the United States, H.F. Ahmanson & Co. (Home Savings of America), has expressed an interest in taking this step. *See* Edward Kulkosky, *Ahmanson Chief Willing to Take Radical Steps to Prosper in the '90s*, Amer. Bank., Nov. 12, 1993, at 10. *See generally* Terrence O'Hara, *Regulations Driving Thrifts to Become Mortgage Banks*, Amer. Bank., July 13, 1994, at 1.

26. *See, e.g.*, Barbara A. Rehm, *Ludwig Vows Easier Exams For Smaller Banks by Fall*, Amer. Bank., June 17, 1994 at 1. Insured state banks are regulated by the state banking department and the FDIC. Obviously, however, this strategy is attractive only so long as the FDIC remains a nonpolitical regulatory agency.

27. *See, e.g.*, Robyn Meredith, *Fiechter of OTS Sees Charter Flips in Thrifts' Future*, Amer. Bank., Nov. 1, 1993, at 8; Robyn Meredith, *Rapid Flight From Thrift Charters May Leave the OTS High and Dry*, Amer. Bank., Sept. 20, 1993; Bill Atkinson, *Indiana Regulator Sees Big Shift To State Thrift Charters in '94*, Amer. Bank., Sept. 24, 1993.

28. *See, e.g.*, John Racine, *Minneapolis Seen as Model for Consolidation*, Amer. Bank., May 25, 1994, at 20; "Bank Consolidation Data," in ANNUAL 1994 FINANCIAL INDUSTRY TRENDS 36 (Federal Reserve Bank of Kansas City 1994) (noting a decline in the number of banks from 14,448 to 10,880 in the last decade); Bill Atkinson, *'93 Buyouts Thinned the Ranks of Small Banks to 60-year Low*, Amer. Bank., Mar. 21, 1994, at 1; Stacy Martin, *Community Banking Slips Out of Sooner State*, Okla., Dec. 5, 1993, at 1; Terrence O'Hara, *Baltimore Proves Stony Ground for Start-Ups*, Amer. Bank., April 7, 1994, at 6.

not be used to save an error in a termination statement. The *Victory Lanes* court concluded that a continuation statement is sufficiently similar to a financing statement to be covered by section 9-402(8), while a termination statement is not.

XI. Effect of Lapse on State and Federal Law Security Interests

U.S. v. Currituck Grain, Inc.[46] serves as a reminder that once a financing statement lapses due to the passage of time, the security interest is unperfected both prospectively and retroactively, as against subsequent competing claiments and those who became purchasers or obtained a competing lien or security interest before the lapse.[47]

This case also contains an interesting discussion of the interplay between the UCC provisions on lapse, other state law,[48] and federal law.[49] Citing *United States v. Kimbell Foods, Inc.*[50] and *Clearfield Trust Co. v. United States*,[51] the Fourth Circuit applied UCC section 9-403(2) and North Carolina General Statute section 44-69.1 in determining that the Farmer's Home security interest had lapsed under state law 18 months after sale of the collateral.

XII. Conclusion

Continuation statement and related problems "continue" to take a "toll" on secured parties far out of proportion to the seemingly simple mechanics involved. This suggests a need for secured creditors to regularly monitor continuation statement filings with a full understanding of the intricacies of section 9-403. The travails of those who have learned this the hard way provide valuable lessons for those of us who have been more fortunate thus far.

46. 6 F.3d 200 (4th Cir. 1993).

47. 6 F.3d at 203, citing B. CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 2.14, at 2-144 to 2-145 (1988). For a limited exception, *see* UCC § 9-103(1)(d)(i) (lapse is retroactive only as against certain interests).

48. N.C. Gen. Stat. §§ 44-69.1, providing that a lien or security interest in certain agricultural products lapses 18 months after a sale or delivery to a purchaser.

49. The security interest was a Farmer's Home Administration Crop loan.

50. 440 U.S. 715 (1979).

51. 318 U.S. 363 (1943).

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The banking regulators obviously have noticed this trend and have begun to react, partly by talking up regulatory relief and reform.[29] At the same time, however, there have been hints of efforts by regulators to stem the flight from federal regulation by discouraging use of all escape routes except merger with or acquisition by another owner or institution that would remain within the same regulatory jurisdiction.[30]

All of this provided some cause for concern on the part of the association's Board of Directors. There was some concern that the OTS or OCC (sibling agencies that together control the FDIC Board pending the appointment of an FDIC chair) might seek to bar the termination or even seek retribution against the association or its Board of Directors.[31] As it turns out those concerns were apparently overblown, and the request for termination was granted without incident (though only after an unexplained delay). Consider, however, these more or less contemporary events:

- After hearing of the decision to terminate deposit insurance, a good friend (and nationally respected authority in this area of law) called to say, in effect, "Congratulations, you've got guts–but what do you think your CRA rating will be when the regulators find out about this?" This underscored the Board's concern that the OTS might use the highly discretionary CRA rating system to give Home Savings a low rating and then use that to block the termination.[32]

- While the association's application to terminate deposit insurance was pending, there were reports of several other savings associations whose applications to escape the OTS by converting to a state savings bank charter were rejected due to low CRA ratings.[33]

- There have been other reports of banks with low loan-to-deposit

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29. *See supra* note 24. It remains to be seen whether Congress and the regulators, who obviously are part of the problem, will be willing and able to provide a meaningful solution.

30. *See, e.g.*, Robyn Meredith, *New Laws Could Curb Thrift Conversions to State Charters, Amer. Bank.*, Nov. 17, 1993, at 2; Steve Klinkerman, *Continental Files to Do U.S.-State Charter Flips, Amer. Bank*, Nov. 22, 1993, at 1, 5 (quoting Comptroller of the Currency Eugene A. Ludwig: "From a public policy standpoint, you've got to ask whether [charter flips are] a good thing.").

31. As one industry-insider said to your author, "[a]ren't you afraid you'll come to work some morning and find a seal on the door?"

32. Home Savings always has had a "satisfactory" CRA rating and in fact has long been a reverse-redliner, in the sense of attracting deposits from outside its area and investing them in low and moderate income housing in the association's community. Still, the CRA rating system is inherently discretionary, and the association's high liquidity position (possibly necessary in order to establish the ability to fund withdrawals upon termination of deposit insurance) meant that Home Savings would not meet the proposed CRA 60% loan-to deposit ratio test. *See* Proposed Rule, Community Reinvestment Act Regulations, 58 Fed. Reg. 67466 (Dec. 31, 1993).

33. *See, e.g.*, Albert R. Karr, *Agency Denies Charter Change To Four Thrifts*, Wall Str. J., Feb. 22, 1994, at A4; *Financial Institutions Penalized*, Sat. Okla., Feb. 19, 1994, at 28.

It may be difficult for brokers to defend their actions if, in truth, they had agreed to negotiate loans on behalf of borrowers, but then received compensation from lenders for submitting applications for loans with higher than required rates. The practice of offering buy rates in the automobile financing industry may be one thing where consumers would rarely assume that car dealers are acting in the consumers' best interests. In the mortgage industry, however, it may be reasonable for borrowers to expect that brokers with whom they have entered into a contractual relationship owe some duty to them to obtain the best loan possible.

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ratios that apparently felt compelled to sell out as a result of CRA pressures, rather than abandon their low-risk investment strategy.[34] This raises the possibility that CRA might be used to prevent institutions from becoming sufficiently liquid to qualify for termination of deposit insurance.[35]

- Okmulgee Savings reportedly received approval of its application to terminate deposit insurance (during the Bush administration) in about 60 days. The statute seemingly contemplates approval within 90 days.[36] It took more than five months for Home Savings to receive FDIC approval, despite the fact that career FDIC staff at all levels apparently recommended approval very quickly. When the FDIC Order granting approval finally was received, it was backdated roughly 50 days, with a cover letter explaining that the delay was a result of "suggestions" made by members of the FDIC Board.

- Shortly after Home Savings received approval to terminate deposit insurance, an Oklahoma credit union announced that its members were considering a plan to convert from a mutually chartered credit union to a capital-stock state savings bank, in order to raise capital for expansion and allow the members to purchase shares of stock.[37] Within days, the institution was seized by the National Credit Union Administration ("NCUA"), on grounds of "inadequate management" and "declining earnings."[38] The stated purpose was to "protect the members," apparently from themselves.[39]

While none of this ultimately affected Home Savings, it suggests a possible regulatory attitude that could pose problems for other institutions considering a similar change. There appears to be some danger that federal regulators could use their highly discretionary powers to prevent healthy institutions from leaving the regulatory jurisdiction. If so, an institution may be too late if it waits until it has a problem before seeking to change its charter or switch to another regulator, in the sense that almost any problem (including, potentially, "inadequate management," "declining earnings," or a low CRA rating) could be used as a basis for rejecting the institution's application.

VII. Summary and Conclusions

Home Savings was able to terminate deposit insurance, in order to operate as a "deregulated" depository institution, because of unusual institutional factors, including exceptionally high capital and liquidity ratios, high earnings, a favorable CRA record, a "grandfathered" thrift charter and favorable state laws, a small deposit base and modest aspirations in terms of asset growth.

Banking is being "reinvented" by the U.S. government. Home Savings preferred to reinvent itself in its own image, as an uninsured community building and loan association right out of the early 20th century, an anachronism to some but a flexible niche player to others.

As federally regulated banking institutions are increasingly consolidated, regulated, and controlled, more and more local and creative financing transactions are being conducted outside the banking system. The concept of "narrow banking" and the "utility model" of regulation have essentially won the day at the federal level. If local economies are to flourish, it will require a new perspective on state-chartered financial institutions, some seemingly anachronistic, that can operate outside this stifling federal bank regulatory system.[40] Financial deregulation failed in the 1980s because of federal oversight and deposit insurance;[41] it will be tested again in the 1990s without either, by institutions outside the federal bank regulatory system, in the process also testing some old perceptions about the roles of state and federal governments in the American financial system. The biggest remaining question is whether the states will recognize and fully accommodate the opportunities being presented.

34. This is a clear example of CRA pressures reducing the numbers of community banking institutions, to the detriment of competition and credit availability.

35. Of course an institution could still sell loans, but for some types of loans this is difficult and it could complicate the process.

36. *See* 12 U.S.C. § 1818(a)(1).

37. *See* Stacy Martin, *Credit Union Considering Thrift Status*, Sun. Okla., June 19, 1994, at 1.

38. *See* Stacy Martin, *Regulators Seize Tulsa Credit Union*, Sat. Okla. & Times, June 25, 1994, at 24; Nancy Raiden Titus, *Oneok Employee Credit Union Placed Under Conservatorship*, I. Rec., June 25, 1994, at 4. If the regulators are going to seize every institution with declining earnings in 1994, there aren't going to be many left anywhere in the United States.

39. The credit union had a camel rating of "3," and capital that is about average for the industry. The NCUA appointed new management and announced that the credit union was not insolvent and would not be liquidated, but would operated under direct NCUA control until it could be returned to "viability."

40. One Texas lawyer told your author that a bank he represents slowly moving most of its operations outside the bank, leaving the bank as primarily a vehicle for interstate credit card operations (due to preemption of state laws) and access to the payments system.

41. *See, e.g.*, Alvin C. Harrell, Book Review and Commentary: *Where Deregulation Went Wrong*, 42 Consumer Fin. L. Q. Rep. 216 (1988).