SUNSET REVIEW

DIVISION OF BANKING
VOLUME 1

SUBMITTED BY
THE COLORADO DEPARTMENT
OF REGULATORY AGENCIES
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STATE OF COLORADO

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Roy Romer
Governor

July 27, 1993

The Honorable Vickie Agler, Chairperson
Joint Sunrise/Sunset Review Committee
State Capitol
Denver, CO 80203

Dear Representative Agler:

The Colorado Department of Regulatory Agencies has completed the evaluation of the Division of Banking. We are pleased to submit this written report, which will be the basis for my office's oral testimony before the Joint Legislative Sunrise/Sunset Review Committee. This report is submitted pursuant to Section 24-34-104 (8)(a), of the Colorado Revised Statutes, which states in part:

> "The Department of Regulatory Agencies shall conduct an analysis of the performance of each division, board or agency or each function scheduled for termination under this section...
>
> The Department of Regulatory Agencies shall submit a report and such supporting materials as may be requested, to the Sunrise and Sunset Review Committee created by joint rule of the Senate and House of Representatives, no later than July 1 of the year preceding the date established for termination..."

This report discusses the question of whether there is a need for the regulation provided under title 11. The report also discusses the effectiveness of the Division of Banking and its staff in carrying out the intention of the statutes and makes recommendations for statutory and administrative changes in the event this regulatory program is continued by the General Assembly.

Sincerely,

Joseph A. Garcia
Executive Director

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EXECUTIVE SUMMARY

The 1993 Sunset Review of the Colorado Division of Banking is being conducted during a time at which the state and national banking industry is experiencing all-time prosperity after a period of uncertainty and decline. The push to deregulate the banking industry in the mid-to-latter 1980's has given way to reregulation, as evidenced by numerous federal banking statutes and regulations. This report concludes that regulation of banks and trust companies at the state level in Colorado has improved significantly since 1988, the time at which the Division of Banking was most recently audited.

The Division of Banking currently regulates all state-chartered commercial banks, industrial banks, trust departments, trust companies, public depositories, and other entities. Its regulatory jurisdiction primarily extends to monitoring the safety and soundness of these institutions, protecting the public from risk arising from their unsafe and unsound operation, and ensuring their compliance with various statutes, rules, and regulations.

Statistics compiled by the Division demonstrate that the safety and soundness of these institutions and their deposits have improved dramatically since the late 1980's. The success of the Division in carrying out its mission is also demonstrated by the cooperation exhibited by the Division's federal regulatory counterparts and by its recent accreditation by a nationally-recognized certification authority. Colorado's state-chartered banks and trust companies also support and approve of the Division's regulatory performance.

This report recommends that the General Assembly continue the Division of Banking's regulatory mission as outlined in Section 11-11-101.5, C.R.S. It also makes numerous recommendations aimed at continuing and fostering the improvement demonstrated by the Division of Banking. In general, these recommendations revolve around the need to preserve and promote safety and soundness, the need to promote regulatory parity and sound competition among financial institutions, the need to protect Colorado consumers, and the need to promote organizational competence and to preserve resources. Various other recommendations also address statutory amendments or revisions which are supported by the Division and by the Department of Regulatory Agencies.

CHAPTER 1

INTRODUCTION AND HISTORICAL PERSPECTIVE

THE SUNSET PROCESS

The Colorado Division of Banking (DOB) and its regulatory functions under Title 11 of the Colorado Revised Statutes will terminate on July 1, 1994, unless continued by the General Assembly pursuant to the Sunset Act, Section 24-34-104(23)(a)(I), C.R.S. The purpose of this sunset report is to evaluate the performance of the DOB based on statutory evaluation criteria which are attached as Appendix 1 of this report. The central question this report seeks to answer is whether the continuation of this regulatory program is necessary and beneficial to the public health, safety and welfare of the people of Colorado, and whether, if the program is continued, significant changes are necessary to improve agency operations and thereby enhance the public interest.

Research for this report began in January, 1993. Most of the employees of the DOB were interviewed at length, as well as former employees, representatives of the regulated industries, representatives of federal and sister state regulatory agencies, consumers, consumer activists, and many other individuals who are knowledgeable about the operations of the DOB. Research was conducted which yielded large amounts of information on similar divisions in other states. Members of the Banking Board were invited to express their opinions and ideas during the course of the review, and two members of the Board were interviewed in person and over the telephone. A literature search unearthed information concerning the state and volatility of today's financial industries, as well as information addressing the problems and challenges associated with regulation of these industries. The studies of the Conference of State Bank Supervisors, the PITON Foundation, the Division of Civil Rights, and Denver Community Reinvestment Alliance were reviewed, along with studies conducted by various agencies of the federal government and by private industry. Numerous state and federal laws were also reviewed, and U.S. congressional records were searched to determine whether recent federal banking regulation was passed with the intent to diminish the role of state regulation in our dual banking system. Monthly banking board meetings were attended and certain issues which were discussed were further researched. State legislative committee hearings concerning proposed and pending legislation impacting the DOB, and public rulemaking hearings conducted by DOB and Colorado's Division of Financial Services were attended. The Colorado Attorney General's Office and other state agencies were consulted.

The author of this report wishes to thank all of those persons who gave their time in personal interviews and written submissions to make this report possible.

HISTORICAL REVIEW

State regulation of Colorado banks commenced in 1877, one year after statehood was achieved, when the Colorado Legislature first codified the process by which banking associations could be chartered and operated. In addition to setting forth the rudimentary powers and duties of banks and the obligations of bank directors, officers, and stockholders, this initial legislation also required banks to submit semi-annual examination reports to the State Treasurer.

In 1877, banks possessed the latitude under the dual banking system, as they do now, to choose whether they wish to operate under a state or national charter. Colorado's venture into state banking regulation occurred at a time when the federal government was chartering, supervising, and examining all nationally-chartered banks through the Office of the Comptroller of the Currency (OCC). Therefore, when Colorado's earliest banks chose to operate under a state charter, they were subject only to supervision and regulation by the state authority.

This clear-cut regulatory delineation was terminated in 1913 with the passage of the Federal Reserve Act, a response to runs on deposits in the infancy of the 20th century which sometimes exhausted cash reserves and sometimes resulted in bank failures. The Act established the Federal Reserve System, a scheme of 12 district banks at which the assets of member-banks could be converted into notes to meet temporary cash drains. These federal banks were also given the authority to hold the reserves of its members and, subsequently, to fix the amount of reserves which its members must set aside. With these powers came supervisory and examination authority over all member-banks. Therefore, state-chartered banks which opted to join the Federal Reserve System became regulated by state and federal entities.

This juxtaposition of regulation increased when the nation experienced an enormous financial and banking collapse during the 1930's. After Congress witnessed the failure of over half of the country's banks, it passed legislation in 1933 which established the Federal Deposit Insurance Corporation (FDIC) to insure deposits. Not only did this landmark legislation guarantee depositor security in the event of bank failure, it also charged the FDIC with the authority to supervise and examine all insured banks. As a result, the federal government's regulatory authority over state-chartered banks extended to those institutions which took out federal insurance but which were not Federal Reserve System members.

Just as the federal government verged on expanding its regulatory authority, the Colorado Legislature increased state regulatory authority over state-chartered banks by creating the office of the State Bank Commissioner in 1907. The statutory authority of the Commissioner was fleshed out to include the granting of state charters, the examination and investigation of banks, the collection of fees, and the liquidation of insolvent institutions.

The power of the Commissioner to conduct himself as the sole state banking regulator remained unsullied for years, with one exception. In 1913, the statute was amended to give the Governor, Attorney General, and State Treasurer power to override the Commissioner's denial of a charter application. It was not until the 1957 overhaul of the Banking Code that the Banking Board was established which, together with the Commissioner, operated within the Banking Department as a free-standing agency to oversee and administer the banking statute. The Division of Banking was subsequently situated within the Department of Regulatory Agencies (DORA) in 1968 upon the passage of the Administrative Reorganization Act.

In addition to the organizational restructuring which the Division and its principals have experienced, the regulatory jurisdiction of the Commissioner and Division has been increased by the Legislature numerous times over the years to include trust departments of commercial banks (1907), industrial banks (1923), credit unions (1931), trust companies (1947), money order companies (1959), debt adjusters (1963), and public money depositaries (1975).

The Division's regulatory jurisdiction constricted in 1988, however, when oversight of credit unions was transferred to the Division of Financial Services. Moreover, legislation passed in 1988 through 1990 redefined the structure of the Division and the duties and scope of authority held by the Commissioner and the Banking Board.
Today, Colorado's Division of Banking is confronted with the dilemma of how to regulate but not suffocate an industry which is no longer the dominant player in the scheme of financial services and markets in our shifting economic environment. Bankers argue that regulation, particularly federal banking regulation, and its excessive cost, has contributed mightily to the diminishing profitability of banks. They also blame regulatory restrictions for their inability to compete effectively with other financial industries. Commercial and industrial banks are experiencing sharp competition from financial institutions which are permitted to engage in additional financial services, such as insurance or stock sales. Some of these institutions may not be regulated at all or, if so, may not be scrutinized as closely as banks. This perceived lack of regulatory parity arouses the contempt of bankers, who contend that they are unfairly hamstrung by red tape.

The Division is also faced with watershed issues, such as reregulation following on the heels of deregulation and the threat of an eroding dual banking system, as a result of expanding and preemptive federal regulations. And, it must deal with increasingly complex regulatory issues with the advent of new developments, including bank holding companies, depository trust companies, branching and interstate banking, consumer protection issues, and evolving technology.

In spite of these challenges, the Division has demonstrated its willingness to adapt to changing conditions in order to promote the safety, soundness, and security of financial institutions and their deposits. For example, in the past the Division examined every bank with the same frequency, no matter how sound or precipitous their financial condition. Now, the Division examines institutions based on their financial condition and risk level in an effort to balance the necessary scope of regulation against the industry's desire to free itself from unduly burdensome regulation.

Notwithstanding the challenges and difficulties voiced by the industry, the great majority of state-chartered banks are satisfied with the performance of the Colorado Division of Banking, and they express their continuing preference to be primarily regulated by the state.

Table 1 shows the statutory history of the Division of Banking and its predecessors, the Banking Department and the office of the State Banking Commissioner.

Table 1

COLORADO DIVISION OF BANKING STATUTORY HISTORY

1877	First codification of banking laws requiring bank directors to report semi-annual examination results to the State Treasurer for publication.
1885	Statute amended to provide criminal penalty of imprisonment for receipt of deposits after insolvency. Statutory restrictions placed upon loan amounts.
1907	State Commissioner of Banking created with duty to supervise and examine banks and trust companies at least twice a year, to liquidate banks and trust companies, and to issue state charters. Banks are required to submit call reports to the Commissioner three times a year.
1913	Minimum capital and reserves against deposits requirements fixed by statute. Prohibition against branch banking established. Provision for district court review of Commissioner's decisions. Board consisting of Governor, Attorney General, and State Treasurer may overrule Commissioner's decision to deny a state charter.
1915	Banks are authorized to form separate trust departments, in which trust funds must be kept separate, to be supervised by Commissioner.

1923	Industrial banks created, subject to Commissioner's right to examine, for purposes of lending money. Fiduciary obligations established. Banks permitted to accept and forward checks drawn on other banks.
1927	Limitations on bank investments and borrowing established, along with new capital, surplus, and reserve requirements. Commissioner vested with authority to refuse the approval of bank directors. Duties of director include submission of director's reports, in addition to call reports, to Commissioner at least twice a year. Liquidation procedures created.
1931	Credit unions subject to regulation by Commissioner.
1947	Trust companies subject to regulation by Commissioner.
1949	Provisions established regarding circumstances in which checking and demand items are honored.
1951	Chartering, rights, and duties of industrial banks set forth. State bank merger and consolidation permitted with approval of Commissioner.
1957	Banking statute repealed and new, comprehensive statute enacted to apply only to commercial banks and their trust departments. Banking Department and seven member Banking Board established to include four bankers, two public members, and the Commissioner as chair. Commissioner authorized to accept federal examination results in lieu of a state examination. Criminal offenses specified for code violations, and injunctive remedy made available to Department for the first time.
1959	Commissioner is vested with regulatory authority over money order companies.
1961	Code amended to authorize Commissioner to exercise supervision and examination authority over industrial banks. Commissioner required to notify existing banks of a competitor's application for charter. Procedure regarding the chartering process, including the applicant's burden of proof, is incorporated.
1963	Commissioner is given regulatory jurisdiction over debt adjusters.
1967	Banks are authorized to pay interest on savings deposits, time deposits, and certificates of deposit.

1968 Division of Banking is created as part of the Department of Regulatory Agencies. Commissioner of Banking is appointed as head of the Division.

1969 Banks are permitted, with Banking Board approval, to operate one detached facility for limited purposes, including receiving deposits, cashing checks, and issuing various instruments.

1973 Procedures defined for the disposition of unclaimed property. Industrial bank savings guaranty act passed, along with legislation expanding Commissioner's authority to require industrial banks to maintain adequate capital structure.

1975 Public Deposit Protection Act promulgated, to be administered by Division of Banking. Code is amended to require Division to examine banks once a year and to prohibit Division from accepting federal examinations in lieu thereof.

1976 Division of Banking subject to sunset review.

1977 Bank Electronic Funds Act passed, authorizing state and national banks to operate automated teller machines and giving the Banking Board regulatory jurisdiction.

1979 Requirement that bank directors must own shares of the bank is eliminated by amendment. Banks are permitted to make loans secured by junior liens on real estate under certain conditions.

1981 Major revision of industrial bank legislation incorporates liquidation provisions pertaining to industrial banks.

1983 State banks are permitted by statute to maintain any type of accounts which are allowable in national banks.

1985 Banking Board is permitted to assess civil money penalties against any person who violates a cease and desist order after notice and hearing. Also, the statute is amended to permit bankers to engage in activities which are "primarily investments in real estate."

1986 PDPA is amended to specify collateral requirements, to require all eligible public depositories to file annual independent reports and to submit to discretionary examinations, and to impose criminal penalties for the deposit of public monies in insolvent institutions.

1987 Insolvent bank legislation is amended to require Commissioner to conduct a mandatory examination and assessment against banks which have impaired capital. Banks may operate up to two branch banks, provided they do so by receiving emergency grants of charters of insolvent state banks which may be converted into state banks. Priority of claims in the event of liquidation are expressed, including claims by governmental units made pursuant to the PDPA.

In response to the industrial bank crisis, all such banks are required by legislation to become members of the FDIC or the Federal Reserve System and to apply for membership no later than September 1, 1987. Mechanisms are set up for the distribution of the guaranty fund and dissolution of the guaranty corporation. Emergency charters for branch facilities similar to those applicable to commercial banks are permitted for industrial banks.

1988 Composition of Banking Board is changed to eliminate Commissioner as chairman and board member and to require that Banking Board membership consist of four banking industry representatives and three public members. Banking Board is directed to make policy and rules, while Commissioner is required to administer the Division and the Banking Board's decisions. The Banking Board may delegate powers to the Commissioner, subject to Banking Board review of delegated adjudicatory functions.

All regulatory functions with respect to credit unions are transferred from the Division of Banking to the Division of Savings and Loan.

Limited interstate banking by acquisition of Colorado banks and bank holding companies under narrow circumstances is introduced by new legislation. Subject to conditions imposed by statute and the Banking Board, Colorado bank holding companies may acquire control of banks or bank holding companies in reciprocal states, and vice versa. Existing prohibition against branch banking across state lines expressly continued.

Industrial bank liquidation statute supplemented to provide for the appointment of a bank receiver with broad power to undertake liquidation of industrial banks in the Commissioner's possession or which have filed bankruptcy petitions. Separate legislation authorizes early entry by a non-reciprocal out-of-state bank to raise additional funds for depositors in troubled industrial banks.

1989 Banking Code of 1957 undergoes substantial revisions by repeal, reenactment, and amendment.

Banking Board is reconstituted to include two public members, four state bankers, one industrial banker, and one trust company officer. Banking Board's policy and rule-making powers are refined, and Commissioner's administrative powers are set out to include examination and enforcement functions for banks, industrial banks, trust companies, their controlling shareholders, affiliates, and electronic data processing centers to the extent required by the Board. An express legislative declaration of policy sets forth that state banks are to be supervised and regulated so as to preserve and promote secure deposits, sound competition, a dual banking system, safety and soundness, and to seek regulatory parity and coordination, and diverse financial products and services.

The Banking Board is given discretion to appoint a hearing officer to conduct public hearings other than contested charter applications. The right to bring a legal action for violation or enforcement of the code is limited to the Banking Board.

Bank and trust directors are directed to submit biographical reports to Commissioner, and changes of control are required to be reported to the Division. The Banking Board may remove or suspend any bank officer, director, employee, or agent for cause. Grounds for assessing civil money penalties are expanded, and the Board and Commissioner are authorized to initiate informal enforcement actions to enforce code.

Annual audits are required of banks and trust companies.

Banking Board is authorized to take possession of an industrial bank without a prior hearing in an emergency. Procedures for the distribution of guaranty corporation assets are set forth.

In a major statutory revision, state-chartered trust companies are authorized to become depositories and to pay interest on savings, time, and certificates of deposit if they are FDIC-insured. Capital requirements are removed from the statute and the Banking Board is authorized to adopt rules setting capital and reserve requirements. Fiduciary funds awaiting investment or distribution may be placed in a trust company's deposit account. Operational and reporting requirements are amended, including limitations on investments, director duties and provisions for their removal or suspension, assessment of civil money penalties, informal enforcement authorities, liquidation procedures, and emergency grant of new charter and branch facility provisions.

PDPA is repealed and reenacted with amendments to modify a comprehensive scheme regarding the protection and collateralization of public funds in eligible public depositories. Procedures are set forth to designate public depositories, to track deposits in accounts, to establish a list of eligible collateral for uninsured public deposits and requirements regarding where such collateral may be held, to require reports and examinations, and to liquidate collateral upon default.

1990 Further realignment of Banking Board/Commissioner powers occurs. Banking Board's authority to hold confidential executive sessions is clarified. Directors examinations may be conducted by independent persons other than CPA's if approved by rules and regulations adopted by the Banking Board.

Requirements for the acquisition of controlling interests in industrial banks are set forth, and industrial banks are required to submit call reports to the Commissioner.

Colorado banks and trust companies are authorized to be substituted as fiduciaries for the fiduciary business of another company without court approval in certain situations. Colorado banks and trust companies are authorized to invest their trust assets in designated securities.

Qualified financial institutions are authorized to issue Colorado Investment Deposits to be used primarily for loans to small business enterprises, with priority to minority and women-owned businesses.

1991 Hearings regarding the involuntary liquidation of commercial banks by the Banking Board may be conducted confidentially. Banks are permitted to operate loan production offices in addition to a branch.

PDPA eligible collateral may be held in any bank approved by the Banking Board.

Bank branching is permitted. Article 25, "Financial Institutions-Operation of Branches-Organizational and Operational Equality" is passed to permit 100% of all Colorado affiliates to be converted to branches, subject to capital standards and other limitations, by July 1, 1993. Financial institutions are also permitted to establish one de novo branch anywhere in the state after that date and, further, to establish one or more such branches after January 1, 1997.

Colorado financial institutions are permitted to accept deposits and pay out withdrawals, personally or by machine, of other Colorado financial institutions pursuant to contract.

1992 The Division becomes cash-funded based on assessments imposed on regulated financial institutions.

Money penalties may be imposed upon persons who control, manage, or operate banks or trust companies and who fail to submit required personal statements.

Reverse mortgage loan transactions are authorized in Colorado.

1993 HB 93-1030 is passed to require all state-chartered trust companies to conduct a "substantial portion" of business in Colorado and to restrict the use of the term "trust" by financial institutions to entities which are engaged in trust functions.

HB 93-1261 legislatively overrules Colorado case law. Public policy permits insurance policies for directors and officers of financial institutions to exclude coverage for claims made by depository insurance organizations or by federal or state regulatory agencies.

CHAPTER 2

STRUCTURE AND FUNCTION OF THE COLORADO DIVISION OF BANKING

INTRODUCTION

The Colorado Division of Banking is charged with the responsibility of regulating 174 state-chartered commercial and industrial banks, trust departments, and trust companies that conduct business at over 218 locations in Colorado. These financial institutions have over $26.8 billion in assets. [February 9, 1993 DOB Memo to Department of Regulatory Agencies].

The Division is also responsible for ensuring that $1.1 billion in public funds are deposited and collateralized in eligible state-chartered institutions and in 184 national banks. It monitors whether state-chartered institutions comply with the Uniform Colorado Consumer Credit Code, and it licenses and regulates organizations which sell over $1.6 billion in money orders and travellers checks in Colorado annually. The Division regulates four licensed debt adjuster organizations which disburse approximately $40 million annually on behalf of over 8,300 customers. [February 9, 1993 DOB Memo to Department of Regulatory Agencies].

Eight Banking Board members are appointed to establish and direct the policies and promulgate the rules necessary to implement and enforce the extensive banking and financial statutes. Forty-two full-time employees are authorized to administer these functions. [DOB Budget, Fiscal Year 1992-93].

OPERATING STRUCTURE

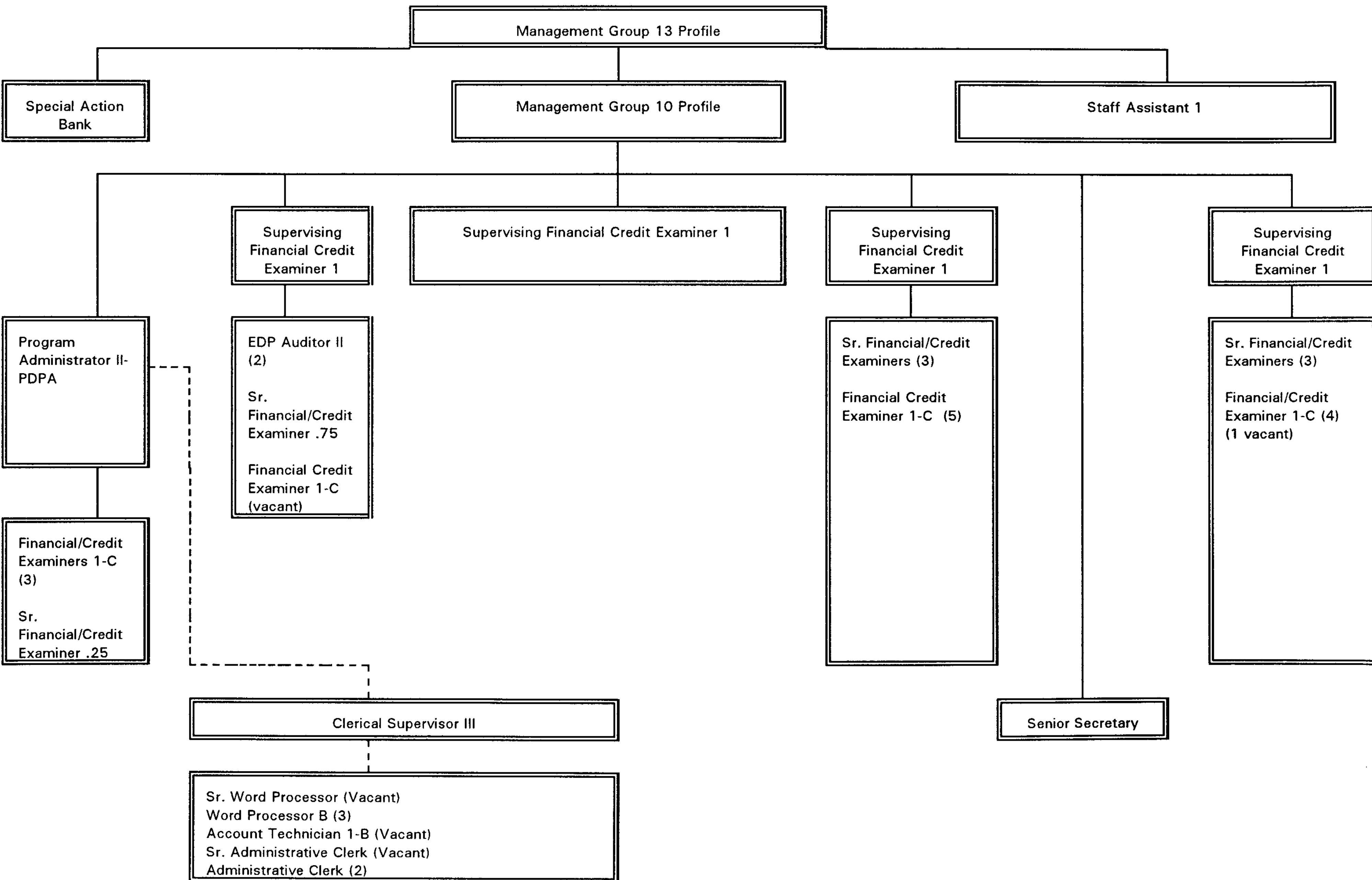
Before 1988, the Commissioner served as Chair of the Banking Board, operating in the dual role of policy-maker and administrator. However, a 1988 report generated by the State Auditor concluded that the relationship of the Commissioner to the Banking Board was systemically flawed since the Commissioner, as administrator of the Division's activities, was effectively self-accountable in his role as Chairman of the Board. A separation of policy-making and administrative functions was accomplished through legislation which removed the Commissioner from the Banking Board and clearly delineated the Banking Board's policy-related duties from the Commissioner's administrative functions.

The Division continues to examine regulated commercial and industrial banks for safety and soundness as its "bread and butter" function. In addition, though, certain supervisors and examiners are assigned to focus upon specific institutions or programs and to conduct "specialty examinations." These programs and examinations monitor the safety, soundness and processes of trust companies, trust departments, special action banks, electronic data processing controls (EDP), UCCC compliance, PDPA, debt adjusters, and money order companies.

The Division currently performs its regulatory tasks by dividing itself into components which perform fairly specialized functions. There are two safety and soundness examination teams, which, when combined, consist of two supervising examiners and fifteen field examiners. Each team is responsible for conducting on-site safety and soundness examinations at commercial and industrial banks and for monitoring the financial condition of banks off-site through the review and analysis of financial information, audits, and federal regulatory ratings and reviews. One special action bank specialist monitors the condition of troubled commercial and industrial banks on- and off-site. The remaining trust and specialty programs are administered by two supervisors and conducted by field examiners who are typically trained in safety and soundness examinations but are compartmentalized because of their specialty exam expertise. These two supervisors also perform training, automation, and rule, policy and procedure drafting.

Finally, one supervisor investigates and processes all applications before the Banking Board and schedules and coordinates examinations. One senior examiner is conducting, on an as-needed basis, investigation of complaints of suspected criminal activity and certain suspected licensing violations. Table 2 outlines the Division's current organizational structure.

TABLE 2



The staffing level of each unit is critical to its successful function. Therefore, the successful function of the Division may be crippled by a significant vacancy rate which may occur this year. As this report is written in May 1993, one safety and soundness field examiner has retired and two of five office support positions are vacant. The Division anticipates that an additional three examiners will also retire, leaving four examiner vacancies. However, the Division anticipates filling all but one of these vacancies before the end of the calendar year.

BANKING BOARD

The Banking Board is a type 1 (policy autonomous) board. Its present composition consists of four commercial bankers, one trust company representative, one industrial banker, and two public members, each of whom are appointed by the Governor. The Banking Board is the ultimate decision-maker of the Division. It is statutorily empowered to interpret all relevant statutes by rule and regulation and to make all policy decisions except administrative decisions. It is required to form a quorum of at least four members to meet monthly to carry out the business of the Banking Board. It is assisted by a staff member, who also assists the Commissioner, and any other staff member who is required to present applications or other matters to the Banking Board. The Board receives legal counsel from a Department of Law assistant attorney general, who is assigned to render legal advice to the Division of Banking, the Division of Financial Services, and the Division of Securities.

STATE BANK COMMISSIONER

The Commissioner is the administrative head of the Division who internally administers the Division and makes administrative policy. A primary responsibility of this office is to coordinate all examination and enforcement functions and, otherwise, to implement the statutes and policies of the Banking Board. The Commissioner is specifically authorized to require regulated financial institutions to comply with certain Division directives, such as undergoing additional examinations. The Commissioner manages the legal representation received by the Division, and the position is also authorized to carry out duties delegated by the Banking Board. The Commissioner is a full-time state employee who is appointed by the Executive Director of the Department of Regulatory Agencies. The Commissioner is assisted by Division staff, most particularly, by the Deputy Bank Commissioner, by a staff assistant, and by supervisors within the Division.

This position has been filled by three individuals since 1988. At that time, the existing Commissioner resigned as a result of a critical audit which concluded that the Division suffered from extensive deficiencies. He was replaced in 1989 by an individual who, along with the General Assembly and Banking Board, implemented sweeping changes within the Division in the wake of the audit. The current Commissioner has continued along the course of implementing necessary changes since undertaking this office in 1991.

DEPUTY BANK COMMISSIONER

This official is appointed by the Commissioner to assist with administrative, examination, and enforcement duties. The Deputy Bank Commissioner is, as the title implies, the second in line of authority in the Division. The position is primarily responsible for overseeing the daily operations, budget, examination and enforcement functions of the Division.

SPECIAL ACTION BANK SUPERVISOR

This individual monitors troubled banks which have received inadequate ratings or which, in the opinion of the Commissioner or Deputy Bank Commissioner, have otherwise experienced financial or operating problems requiring increased monitoring and supervision. This senior examiner is expected to monitor the institution continuously, to maintain frequent communications with the institution, and to keep the Commissioner and Deputy Bank Commissioner fully apprised of the institution's progress. This position also facilitates the informal resolution of complaints directed against troubled banks by consumers. This position is rotated annually among senior examiners, who are experienced safety and soundness field examiners. The special action bank supervisor does not have supervisory authority over any other staff.

INVESTIGATIVE SERVICES

This senior examiner reports directly to the Commissioner and is responsible for examining suspected criminal violations and certain other suspected licensing violations. The amount of work for which this position is responsible is determined by the level of suspected criminal activity and licensing violations at any given time and, therefore, is not constant. The Division estimates that approximately ten to twenty percent of this examiner's time is spent on investigative matters. Another one-third of this individual's time is spent performing safety and soundness examinations, while the balance of time is spent investigating other target areas in banks, including the review of expenses. The Commissioner intends to assign these duties to the Special Action Bank Supervisor at the beginning of the 1994 calendar year.

COMMERCIAL AND INDUSTRIAL BANK SAFETY AND SOUNDNESS EXAMINERS

This section is comprised of two groups of on-site and field managers, each of which is headed by a supervising examiner. These groups conduct safety and soundness examinations upon all state-chartered commercial and industrial banks. These institutions are assigned to one of two portfolios which the groups monitor and examine.

The two supervising examiners provide guidance and review the work and analysis of their subordinates. They also perform independent examining functions since they are primarily responsible for conducting off-site monitoring of the financial institutions in their portfolio. This important examination technique requires the supervisor to review and analyze an institution's financial data and other relevant information to monitor its financial condition and risk status. In addition to their supervision and examination responsibilities, these supervisors handle consumer complaints and try, informally, to negotiate their resolution.

On-site managers, or OSM's, travel to the site of the examination as lead examiners. As such, they participate in the examination, evaluate the institution's management system, and delegate, oversee, and assist the field examiners with their responsibilities. These five individuals also conduct exit interviews with bank management to advise them of the preliminary findings uncovered by the examination. Once their on-site duties are completed, OSM's report to the Division office for one week to write the examination and to review and edit the worksheets and conclusions of the field examiners, to recommend sanctions or enforcement actions, and to write the examination report. The OSM is expected to generate a report which is "mail-ready" or error-free. These reports are reviewed by the supervising examiner before being mailed to the examined institution.

Field examiners are the eyes and ears of the Division who examine financial institutions on-site and whose conclusions form the basis of an institution's recommended rating. There are ten field examiners who are assigned by the scheduler to travel to state-chartered financial institutions to conduct safety and soundness examinations of loan, securities, and operating portfolios. While on-site, they inspect bank records, fill out worksheets, and enter their conclusions into a computerized examination program. Ultimately, an examination report is generated, and recommended ratings are assigned to various operations of the institution.

Each member of the field examiner staff possesses a minimum of 12 to over 30 years of expertise in the examination and operations of financial institutions.

TRUST AND EDP EXAMINERS

This section is comprised of one supervising examiner, one trust examiner, and two electronic data processing (EDP) auditors.

In addition to supervision responsibilities, the supervising examiner of this section conducts on- and off-site monitoring for the institutions in the portfolio. The position also facilitates resolution of complaints against trust companies, most of which charge that consumers have been charged excessive fees or that trust accounts have not been transferred rapidly. The supervising examiner is responsible for drafting internal policies and procedures at the Commissioner's request. Additional duties include oversight of internal automation and rule drafting for the Banking Board.

The trust examiner, who is also an OSM, is responsible for conducting all mandatory and discretionary safety and soundness examinations for state-chartered trust departments and trust companies. Like his bank examiner counterparts, this examiner is expected to travel on-site to examine trust operations, to conduct interviews with management, and to generate a mail-ready written report which contains conclusions and rating recommendations.

The EDP auditors undertake the responsibility of monitoring and examining the record-keeping and electronic data processing of all state-chartered financial institutions. The primary goals of these examinations are to determine how an institution's information is stored, how it is calculated, whether it is analyzed accurately, and whether these electronic data processing internal controls are adequately redundant in case service is lost and must be restored. Besides examining the in-house EDP systems of financial institutions, these auditors also examine EDP "servicers" who provide electronic data processing services to several financial institutions from one location. Finally, they are responsible for generating written examination reports which contain a recommended rating of the institution's EDP system.

PDPA, UCCC, MONEY ORDER AND DEBT ADJUSTER COMPANY EXAMINATION

A program administrator administers the Public Deposit Protection Act (PDPA) program and supervises the examination of institutions for PDPA and UCCC regulatory compliance. The position also manages the Division's regulatory program for debt adjusters and money order companies. This program administrator is responsible for rule drafting functions with respect to these areas, and this individual is also the training coordinator for the Division.

The PDPA program exists to protect public deposits from losses by ensuring that all such funds which are not federally insured are deposited in an institution which is equipped to collateralize them adequately. Eligible public depositories must be able to collateralize public funds with a minimum amount of collateral which has been approved as being sufficiently safe by the Banking Board. This program is carried out in the field by safety and soundness examiners, who examine the PDPA functions of state-chartered institutions during the course of safety and soundness exams. One additional field examiner examines all other nationally-chartered eligible public depositories, all state-chartered institutions which have a CAMEL rating of 4 or 5, and state-chartered institutions which are not scheduled to have safety and soundness exams conducted. Eligible public depositories are examined to determine whether they are properly complying with collateralization requirements. Two administrative clerks enter and update collateral change forms that list all collateral pledged by banks against their public deposits. They also release pledges requested by banks on a daily basis. In addition, they manually monitor the amount and types of public funds which each eligible depository has on deposit. These monthly liability reports are reviewed once every four months. The PDPA program has been separately funded by bank assessments since 1988, and appropriations for the program are statutorily earmarked to fund four FTE.

Although the Division has had the authority to examine state-chartered banks for UCCC compliance since the early 1970's, its compliance examination program was not fully instituted until 1990. One field examiner has undertaken the responsibility of conducting debt adjuster and UCCC compliance examinations for all state-chartered institutions on-site. The position is required to travel to the banks, to inspect and examine their consumer transactions for compliance with the code, to note violations and to recommend sanctions in a written examination, and to make a recommended rating of the institution for its compliance.

SCHEDULING AND CHARTER APPLICATIONS SUPERVISOR

A supervising examiner analyzes and processes all types of applications before the Banking Board. The position is also responsible for scheduling over 400 safety and soundness and specialty examinations, for coordinating these examinations with examinations conducted by federal regulatory agencies to the extent possible, and for assigning OSM's and field examiners to projects. This individual is also responsible for generating written and oral reports which are presented to the Banking Board at its monthly meetings.

OTHER IMPORTANT DIVISION PERSONNEL

The Division receives its legal advice and representation from one attorney who is a member of the Office of the Attorney General. This attorney divides his time between representing of the Divisions of Banking, Financial Services, and Securities.

As noted previously, the Staff Assistant to the Commissioner and Banking Board provides necessary administrative and clerical support to these entities. This position serves as the secretary at Banking Board meetings, drafts and distributes meeting notification and agenda forms, conducts research and prepares drafts for the Commissioner, performs rule-making and policy and procedure updates for the Division, and assists any Division staff who makes presentations to the Banking Board. A senior secretary provides clerical support to the Deputy Commissioner and to the two Supervising Examiners in charge of safety and soundness examinations.

The Division is funded to receive administrative staff assistance from ten full-time employees. It is currently operating with the service of seven staffpersons owing to vacancies brought on by one resignation and one termination. The clerical supervisor is responsible for overseeing these seven positions, which include the PDPA administrative clerk and one word processor, and associated personnel matters.

One of the three word processor positions is responsible for entering information into the internal inventory tracking system, which is the Division's computerized "tickler" and calendar system. The remaining two positions process examination reports, edit policies and procedures, and type correspondence for supervisors. The administrative clerk is assigned to make certain that all incoming and outgoing documents and records are properly filed. The vacant accountant technician position processes assessments for safety and soundness examinations, billings for specialty examinations, and performs other accounting functions for the Division.

CHAPTER 3

A PORTRAIT OF THE REGULATED INDUSTRY

The Division of Banking regulates a portion of the private business sector which claims to be the most heavily regulated industry in existence. A profile of Colorado's banking and trust industries is necessary to gain a complete understanding of the Division's performance and mission.

COMMERCIAL BANKS

A snapshot of the nation's commercial banks as of December 31, 1991 reveals that there were 11,928 banks with assets of $3.430 trillion in the United States. More than two-thirds of all banks were state-chartered and held 42.2% of all bank assets in the country. [FDIC; Conference of State Bank Supervisors, A Profile of State Chartered Banking (14th ed. 1992)(hereinafter "CSBS")].

At the end of 1991, 60% of all commercial banks were supervised by state authorities and the FDIC, and 8.2% were supervised by state authorities and the Federal Reserve. The remaining 31.8% consisted of national-chartered banks which were supervised solely by the Office of the Comptroller of the Currency (OCC). [FDIC; CSBS, A Profile of State Chartered Banking (14th ed. 1992)]. Table 3 illustrates the regulatory scheme under which commercial banks presently operate.

THE PRESENT BANK REGULATORY STRUCTURE

	NATIONAL BANKS	STATE BANKS		
		Members of the Federal Reserve System	Insured Nonmembers	Uninsured
CHARTERING AUTHORITY	Comptroller of the Currency	State Banking Department		
FDIC INSURANCE	Automatic with Charter	Automatic with Membership	Upon FDIC Approval	
FEDERAL RESERVE MEMBERSHIP	Automatic with Charter	Automatic with Membership	Upon FDIC Approval	
APPROVAL FOR BRANCH APPLICATIONS	Comptroller of the Currency	Upon Federal Reserve Approval		
APPROVAL FOR BANK MERGERS	Comptroller of the Currency		State Banking Department	
		and Federal Reserve System	and FDIC	
APPROVAL OF BANK HOLDING COMPANY FORMATIONS AND ACQUISITIONS	Federal Reserve System			

Source: Kenneth Spong, Banking Regulation: Its Purposes, Implementation, and Effects (3rd ed. 1990)

In 1990, Colorado laid claim to 424, or 3.5%, of the nation's commercial banks. These institutions held $26.9 billion, or 0.8%, of all of the industry's assets. Forty percent, or 168, of these banks were state-chartered, and they held total assets of $5.393 billion and total deposits of $4.833 billion. Therefore, Colorado's state-chartered commercial banks held approximately 20% of all Colorado commercial bank assets.

By December 31, 1992, the number of Colorado's state-chartered commercial banks diminished from 168 to 157. This figure is misleading, however, since the decrease in the number of state-supervised institutions is not attributable to bank failures but, rather, is offset by bank consolidations. The growth of Colorado's commercial banks during this time frame can be appreciated by the fact that banking assets under supervision of the Division increased to $6.315 billion, while total deposits likewise increased to $5.646 billion. [83rd Annual Report of the State Bank Commissioner].

The number of nationally-chartered commercial banks also experienced a decrease during 1991 and 1992. In light of this national bank contraction, the market share of state-chartered commercial banks increased from 40% to over 46%. [82nd Annual Report of the State Bank Commissioner; DOB memorandum; Colorado Bankers Association, Focus on Red Tape Reduction, February 21, 1993].

Since state authorities possess primary regulatory authority over 68.2% of all commercial banks on national average, the Division's jurisdictional share of 46% over Colorado's commercial banks is somewhat slight by comparison. However, the smaller pool of state-chartered banks and the recent slight decline of that bank base cannot be construed as an expression of industry dissatisfaction with the state regulatory authority. The vast majority of Colorado bankers who responded to a survey in early 1993 expressed high overall satisfaction with the Division of Banking's regulation of their institutions.

Instead, this recent phenomenon appears to be attributable to de novo branching and mergers facilitated by Colorado's branching law. An examination of recent trends indicates that Colorado's regulatory jurisdiction is gaining ground when branch conversions and acquisitions are viewed in context. For example, in 1991 the Division approved only one de novo bank charter, yet it granted ten branch certificates through conversion or acquisition. [82nd Annual Report of the State Bank Commissioner]. This trend continued in 1992, when twelve de novo state bank branch certificates were granted and nine conversions were approved. [DOB December 1992 Production Report].

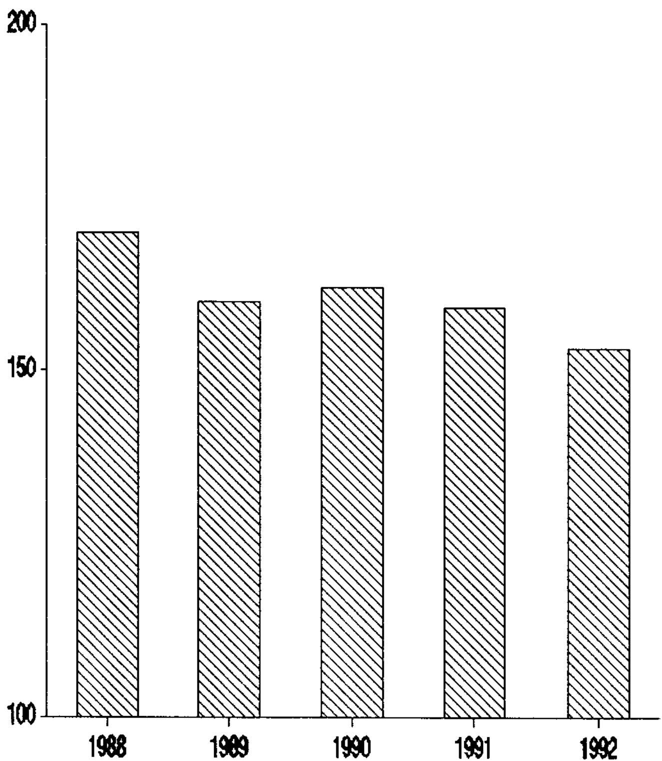
In contrast, the contraction of Colorado's nationally-chartered bank base is not offset by branching or merger acquisitions. These institutions, particularly smaller banks, are under the gun to sell out to large banks which are more profitable for the OCC to regulate. Therefore, they have started to convert to state charters because of their increasing dissatisfaction with the deteriorating supervision of the OCC. [DOB memo]. As testament to this dissatisfaction, three national banks in Colorado converted to state charters in 1991. These conversions preceded five national-to-state bank charter conversions in 1992 and two national bank conversions during January 1993. In addition, more than six national banks have approached the Division to discuss state charter conversions in 1993. [DOB 1992 Annual Review for CSBS Accreditation, March 26, 1993].

The state charter conversion trend is supplemented by encouraging statistics regarding the rebounding strength and safety of all of Colorado's commercial banks. In 1991, the total assets of Colorado's state-chartered banks increased by 6.4% ($5.739 billion) and total deposits increased by 6.7% ($5.158 billion). As of year-end 1992, assets again increased to $6.3 billion, and total deposits jumped to $5.6 billion. Moreover, in June 1992, the average risk-based capital ratio of Colorado commercial banks was 14.7%, amply exceeding the current minimum capital target ratio of 8%. Colorado commercial banks also maintain an equity to capital ratio of 7.9%, in contrast to the national ratio of 6.8%. And, Colorado banks have set aside loan loss reserves of $415 million to protect against loan losses. These indicators of safety are complemented by the gradual, albeit slow, profit recovery which banks are making after experiencing hard times in the late 1980's. [Colorado Bankers Association, Focus on Red Tape Reduction, February 21, 1993]. Table 4 contains graphs illustrating the number and assets of Colorado's state-chartered commercial banks.

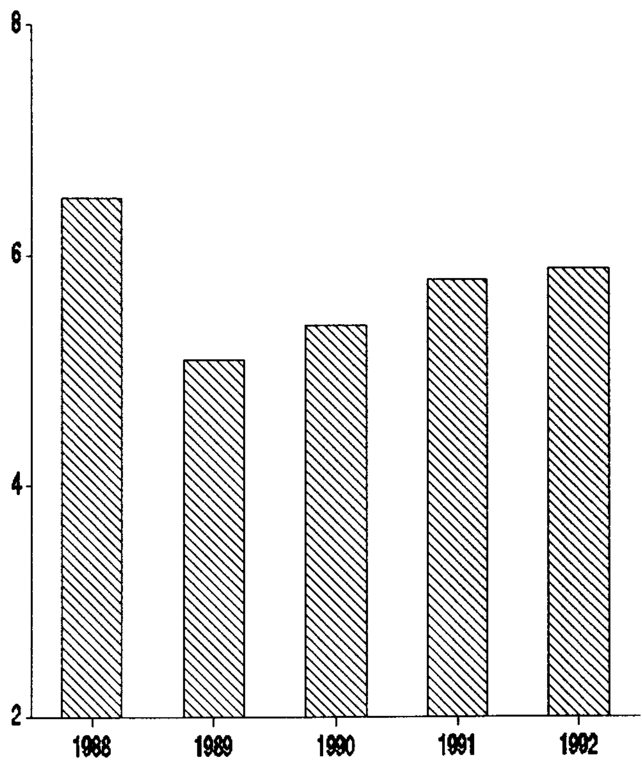
Table 4

CONSISTENCY OF COLORADO COMMERCIAL BANKS

NUMBER OF BANKS



TOTAL ASSETS IN BILLIONS



Source: Division of Banking

The Division has not closed any banks in calendar year 1992 and 1993. Two state-chartered commercial banks were closed in 1991, preceded by four state bank closings in 1989. [DOB 1992 Annual Review for CSBS Accreditation, March 26, 1993; DOB November 6, 1992 Memorandum to DORA].

However, although the number of state-chartered banks in Colorado which require some degree of special supervisory attention by the Division has remained fairly constant during the last few years, the number of institutions with CAMEL ratings of 4 or 5 has decreased dramatically within the last three years. For instance, the Division supervised 30 commercial banks which were rated 4 or 5 in June 1990, compared with 11 similarly rated commercial banks as of May, 1993. [DOB May 1993 Production Report]. The Division expects this trend to continue so long as Colorado's economy remains stable, and it notes that there are currently no state chartered banks that are critically undercapitalized, requiring closure under state or federal laws or regulations.

The Division has continued to initiate enforcement actions against banks on a fairly aggressive level. In 1992, the Division issued or participated in, with federal regulators, 14 written agreements and cease and desist orders, 13 memoranda of understanding and board resolutions, and two other enforcement actions. During the preceding year, the Division initiated or participated in, with federal regulators, 20 memoranda of understanding and board resolutions, and 14 written agreements and cease and desist orders against commercial banks. [December 1991/December 1992 DOB Production Reports]. The Division has also initiated seven criminal referrals since 1991.

INDUSTRIAL BANKS

Industrial banks in Colorado sprang to life years ago by fulfilling a financial need which commercial banks were prevented by law from satisfying: making second mortgage loans. Today's industrial banks look and act like commercial banks with the primary exception that they do not accept demand deposits (checking accounts).

At their peak, the number of Colorado industrial banks approached 150. By 1987, their numbers had diminished to under 100. This financial industry then sustained a severe crisis which withered its community to a handful of 7 banks. Nevertheless, the economic vitality of these survivors is exhibited by their asset holdings, which currently exceed $250 million.

For years, all industrial banks belonged to the Industrial Bank Guaranty Corporation, a statutorily-created entity which assessed each member to provide an insurance fund for the savings obligations of depositors up to the amount of $40,000. In 1987, industrial banks were feeling the pinch of the poor economy and the Division took action with respect to two of its members which were financially impaired. Twelve other industrial banks were also judged by the Division to be in troubled financial condition at that time.

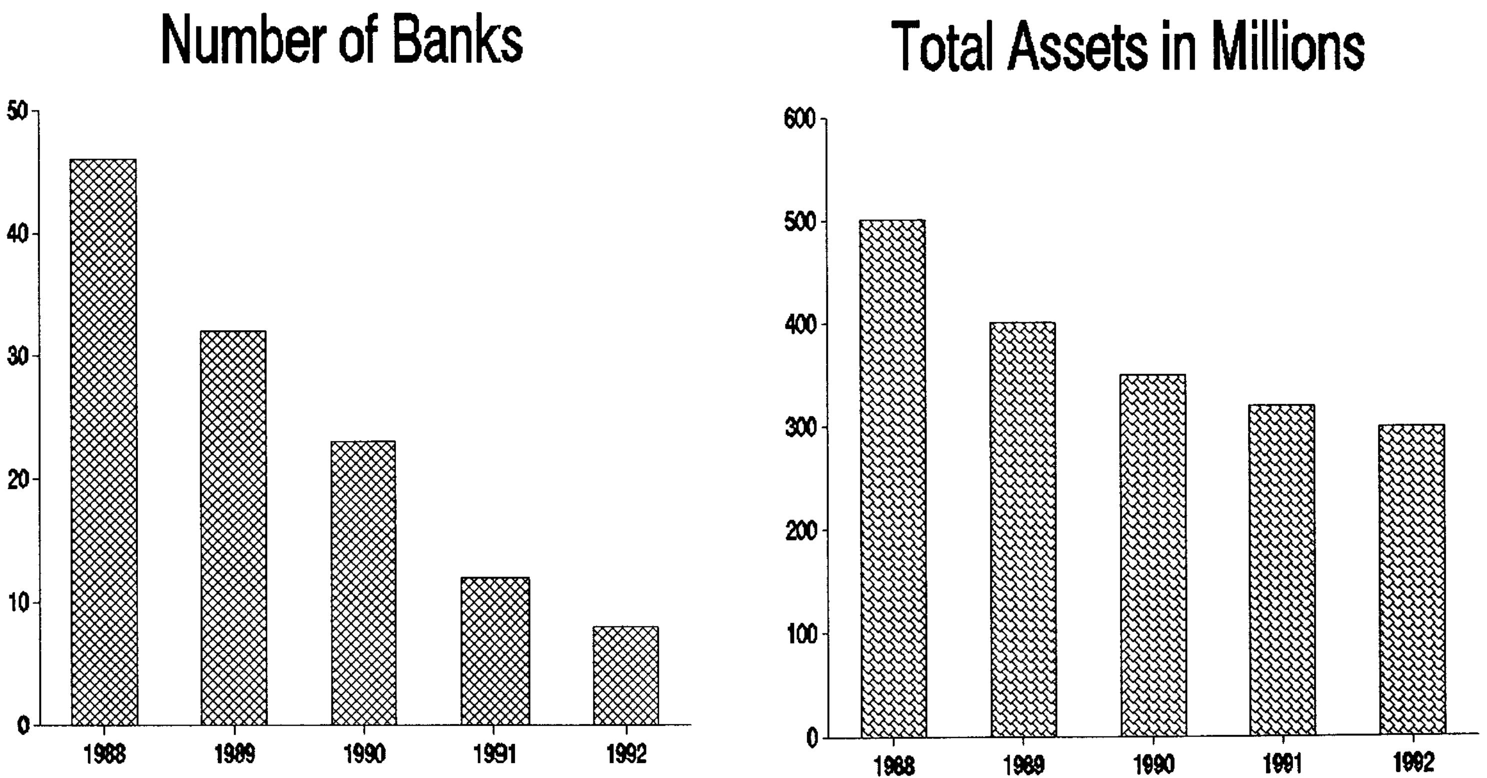
Ultimately, two of the industrial banks decided to file for bankruptcy protection. When the Commissioner decided to take possession of these banks before they filed, it was determined that the Guaranty Corporation would become insolvent if these and the other twelve troubled banks were taken possession of by the Division. Eventually, 14 industrial banks which could not qualify for federal insurance were possessed by the Division and a receiver was appointed.

The Governor and the General Assembly appointed a task force which recommended that a receiver be appointed to oversee the reorganization or, if necessary, the liquidation of these industrial banks. The General Assembly also structured an industrial bank fund for the benefit of depositors of the 14 failed industrial banks. This fund entitles depositors to receive distributions from proceeds which have been deposited by the receiver as a result of industrial bank and asset sales, insurance proceeds, and payments from debtors. Payments to depositors consist of principal and interest as of the date of closure of the industrial bank. [Section 11-22-614, C.R.S.].

Since the late 1980's, industrial banks have closed at a dramatic pace. However, the few remaining industrial banks have stabilized and continue to service their market. In 1990, 23 industrial banks reported total deposits in excess of $223 million and total assets of almost $352 million. The following year, the number of industrial banks dipped sharply to 12. However, total assets only slipped by 8% and total deposits increased by over 10%. [82nd Annual Report of the State Bank Commissioner]. State-chartered industrial banks decreased again in 1992 to 7. [DOB December 1992 Production Report]. Assets in 1992 also experienced a 7.5% decline to $299 million, while deposits decreased 2.8% to $242 million. [83rd Annual Report of the State Bank Commissioner]. Table 5 tracks the decreasing numbers of industrial banks and their assets.

Table 5

DECLINE OF INDUSTRIAL BANKS



Source: Division of Banking

The decline of a formerly robust system of industrial banks ought not to be viewed in an altogether negative light. The industrial bank diminution mirrors the commercial bank trend of charter conversions and branching. For instance, in 1991 no industrial banks were closed by the Division. During the same period of time, one industrial bank voluntarily liquidated, one converted its charter into a commercial bank, while five others converted to industrial bank branch facilities. [82nd Annual Report of the Commissioner].

The regulatory umbrella of the FDIC was extended to state-chartered industrial banks in 1987. See Section 11-22-701, C.R.S. (1987 Repl. Vol. 4B). Since industrial banks are regulated by the FDIC and the state, their regulation mirrors the commercial bank scheme in which state and federal examinations rate the soundness and risk level of the institution's financial condition.

The soundness of the remaining industrial banks can be gauged by the fact that six of the industrial banks were rated as of December 31, 1992, possessing satisfactory or very satisfactory indicators of financial safety and soundness. One industrial bank is experiencing severe financial trouble and, therefore, is monitored by the Division as a special action bank. The Division did not have to initiate any enforcement action in 1992 outside of one cease and desist order, and there were no industrial bank closings. [DOB December 1992 Production Report].

As of December 31, 1992, total settlement fund payouts to depositors amounted to $39,752,000. These payments reflect that depositors of 8 of the 14 failed industrial banks have been paid in full. Another $5,410,000 remains due to depositors of the remaining 6 failed banks. According to estimates provided by the receiver to the Division, $410,000 will be recovered from future asset sales and that $5,000,000 will be recovered and distributed from insurance escheat funds. [DOB memo].

On balance, state-chartered industrial banks appear to have consolidated and stabilized since the crisis of the late 1980's.

TRUST COMPANIES

Of all the institutions regulated by the Division, trust companies stand out as having experienced the most dramatic economic growth. This burgeoning sector of Colorado's financial industry owes its development to 1989 legislation permitting state-chartered trust companies to become federally-insured depository institutions authorized to accept and maintain savings deposits, time deposits, and certificates of deposit. Section 11-23-103(1)(d), C.R.S.

The dawn of depository trust companies permitted these entities to leapfrog beyond their role as traditional fiduciaries. Now, they are allowed to take certain deposits, to engage in the business of depositing fiduciary funds into their own accounts, and to invest funds on deposit for their own profit. In addition to these deposit-taking activities, trust companies in Colorado serve as custodians, administrators, and trustees of IRAs and Keogh plans; they provide a variety of trust services (including the administration of collective investment funds) to institutional customers, such as pension funds and employee benefit plans; and they provide traditional trust services.

Perhaps as astonishing as the volume of this growth is the fact that it derives in large part from the deposit-taking and investment activities of three state-chartered depository trust companies. However, many of the seven non-depository trust companies operate as vital institutions by engaging in traditional managed trust business (i.e., taking another's money in trust, and investing and distributing it as a fiduciary), or by administering self-directed IRA or pension funds which are required by law to be held by a third party with the assets titled in the trustee's name. The Division also regulates trust departments of nineteen state-chartered commercial banks. These non-depository entities are traditional fiduciaries which happen to be compartments of commercial banks with funds and powers separate from banking functions.

Table 6 illustrates the explosive growth which trust companies have experienced since deposit-taking functions were permitted in 1989.

Table 6

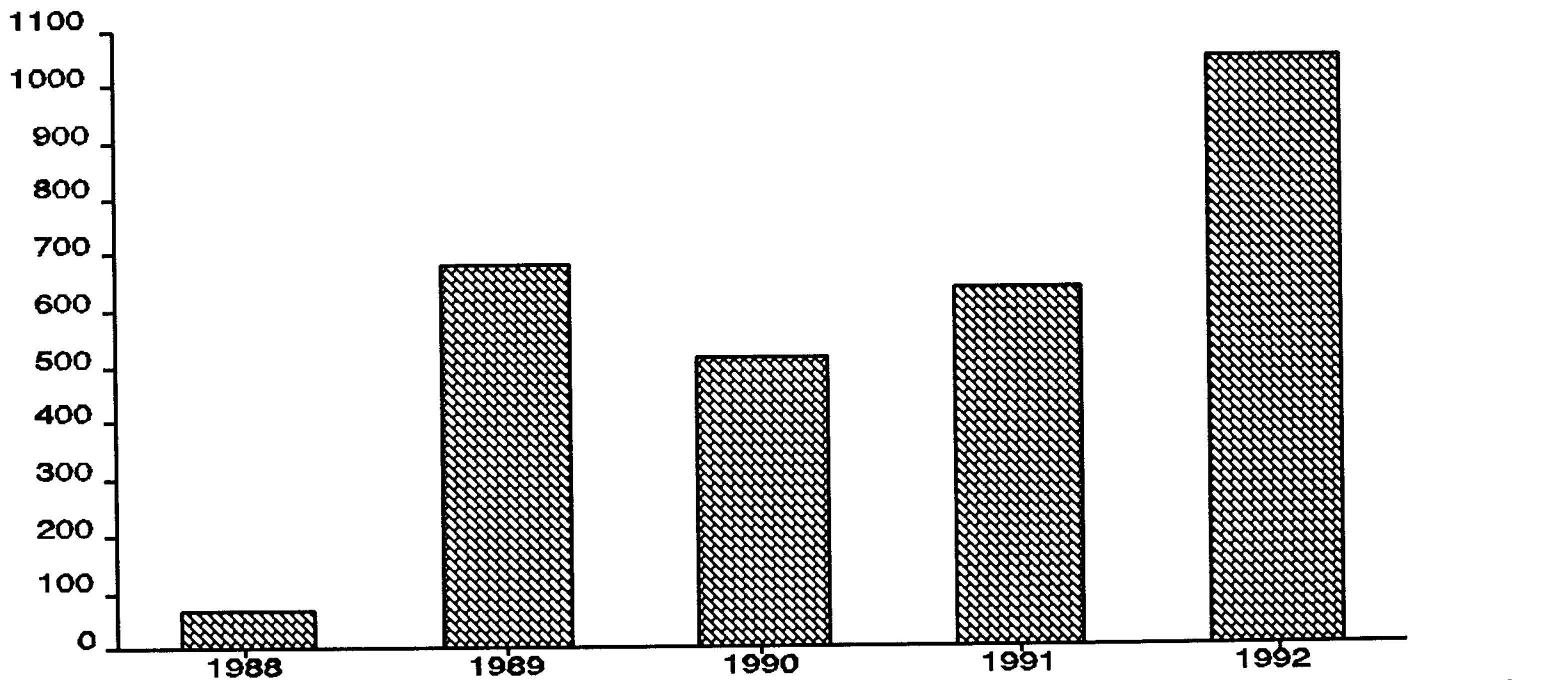
	No. Trust Companies	Total Corporation Assets	Deposits	Total Trust Assets	No. of Trust Accounts
1988	5	$69,723M	$0	$5,673B	310,000
1989	5	$694,752M	$631,753M	$7,008B	193,069
1990	5	$516,456M	$454,586M	$8,723B	647,000
1991	8	$646,432M	$578,950M	$11,001B	690,000
1992	9	$1,267B	$1,126B	$19,703B	700,133

Table 7 illustrates the way in which trust company corporate assets have skyrocketed in the same amount of time. Figures for 1988 are included to provide a basis of comparison.

Table 7

GROWTH OF TRUST COMPANIES

TOTAL ASSETS IN MILLIONS



Source: Association of Colorado Trust Companies

There has never been a trust company failure in Colorado although, at present, one non-depository trust company is subject to a cease and desist order issued by the Division. Should the business of a failed trust company not be purchased by another trust company, the Division is authorized by statute to appoint a receiver to run the business until all fiduciary accounts are sold and transferred to other fiduciaries.

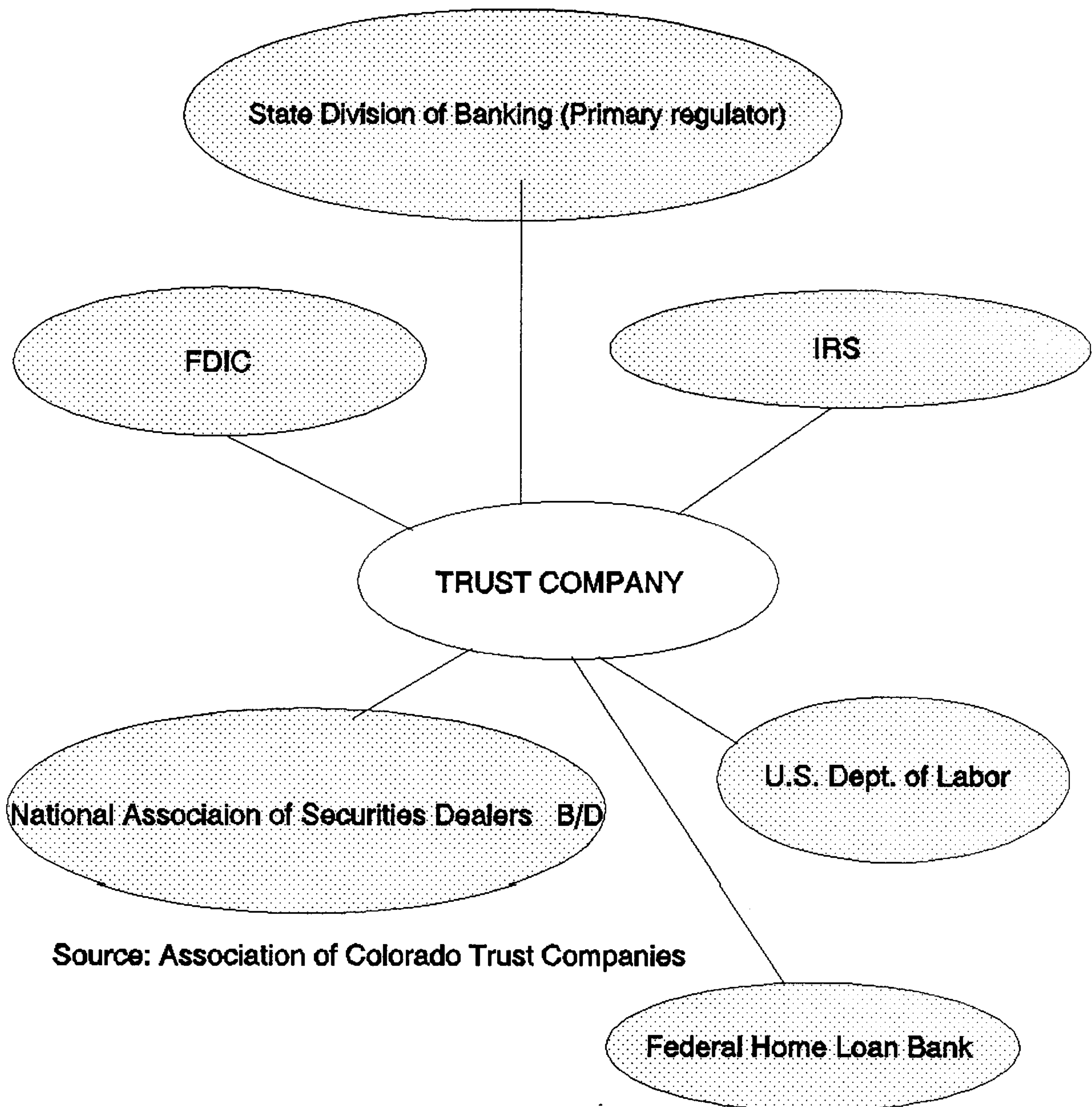
Trust companies and trust departments are subject by statute and rule to risk-based examinations which operate on the same principals which drive commercial and industrial bank safety and soundness examinations. Consequently, these institutions must file financial information with the Division so that their financial condition can be monitored off-site. The frequency of on-site examinations is predicated on the financial condition of each trust institution.

The Division serves as primary regulator for safety and soundness, although depository institutions are also examined by the FDIC and various other governmental agencies, such as the Internal Revenue Service. Non-depository trust companies are also examined by other federal agencies, depending upon the various roles which they may fill. For instance, a non-depository trust company which also conducts itself as an investment adviser is subject to examination by the Colorado Division of Banking and by the Securities Exchange Commission.

Tables 8 and 9 illustrate the various agencies which regulate Colorado's largest depository and non-depository institutions.

Table 8

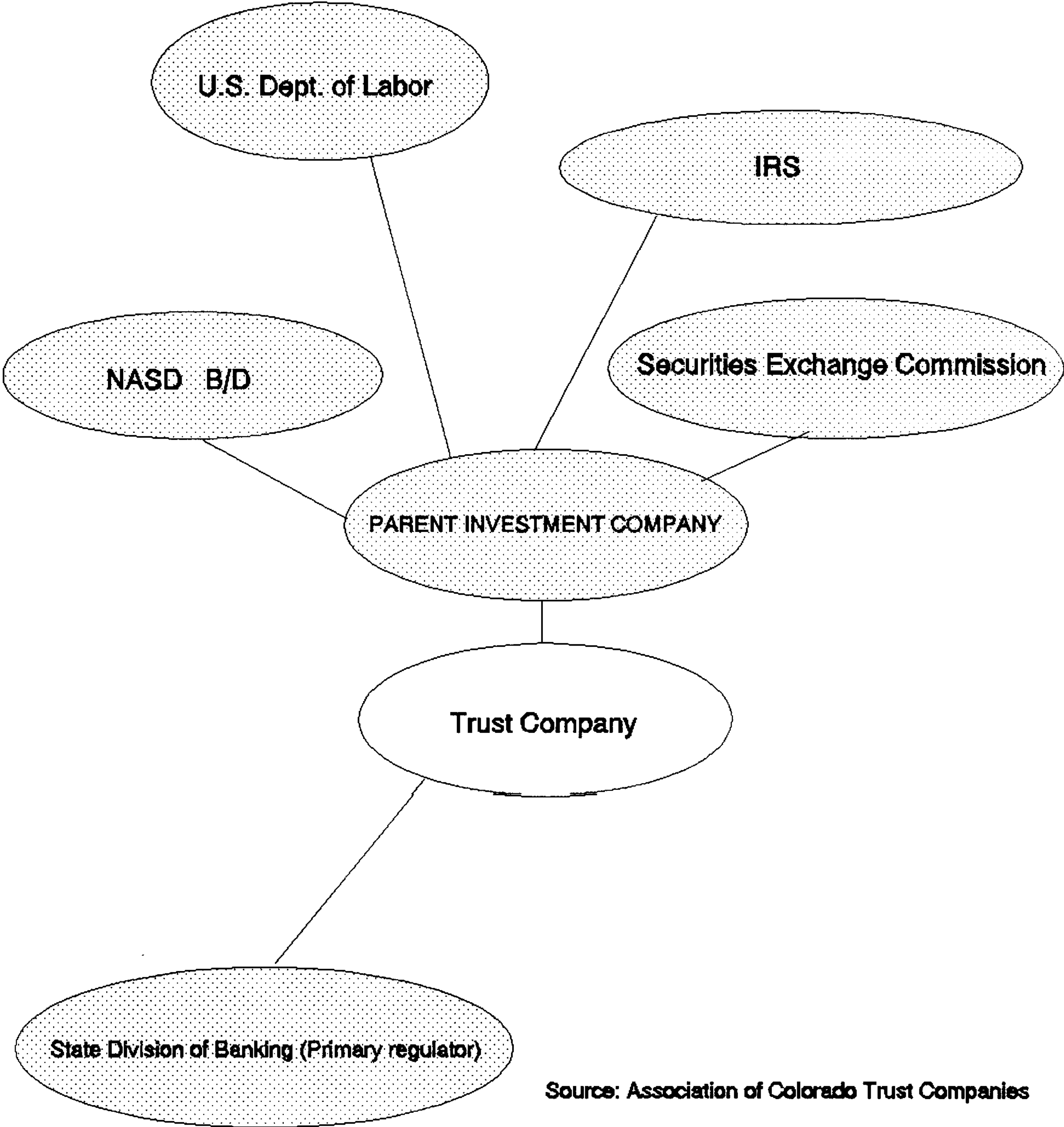
Regulatory Scheme for Colorado's Depository Trust Companies



Source: Association of Colorado Trust Companies

Table 9

Regulatory Scheme for Colorado's Largest Non-Depository Trust Company



Source: Association of Colorado Trust Companies

CHAPTER 4

ISSUES FACING THE COLORADO DIVISION OF BANKING AND THE REGULATED INDUSTRY

INTRODUCTION

The pervasive role which financial industries play in our society, and the importance of regulating their safety and soundness for the benefit of depositors, is underscored by the fact that all 50 states, the District Columbia, and the territories of Guam, the Virgin Islands, and Puerto Rico, actively regulate banks by way of a state commissioner and/or banking board. Each one of these regulators looks much like Colorado's Division of Banking to the extent that their boards and/or commissioners are appointed by the Governor, the state legislature, or a state agency. And, like our Banking Board and Commissioner, the regulatory bodies of our sister states and territories also exercise fundamental regulatory powers such as chartering, examination, regulation, and enforcement authority.

The jurisdiction of these state regulators uniformly extends to the regulation of commercial banks and often extends to credit unions, savings and loan companies, and trust companies. However, in many states, the scope of jurisdiction is expansive and may include the regulation of mortgage bankers and brokers, small loan companies, foreign bank branches, consumer finance companies, check cashers, money order companies, preneed funeral contracts and trusts, debt management companies, escrow companies, and collection agencies. [CSBS Profile of State Chartered Banking (14th ed. 1992)].

Table 10 contains comparative figures compiled by the Conference of State Bank Supervisors which sets forth, by state, whether banking boards are employed as regulatory bodies, the number of banking board members, the numbers of supervisory staff and field examiners in banking divisions, and budgets for fiscal year 1993.

STATE	HAS A BANKING BOARD?	NUMBER OF MEMBERS	NUMBER OF FIELD EXAMINERS	NUMBER OF SUPERVISORY STAFF	FY 1993 BUDGET
Alabama	Yes	6	37	7	$ 3,663,584
Alaska	No		5	2	649,270
Arizona	No		28	3	3,491,200
Arkansas	Yes	6	41	66	4,793,562
California	No		111	27	16,137,000
Colorado	Yes	8	24*	5**	2,769,000
Connecticut	No		46	7	12,137,193
Delaware	Yes	7	19	2	1,937,700
DC	No		1	3	576,000
Florida	No		100	32	8,847,689
Georgia	No		87	16	7,518,578
Guam	Yes	7	2	3	557,860
Hawaii	No		10	10	1,181,800
Idaho	No		13	3	2,193,900
Illinois	Yes	15	172	25	13,714,400
Indiana	Yes	7	68	--	5,232,079
Iowa	Yes	7	72	10	5,547,860
Kansas	Yes	9	53	7	2,715,800
Kentucky	Yes	12	50	5	2,693,900
Louisiana	No		79	15	6,762,345
Maine	No		12	2	1,800,000
Maryland	Yes	8	20	11	478,861
Massachusetts	Yes	3	126	11	7,044,355
Michigan	No		70	5	10,264,800
Minnesota	No		51	12	4,098,000
Mississippi	Yes	5	23	3	1,953,100
Missouri	Yes	5	97	11	4,454,161
Montana	Yes	7	11	3	893,005

STATE	HAS A BANKING BOARD?	NUMBER OF MEMBERS	NUMBER OF FIELD EXAMINERS	NUMBER OF SUPERVISORY STAFF	FY 1993 BUDGET
Nebraska	No		31	7	3,047,774
Nevada	No		10	4	1,047,703
New Hampshire	Yes	3	15	1	1,760,638
New Jersey	Yes	10	57	16	6,474,000
New Mexico	No		14	5	1,063,400
New York	Yes	17	192	129	40,759,300
North Carolina	Yes	15	46	8	3,477,071
North Dakota	Yes	7	17	3	961,233
Ohio	Yes	7	41	7	4,873,287
Oklahoma	Yes	6	38	4	2,556,960
Oregon	Yes	5	19	~6	3,954,087
Pennsylvania	No		76	27	10,794,000
Puerto Rico	Yes	9	32	8	4,730,000
Rhode Island	Yes	5	14	3	920,449
South Carolina	Yes	9	18	2	1,086,800
South Dakota	Yes	6	14	1	855,888
Tennessee	No		71	17	5,590,400
Texas	Yes	9	135	9	11,148,000
Utah	Yes	6	21	8	1,802,700
Vermont	No		10	2	1,023,000
Virginia	No		55	7	8,012,350
Washington	No		22	3	2,500,000
West Virginia	Yes	7	18	2	1,500,537
Wisconsin	Yes	5	57	8	4,396,000
Wyoming	Yes	7	13	1	700,000

Source: CSBS 1992 Profile of State Chartered Banking

* Four field examiner positions are currently vacant. Three of these four positions will be filled, but the remaining position was not funded for fiscal year 1993-1994.

** This figure includes four supervising financial institution examiners and one program administrator. It does not account for the Commissioner, Deputy Commissioner, and one clerical supervisor.

NATIONAL ISSUES

The American banking system is today in the midst of a prolonged crisis of change, its worst since the Great Depression. Legislative efforts to bring about regulatory reform of the industry have centered on the need to avoid further massive losses to the deposit insurance fund and the need to restore competitiveness to the nation's system of 13,000 banks. However, despite the severe problems which the banking industry experienced in the 1980's, the majority of banks throughout the country are currently experiencing record economic highs. Banks in the Federal Reserve Tenth District, including Colorado banks, are among the strongest in the nation.

Fortunately, Colorado has not experienced the commercial bank failure crisis which states such as Texas have recently encountered. However, the Division of Banking is pressed with the same question that all state regulators face: How can regulation be tailored to protect the safety and soundness of deposits in light of today's shifting financial markets? Since the health of Colorado's financial industry and the role of its regulators are increasingly dependent upon outside influences, it is essential to examine the role of the Division of Banking in the context of the changing economic and regulatory environment in which it operates. A wide spectrum of prominent issues impact the Division and, to some extent, define the parameters of its function.

A. An Introduction to the Dual Banking System

The structure of the American banking system has been a point of contention since Jefferson and Hamilton argued about the merits of centralization vs. diversification. What we've ended up with, and what is presently in some peril, is the unique American dual banking system by which federal and state governments share the authority to charter and regulate depository institutions.

The distinguishing characteristic of the dual banking system is that banks are free to select which level of government will be their primary regulator. The essential benefit of this system is that it has produced a decentralized and unconcentrated banking system and a tradition of innovation in bank regulation. On the other hand, the resulting system is often (and disparagingly) said to promote competition in laxity.

The system has given rise to a forbidding jurisdictional web of federal and state bank agencies. The role of these federal and state agencies is determined by a number of characteristics of the particular bank: the source of the institution's charter (state or federal), the bank's membership in the Federal Reserve system, the presence of federal deposit insurance, and the existence of a parent holding company. In areas where the federal and state governments have joint authority, regulation is normally undertaken on a shared basis. However, even nationally chartered banks are subject to major policy decisions such as usury, branching, and interstate banking that are delegated to the states. At the same time, federal regulators have enormous power to regulate state chartered institutions.

Despite criticisms aimed at its inefficiency, the dual banking system has spawned the only banking scheme in the world today which bears the earmarks of local ownership and multiplicity. The unique democratic nature of the American banking system is most striking when contrasted with the nationalized and monopolistic banking systems of our global neighbors. The multiplicity of our system is best defined by comparing our 13,000 banks with the 65 Canadian banks, the 550 British banks, Germany's 900 banks, Japan's 150 banks, and the 2 banks allotted to Holland and Belgium apiece. [The Economic Report of the President (1991)(Table B-3)].

This system and its regulation did not evolve from an ordered or centralized plan, but instead was formed by a series of responses to economic emergencies which are not that distinct from the crisis in which bankers find themselves today. [N. Lash, Banking Laws and Regulations: An Economic Perspective (1980)]. However, while most of these responses tightened regulation and centralized authority, some of the recent legislation has moved in the opposite direction, toward deregulation. This trend has raised important questions about the allocation of regulatory powers and the efficacy of the dual banking system.

B. The Regulatory System Since 1933

The current bank regulatory system is largely the product of the Banking Act of 1933 ("The Glass-Steagall Act"). The objectives of the system were to require banks to operate within limited product and geographic markets, and to protect banks from competitive forces in those markets. To enforce this panoply of restrictions and to limit the FDIC's exposure to bank risk-taking, the system has always provided for extensive regulatory supervision to maintain the safety and soundness of banks. Congress reinforced this protection in 1956 with the Bank Holding Company Act and again in 1970 with an amendment to that Act.

The primary elements of this regulatory system combine to form a set of restrictions, benefits, and prophylactic measures which aim to ensure institutional safety and soundness. They can be categorized as follows:

(1) Restrictions upon the products and services which banks may offer.

The first element subjects banks and their affiliates to stringent restrictions with respect to the financial products they may offer and the services they may perform. This segregation of banking from other financial services, particularly from the securities industry, arose out of bankers' involvement in securities underwriting activities in the 1920's which contributed to the stock market crash and resulting bank failures. Therefore, a bank is basically permitted by current law to take deposits, make loans, pay checks, and perform other services that support these fundamental banking functions.

(2) Restrictions on bank expansion into foreign geographic markets.

Restrictions on entry and geographic expansion have also been a central element of this country's bank regulatory system. In most states, current law prohibits banks from opening branches across state lines, although interstate expansion through bank holding affiliates is permitted in most states.

Bank holding companies are specifically permitted to engage in certain interstate activities which are governed by a combination of state and federal law. Under a provision of the Bank Holding Company Act commonly known as the "Douglas Amendment," a bank holding company in one state may acquire a bank in another state only if the acquisition is expressly authorized by statute in that state. [12 U.S.C. 1842(d)(1988)]. Most state statutes currently allow acquisitions by out-of-state bank holding companies, although some states limit such acquisitions to holding companies from states within a specified region and some, like Colorado, require reciprocity from other states. [U.S. Treasury Department, Modernizing The Financial System: Recommendations for Safer, More Competitive Banks, Ch. XVII at 7-8 (1991)(hereinafter "Treasury Report")]. As a result, many banking organizations currently operate groups of affiliated banks across state lines.

Intrastate branching is generally unrestricted nationwide, although Colorado's law until 1991 reflected a strong populist drive to control banking through the prohibition of branching. [Treasury Report, Ch. XVII at 7-8]. Intrastate branching permits state and national banks to open branches within the state where the bank is located.

(3) The creation of federal deposit insurance.

The third pillar of the bank regulatory system is federal deposit insurance, which was created with the dual purposes of protecting small depositors and preventing bank runs. Federal insurance has evolved over the years into a complex system that comes close to insuring 100% of all deposits of failed banks because of various policy-driven exceptions, such as the rule which extends coverage to uninsured funds in banks which are "too big to fail."[1] The result of these various rules is that 75% of all deposits in the banking system are explicitly insured, and the remaining 25% are very likely to be protected in the event of a bank failure. In fact, since 1985 the FDIC has protected over 99% of uninsured deposits of banks that have failed. [Hearings before the Subcomm. in Economic Stabilization of the House Comm. on Banking, Finance, and Urban Affairs, 102nd Cong., 1st Sess. (1991)(statement of Robert R. Glauber, Under Secretary of the Treasury)].

(4) Prophylactic measures.

Inherent in the regulatory system are three mechanisms which control the FDIC's exposure to losses from bank failures. First, banks are subject to a wide range of regulations governing their activities. Second, banks are subject to a set of capital requirements which are intended to ensure that a bank's shareholders have a sufficient stake in the bank to restrain risk-taking and, therefore, to reduce the FDIC's exposure. Finally, the FDIC has the power to close a state or nationally chartered bank that is insolvent, that engages in "unsafe or unsound practices," or that is in an "unsafe or unsound condition" if the respective state or federal chartering agency fails or refuses to close the bank. In Colorado, the Banking Board always appoints the FDIC as receiver or liquidator of closed state-chartered banks. [12 U.S.C. 191 & 1813(c)(3) (1988)].

In the past, critics of this elaborate regulatory system of benefits and protective measures have complained that its components serve in practice as disincentives which have destabilized bank safety and soundness. Two of their prime complaints have been:

* Despite capital requirements, deposit insurance has permitted bankers to take risks which they otherwise wouldn't take. The euphemism for subsidized risk-taking is "moral hazard," a term of art for the vulnerable position in which the FDIC is placed when banks take risks which cannot be fully monitored; and

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[1] This exception springs from the 1984 failure of the Continental Illinois National Bank, after which the FDIC decided that certain banks are so large that if their uninsured depositors are allowed to lose their deposits, the financial system would sustain severe damage. [Treasury Report, Ch. III at 29-35].

* Geographic and product restrictions have resulted in a lack of diversification of risk. Small banks which serve a limited geographic area and whose portfolios contain limited instruments are riskier than institutions with diverse portfolios. These banks experience higher failure rates than their larger counterparts.

[K. Abraham, Distributing Risk: Insurance, Legal Theory, and Public Policy 14-15 (1986); E. Kane, The Gathering Crisis in Federal Deposit Insurance 7-27 (1985); Treasury Report, Ch. XVII at 8].

Geographic and product restrictions have changed dramatically since the mid-1980's. Nevertheless, although the bank regulatory system worked well for 40 years and appears to continue to do so, its weaknesses were exposed, and the regulatory structure was threatened, in the 1980's.

C. The Banking Crisis of the 1980's

The banking crisis of the 1980's was precipitated by a number of factors which surfaced after forty years of relative regulatory calm. By the late 1970's, the market for financial services had changed dramatically. New developments in the financial field, coupled with new technology, put the squeeze on banking's market share. In an effort to gain a toe-hold in new markets, banks ventured into new lending areas which came back to bite them. A brief explanation of these events is helpful to understand the predicament facing banks and their regulators in the 1990's.

Until the mid-1970's banks were the primary repository of savings and the primary providers of short-term credit for a substantial segment of American business. Banks had also become major providers of home mortgage and consumer financing. However, beginning in the mid-1970's, technological and market forces began to erode the industry's dominant position, with the result that, by the early 1980's, the banking industry had lost its captive markets.

Approximately 15 years ago, banks began to compete for deposits with "nonbank" institutions which perform many traditional banking functions, including checking accounts. These institutions have been characterized as financial supermarkets which combine the whole range of traditional banking functions with a broad spectrum of other financial services and commercial enterprises. Because some of these functions can be performed outside the formal banking system, regulatory restrictions which attempt to separate commercial banking activity from securities and investment banking activities are not always maintained successfully. For example, nonbanks have a tremendous advantage from a regulatory perspective in that they can offer all of these services to consumers at branches all across the county, in any locality. [P. Ferrara, The Regulatory Separation of Banking from Securities and Commerce in the Modern Financial Marketplace, 33 Ariz. L.R. 583 (1991)].

The most significant nonbank entities are mutual funds. The consumer invests money in the stock of an investment company which, in turn, invests it in securities which, depending upon their value, may ultimately yield a higher return than bank deposit interest. The consumer is allowed in certain mutual funds to access his account by writing checks, just as one can access funds in a checking account. Nonbanks, including securities firms, also provide accounts that offer a broad range of deposit services which are combined with other financial services, including credit cards, credit lines, consumer and installment loans, car loans, home equity lines, and investment banking services. Heightening the appeal of nonbanks is the fact that other non-financial services may also be offered, such as accounting, telecommunication services, travel planning, and data processing.

Some of the largest financial supermarkets that come to mind are Merrill Lynch, the Sears Financial Network, and American Express. [A. Gart, Banks, Thrifts, and Insurance Companies (1985); General Accounting Office, Information on Nonbank Banks (1986); Treasury Report, Ch.VIII at 9-12; J. Macey & G. Miller, The Origins and Future of the Current Crisis, 69 Wash. U.L.Q. 769 (1991)].

The technology which has evolved over the last several years is probably the key factor at the foundation of this development. Communications and computer technology has enabled nonbanks to recreate the functional equivalent of bank deposits and checking accounts outside the bank system. And, new technological applications offer the consumer even more ways to take advantage of bank functions outside of the bank system. For instance, debit cards are essentially paperless checking accounts which allow merchants the means to have the consumer's funds on deposit transferred electrically into their own accounts. Automated teller machine (ATM) cards also give consumers the latitude to make withdrawals, deposits, payments, and transfers from account to account. While these services are offered by traditional banks, they are also offered by nonbanks, such as money market funds, so that consumers can conduct their transactions outside of the banking system.

Yet another development which has eroded the market share of banks is the trend towards securitization and away from short-term borrowing. In 1960, the ratio of bank loans to commercial paper outstanding was over ten to one. Since then, traditional bank borrowers, including most blue-chip corporations, have increasingly obtained short-term credit directly from anonymous lenders in the commercial paper market at rates that cannot support banks' overhead. Consumers are also flocking to finance companies for credit, (some of which are affiliates of major commercial and industrial firms such as General Motors, General Electric, and AT&T), which fund themselves with commercial paper. Consequently, although the ratio of bank loans to commercial loans outstanding dropped to two to one in 1980, it had fallen to 1.2 to one by 1989. [Treasury Report, Ch. XVIII at 9-10 & Ch. I at 26 (fig. 10)].

Competition among banks has also increased. Large deposits are now placed in banks by brokers with nationwide access to funds and a nationwide clientele of banks that accept those deposits. Much of the deposit market has become national in scope, opening local loan markets to increased competition among banks. This trend has been solidified by state laws which have eased their restrictions on branching, and by the Federal Reserve Board's policy allowing banks to open "loan production offices" outside the state in which they are headquartered. [Treasury Report, Ch. I at 26 (fig. 11)].

In addition, the economic environment during this time period changed, causing banks to focus on alternative markets. Most notable was the sharp rise and subsequent volatility of interest rates. [Treasury Report, at I-25 (fig. 8)]. Because thrifts had traditionally participated in long-term real estate lending, they were tied up with long-term lending when interest rates spiked. Bankers, who were not traditionally in the business of real estate lending, found themselves confronted with the opportunity to make large profits in that market by increasing their market share in construction financing. Bankers obviously jumped at the chance to increase their construction financing market in the face of other shrinking markets, with the predictable result that banking's real estate market boomed in the mid- to late-1980's. Unfortunately, boom gave way to bust with the occurrence of overbuilding and loan defaults. [N. Novak, The U.S. Bank Crisis: Nothing to be a Fraud Of, 59 Def. Couns. J. 181 (April 1992)].

As a result of all these changes, bank profitability started to decline significantly in the 1970's, spilling over into the 1980's. Bank profits fell "from 0.77 percent of assets in the 1970's to 0.69 percent in 1980-84 and 0.55 percent in 1985-89." [W. Keeton, The Treasury Plan for Banking Reform, Fed. Reserve Bank of K.C. Econ. Rev. 5, 6 (May/June 1991)]. The riskiness of banks also increased, as evidenced by the increase in loan chargeoffs from .39% in the 1970's to .99% in the 1980's. [Treasury Report, Ch. I at 25 (Table 6)]. The full ramifications of bank risk-taking became apparent as the decade wore on. In 1980, there were 10 bank failures nationally involving approximately $236 million in bank assets. In 1985 there were 120 failures nationally involving approximately

$9 billion in assets. And in 1988 and 1989, there were 200 and 206 failures nationally respectively, involving a total of approximately $65 billion in assets. The OCC released a study of bank failures that concluded that 80% of failed banks suffered from "overly aggressive" management which resulted in increased risk-taking. [Comptroller of the Currency, Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks (1988)].

This cycle succeeded in sapping the FDIC's insurance fund to its lowest level ever. [FDIC 1989 Annual Report (1990); S. Labaton, U.S. Bank Insurance: A $4 Billion Hole?, Int'l Herald Trib., Apr. 25, 1991, at 9]. When the federal government was left holding the bag, it retrenched by way of legislation.

D. National Regulatory Reform

From 1989 to 1991, the federal government responded to the banking crisis with a flurry of proposals and legislation, much of which cuts into the regulatory jurisdiction of states.

(1) Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)

FIRREA was most directly caused by the savings and loan crisis; it also revamped and restructured the federal deposit insurance apparatus for commercial banks. FIRREA essentially gives the FDIC increased enforcement powers and heightened authorities and duties relative to failed and failing banks which are federally insured.

The major provisions of FIRREA permit the FDIC to:

* Accept the appointment as receiver or conservator of any failed depository institution and, in that capacity, to act free of the supervision of any federal or state agency or department;

* Take any action necessary as conservator to put the depository institution in a sound and solvent condition;

* Repudiate burdensome contracts or leases and to enforce any other contracts;

* Process and determine claims brought against the FDIC in its capacity as receiver;

* Assist failing institutions by purchasing assets, making loans or deposits, assuming liabilities, or making contributions to prevent their closing;

* Assist failing institutions by permitting the emergency interstate acquisitions of banks or the formation of new or bridge banks upon default; and

* Carry out increased enforcement powers, including cease and desist orders, affirmative correction actions, suspension and removal orders relative to bank officers and directors, and expanded civil money penalties jurisdiction.

In addition, FIRREA enhanced the FDIC's ability to terminate an institution's deposit insurance. [D. Gail & J. Norton, The Financial Institutions Reform, Recovery and Enforcement Act of 1989: Dealing with the Regulators, 107 Banking L. J. 196 (May-June 1990)].

(2) The Bush Administration Proposals

Subsequent to passage of FIRREA, the executive branch proposed sweeping regulatory reform measures which would have deregulated banking, pre-empted state law, ended the enforced separation of banks from other financial activities in the financial marketplace, and established regulatory constraints that reduce the deposit insurance subsidy. The Bush Administration attempted to codify these proposals in the Financial Institutions Safety and Consumer Choice Act (FISCCA). Although this proposed legislation was rejected in November 1991, it embraced numerous issues with which the industry continues to wrestle today. [See K. Bacon, The New Banking Law Toughens Regulation, Some Say too Much, Wall St. J., Nov. 29, 1991, at A1].
The Bush Treasury Report concluded that "[t]he single most powerful tool to make banks safer is capital." Unfortunately, it also found that "the ratio of aggregate capital to total assets of the banking system has generally declined from a high of over 50 percent in the 1840's to its current levels of well under 10 percent. [Treasury Report, Part I at 12]. Therefore, the Report recommended that increased capital adequacy standards be implemented and that "well-capitalized" banks be permitted to affiliate with other nonbank financial intermediaries, such as insurance companies and securities firms.

The Treasury Report recommended establishing five "zones" for banks that reflect different levels of capitalization, adjusted for risk. Zone 1 banks would be "well-capitalized" and would realize the most regulatory freedom, including the ability to engage in securities, insurance, and mutual fund activities through affiliates. Zone 2 banks would enjoy less regulatory freedom. Zone 3, 4, and 5 banks would not meet capital adequacy requirements and would be subject to mandatory and prompt corrective actions by regulators.

The Administration also endorsed eliminating the regulatory separatism that has defined banking by proposing that commercial firms, such as AT&T and IBM, be permitted to own banks. It reasoned that commercial firms would provide a viable source of capital and, therefore, would constitute potential "sources of strength" for banks. Implementation of this concept would have necessitated the repeal of long-standing banking law which restricts activities and affiliations of commercial banks.
The Administration wished to abolish geographic restrictions by permitting banks to branch and to operate nationwide. Again, national banking law would have had to be repealed to accomplish this proposal, and state law would have been pre-empted. The Treasury Report also advocated overhauling the current regulatory system to streamline existing redundancies and inefficiencies.

Several measures were also introduced to reduce the federal deposit insurance subsidy which is currently extended to risky banks. These mechanisms include a higher deductible, more coinsurance, stricter limits on FDIC liability, risk-based premiums, stricter conditions of coverage, and better FDIC access to information regarding bank riskiness.

(3) The 1991 FDIC Improvement Act

Despite the Bush Administration's failure to pass FISCCA, President Bush signed succeeding legislation into law on December 19, 1991. The FDIC Improvement Act (FDICIA) fundamentally seeks to increase safety and soundness monitoring, including the use of management and independent audits of internal controls and regulatory compliance, new accounting rules, and greater regulatory control over management, to ensure that the bank crisis is not repeated in the future.

In addition to safety and soundness provisions, the FDICIA placed severe restrictions upon the activities of insured state chartered banks. In general, the limitations of Section 303:

* Restrict the ability of insured state banks and their subsidiaries to underwrite insurance. This provision legislatively overturns the Second Circuit's June 1991 decision in Citicorp v. Board of Governors of the Federal Reserve System, 936 F.2d 66 (2nd Cir. 1991), cert. denied sub nom. Independent Insurance Agents, Inc. v. Citicorp, 112 S.Ct. 869 (1992), which upheld 1990 Delaware law permitting a Delaware state-chartered bank to engage, on a nationwide basis, in all aspects of the insurance business through separate divisions, departments, or subsidiaries.

* Prohibit, after a one-year period, insured state banks and their subsidiaries from engaging "as principal" in any type of activity not permissible for a national bank (unless it is approved by the FDIC and capital standards are met). This provision would not appear to restrict the insurance broker or agent activities of a state bank and its subsidiaries.

The FDICIA consists of five other provisions which primarily impact safety and soundness and regulatory improvements. These main provisions can be summarized as follows:

* Section 131 requires the federal banking agencies to take mandatory specific actions when an insured depository institution falls below certain capital levels, thereby depriving regulators of the significant discretion they previously possessed to deal with each troubled institution on a case-by-case basis. It also requires the regulators to establish five categories of insured depository institutions based on their capital. Perhaps the single most significant provision in the FDICIA requires federal regulators to place a "critically undercapitalized" institution, i.e., one with a ratio of tangible equity to total assets of less than 2%, in conservatorship or receivership within 90 days after it becomes "critically undercapitalized." [12 U.S.C. Section 1831(o)(h)(3)(A)]. It also generally requires appointment of a receiver if the institution does not achieve a certain capital level within three quarters after becoming "critically undercapitalized." Finally, this section permits regulators to impose a number of other specified sanctions, one of which is the replacement of directors or senior executive officers of "significantly undercapitalized" institutions.

* Section 112 requires each insured depository institution with assets in excess of $150 million to have independent audits conducted annually. Bank management and outside auditors must also submit annual reports to federal and state regulators which assess the effectiveness of internal controls and an institution's compliance with safety and soundness laws and regulations.

* Section 121 sets forth accounting reforms, specifically requiring insured depository institutions to disclose the estimated fair market value of assets and liabilities pursuant to regulations developed by federal banking agencies.

* Section 132 addresses the topic of executive compensation and prohibits as an unsafe and unsound practice any employment contract or compensation agreement that provides any officer, employee, director, or principal shareholder of the institution with excessive compensation or which could lead to material loss to the financial institution.

Obviously, the FDICIA curtails the discretion of the federal regulators in significant respects and imposes new requirements upon bank executives to make them more accountable. As one commentator has noted:

> By making even existing legal obligations of directors and officers of depository institutions the subject of federal legislation, Congress has effectively forced those directors and officers to focus on the discharge of their obligations to a significantly greater degree than in the past, and in a manner that will both materially increase the costs associated with regulatory compliance, and perhaps effect fundamental changes between directors of insured depository institutions on the one hand, and the management whose conduct they are obliged to oversee on the other.

[R. Stevens, The Effect of Selected Provisions of the Federal Deposit Insurance Corporation Improvement Act on Banks and Thrifts, 46 Consumer Fin. L. Q. Rep. 179 (Fall 1992)].

The banking industry views the FDICIA as draconian legislation which results in detrimental regulatory "micromanagement." The federal government defends the high level of scrutiny demanded by the FDICIA as necessary to ensure that the bank crisis is not repeated in the future.

E. Regulating Safety and Soundness in the 1990's

Although the banking industry and Bush Administration rallied around the battle cry of deregulation in the wake of the most recent banking crisis, FISCCA's defeat and FDICIA's passage has temporarily abated the push for deregulation. The current focus of regulators continues to be the safety and soundness of banks, with an emphasis upon bank capital adequacy standards.

The Division examines state-chartered institutions periodically based upon their financial condition and associated risk. The frequency, scope, and mandatory or discretionary nature of on-site and off-site examinations which the Division must conduct is established by the Banking Board in a policy which is referred to as the "mandate." For example, commercial banks must receive a full-scope and target safety and soundness examination every three years if they have a good financial rating, every two years if their rating is satisfactory, and once every year if their rating is poor. [DOB Policy No. 80-1].

The principal purpose of the on-site examination is to evaluate a bank's loan portfolio and management. The examiners inspect the documentation, collateral, and payment records of most large loans and a sample of small loans. The loans are classified as good, substandard, doubtful, or loss. The bank's internal control system and managerial practices are reviewed and evaluated, the amounts of recorded assets, liabilities, and off-balance sheet account (such as security and loan commitments) are verified, and the bank's compliance with federal and/or state laws is determined. Emphasis is placed on laws that prohibit or restrict dealings between the bank and its officers, directors, and stockholders, and that limit loans to individual and related borrowers. Separate compliance exams are conducted to verify that consumer protection laws are being followed, i.e. UCCC and PDPA. The examiners discuss their findings with management when the examination is completed.

Regulators use examinations as tools to supervise banks. The evaluation of loans assists the regulator in identifying substandard loans to predict loan losses. Examination data and ratings may assist regulators in predicting bank failures. Some examinations turn up evidence of fraud and defalcation. And, of great concern to regulators are indices which establish whether bank management is taking excessive risk in its loan and operation procedures. Banking supervisors then use the examination report and rating to determine the extent to which the bank is complying with regulations or must be specifically supervised.

Since 1978, federal agencies have adopted the regulatory system of rating an institution's safety and soundness pursuant to the CAMEL system. This system utilizes capital adequacy as one of a number of factors that are evaluated individually and then collectively by the bank regulators in applying a soundness rating for a particular banking institution. In particular, the CAMEL system, which is also utilized by Colorado's Division of Banking, has two basic aspects:

(1) An assessment by bank examiners of five key aspects of a bank's operations and conditions:

(C) **capital adequacy** (capital offers an important margin of safety, which cushions depositors from operating losses)

(A) **asset quality** (quality of asset base is measured by comparing loan chargeoffs to the total loan portfolio)

(M) **management** (weaknesses may be apparent by a high ratio of overhead expenses to total assets)

(E) **earnings** (earnings are an important measure of solvency and net earnings on its portfolio is monitored relative to total assets and shareholder equity)

(L) **liquidity** (owners prevent runs on banks by holding short-term marketable investments which are easily convertible into cash); and

(2) A component evaluation of these factors to arrive at a composite, overall rating of the bank's condition and soundness into one of five categories. Ratings are based on a one to five scale, one being the highest rating a bank can receive, and five being the lowest.

[Banking Agencies Adopt Uniform Interagency Bank Soundness Rating System, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) Section 97,451 (May 11, 1978)]. Although the CAMEL rating system continues to be the primary standard by which state and federal banks are rated for safety and soundness, one extremely significant change has evolved over the years with respect to the capital adequacy rating. Capital represents the amount and type of financial resources of a particular institution which the regulator evaluates when assessing the level of financial solvency of the enterprise. The bank regulator monitors capital to ensure that, over time, a bank can sustain extraordinary losses and remain solvent.

Government efforts to regulate bank capital reflect the tension between the need for prudential risk management and the need to produce an acceptable return for investors. Since regulatory agencies seek to minimize bank insolvency, capital requirements tend to be based upon a worst case scenario. There are several forms of capital that provide the necessary cushion for a bank in times of financial crisis. The bank regulator's mission is to identify capital that realistically can serve as this desired protective financial cushion. [J. Norton, Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?, 49 Ohio St. L.J. 1299 (1989)].

CAMEL's first component, the capital adequacy of an institution, used to be measured by ratios of equity to total assets and of primary capital to assets. [C. Mercer, Valuing Financial Institutions (1992)]. This ratio has been replaced by risk-based capital standards. These key indicators of financial safety and soundness are established by computing technical financial data which permits regulators to relate a bank's capital needs more closely to its risk profile.

Risk-based capital guidelines divide a bank's capital into two components: Tier 1, or core capital, and Tier 2, or supplementary capital. Tier 1 capital represents the most stable and readily available form of capital for supporting a bank's operations. The sum of Tier 1 and Tier 2 capital make up a bank's total capital holdings.

These capital components are then assigned a risk weight which is derived from four possible categories. Each category has a separate risk weight, with higher weights applied to those items generally thought to pose more risk to a bank. For example, cash and U.S. Treasury securities are completely safe capital which are assigned 0% risk weight. On the other hand, bank capital which is comprised of bank-owned real estate is considered to be in the highest-risk category, and is therefore assigned 100% risk weight. Once all assets are assigned a risk weight, the dollar amount of items a bank has in each risk category is multiplied by an appropriate risk weight, and the resulting figures are added across the categories to derive the overall measure.

Currently, banks are expected to maintain a ratio of total capital to risk-weighted assets of at least 8 percent, with half of this in Tier 1 capital. They must also maintain a minimum leverage ratio, yet another calculation relating Tier 1 capital to assets which ensures that banks have enough capital to deal with interest rate exposures and other risks not directly covered by the risk-based capital guidelines. [K. Spong, Banking Regulation: Its Purposes, Implementation and Effects (3rd ed. 1990)].

The technicalities of risk-based capital guidelines are far too complex to be treated adequately in this review. However, as one commentator has noted, their overall effect is "to present a meaningful risk profile of bank operations in light of a bank's capital base, to incorporate off-balance sheet risks into the profile, and to provide a disincentive for banks to shift resources from more liquid, less risky assets to less liquid, riskier assets and activities." [J. Norton, Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?, 49 Ohio St. L.J. 1299, 1310 (1989)].

F. Revisiting the Dual Banking System: Is it Still Viable?

As this brief survey illustrates, there is every indication that federal regulation and nationwide banking institutions will continue to grow. This trend is fueled in part by the increasingly national and global economic activity which is made possible by new technology and electronic banking. Consequently, despite the failure of the Bush Administration deregulation proposals, one commentator has opined that the Treasury Report recommendations "foreshadows a gradual evolution toward strong, well-capitalized national banks, with diversified powers and unified regulation--the sorts of banks that made failures great rarities in England, Canada and elsewhere." [R. Chernow, Bank Reform? What Bank Reform?, Wall St. J., Apr. 19, 1991, at A-1].

However, at the same time, states continue to maintain considerable residual power to regulate banking under the dual banking system. The benefits which states have conferred upon our banking system arise out of their role, envisioned by Justice Brandeis, as laboratories of change:

> "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."

New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932)(Brandeis, J., dissenting).

(1) Case Study: Interstate Branching and the Exercise of State Regulatory Authority

Perhaps the most striking contemporary example of state banking authority is the power which the federal government appears to have ceded to states regarding interstate banking and branching.

The rationale underlying the recent groundswell of support for interstate branching was articulated by Federal Reserve Board Chairman Alan Greenspan, who commented in 1991 that "interstate banking promises . . . wider consumer choices at better prices and, for our banking system, increased competition and efficiency, the elimination of unnecessary costs associated with the delivery of banking services, and risk reduction through diversification." [137 Cong. Rec. S16694 (November 14, 1991)]. Whether one agrees or disagrees with Chairman Greenspan, the best estimates of industry and government officials place interstate banking as a reality in the United States within the next two years. [DOB; Colorado Bankers Association].

Assuming that Congress paves the way for interstate branching by repealing national legislation which presently bars its implementation, it is clear that branching will proliferate by way of banks acquiring already existing banks in other states. Consequently, as interstate branching becomes more common, the extent to which a state allows its banks to be acquired will be critical. The dual banking system will ensure that the substantive powers that the home state permits the bank to undertake will assume great importance.

The extent to which the federal government has deferred to state authorities on the interstate branching issue is best illustrated by the discussion generated on the floor of the U.S. Senate in November of 1991, during the debate of an interstate banking bill. At that time, the Senate debated whether to amend the bill to include "opt-in" or "opt-out" provisions. Under either scenario, states were to be given the ultimate say as to whether banks within its boundaries could participate in interstate activities.
Under the "opt-out" provision of the bill, each state legislature would have received three years in which to cast a vote opting out of (i.e., prohibiting) participation in interstate banking. Under an "opt-in" provision, the federal government would have additionally permitted states to retain some control over the conditions under which they could accept interstate branching. For example, the sponsor of this amendment stated that:

> [States] might want to be able to say that if an out-of-State bank is going to branch in our State, it must have a certain amount of capital. [States] might want to say that the board of directors of branches in Arkansas must be Arkansas citizens. [States] might want to allow branching, but only on a regional basis. . . . [States] might want to say that we expect a certain percentage of assets in our State.

137 Cong. Rec. S16702 (November 14, 1991).

The Senate voted to adopt the opt-out provision as part of a bill which was ultimately defeated. Nevertheless, Congress clearly positioned itself to extend to states the significant right to control entry of out-of-state banks into their markets and, thus, to control the financial destiny of their states. This policy decision was based upon the dual banking system and its goal of preserving unto states the rights to determine banking policy, to maintain local influence over bank policies, and to choose whether and under what condition to allow interstate banking, consistent with the needs of its consumers and its economy. The role which Congress was prepared to give states in this particular scenario demonstrates the continuing vitality and value of the dual banking system.

(2) State Regulatory Authority as "Laboratories of Experimentation"

State banking regulation has earned a reputation for innovation. While federal regulators exhibit an increasingly inflexible, overly-mechanistic, expensive, and pervasive approach, their state counterparts have established a track record of flexibility.

Federal and state banking laws allow banks to convert between national and state charters without the approval of their current regulator. Therefore, the dual banking system provides a "safety valve" which allows banks to escape from arbitrary, inflexible, or outdated regulation. [Blueprint for Reform: the Report of the Task Group on Regulation of Financial Services (1984), reprinted in Fed. Banking L. Rep. (CCH) No. 1050 (pt. II) 23 (Nov. 16, 1984); Frankel, The Dual State-Federal Regulation of Financial Institutions - A Policy Proposal, 53 Brooklyn L. Rev. 53, 54-46 (1987)].

States also continue their tradition of encouraging innovation. In the past, states have adopted new approaches to bank regulation which have subsequently been adopted by Congress. For instance, during the 19th and early 20th centuries, the state banking system originated free banking laws, checking accounts, branch banking, real estate lending, trust services, reserve requirements, and deposit insurance, all concepts that Congress later incorporated in laws governing national banks. [See B. Hammond, Banks and Politics in America (1957); E. Symons & J. White, Banking Law: Teaching Materials (2d ed. 1984)].

Recently, states have permitted banks to create interstate electronic funds transfer (EFT) systems through the establishment of networks of automated teller machines (ATM's). They have initiated the concept of negotiable order of withdrawal (NOW) accounts, savings accounts which allow the customer to withdraw funds by means of a negotiable instrument such as a check. States have also authorized interstate acquisitions of banks by bank holding companies. The latter two developments are especially provocative examples of recent state innovations. Congress gave nationwide authorization for NOW accounts only after several states had demonstrated their desirability to consumers and banks. And, the state acted to allow interstate acquisitions of healthy banks by bank holding companies while Congress faced a stalemate at the federal level among competing segments of the banking industry. As a result, interstate acquisitions have been accomplished under state law instead of by federal preemption. [See S. Rep. No. 368, 96th Cong., 2nd Sess. 2-6, reprinted in 1980 U.S. Code Cong. & Admin. News 236].

In spite of the defeat which the FDICIA dealt the states regarding their right to engage in certain insurance activities, states continue to find ways to implement innovations. Two of the most pressing examples concern the extent to which state banks may expand the scope of their business to the securities and real estate investment fields.
In the late 1980's, a Delaware bank formed a wholly-owned insurance subsidiary to conduct insurance business pursuant to a Delaware statute permitting state-chartered banks to engage, on a nationwide basis, in all aspects of the insurance business through separate divisions, departments, or subsidiaries. In December 1988, the Federal Reserve Board responded to this action by issuing a proposed amendment to one of its regulations that would have required Board approval before a state-chartered bank owned by a bank holding company could establish a wholly-owned subsidiary.

However, in Citicorp v. Board of Governors of the Federal Reserve System, supra, the federal court of appeals ruled that the Bank Holding Company Act of 1956 (BHCA) does not give the Federal Reserve Board regulatory authority to govern the activities of the subsidiaries of state-chartered banks, even if the banks are owned by a bank holding company. Citicorp represented a significant setback to the Federal Reserve Board's efforts to assert authority over subsidiaries of state-chartered banks, although its effect was partially reversed by the FDICIA. However, the implications of the Citicorp decision extend beyond insurance underwriting activities. This ruling means that neither state banks nor their subsidiaries are subject to the restrictive provisions of the BHCA, but, rather, that state law will determine the scope of permissible activities for these entities.

Recent surveys conducted by CSBS indicate that, as of December 31, 1992, at least twenty-eight states allow state banks, directly or indirectly, to underwrite at least some types of national bank-ineligible securities. Of these states, at least eleven limit the types of national bank-ineligible securities that may be underwritten, at least seventeen require such underwriting to be conducted through a subsidiary or affiliate of the bank, and at least four limit the amount of a single issuance or all issuances of securities to a specified percentage of bank capital. (See Appendix 3).

With respect to real estate powers, the CSBS survey indicates that thirty-three states permit state banks to participate actively in real estate development ventures or to make passive investments in such ventures. Of these states, at least six permit such participations or investments to be conducted only through a subsidiary or affiliate, and at least twenty limit such participation or investments to a specified percentage of bank capital, deposits, or assets. (See Appendix 4).

Even with respect to insurance powers, the CSBS survey indicates that seven states allow banks to engage in insurance underwriting activities which are not permitted by federally-insured and national banks and bank holding companies. Also, twenty-three states permit banks to engage in insurance brokerage activities. (See Appendix 5).

As these trends demonstrate, states continue to take significant initiatives, despite the invasiveness of federal regulation, to expand the powers of state banks outside of traditional banking areas. This exercise of state banking authority results in yet another benefit attributable to the dual banking system, competition among regulators.

(3) The Dual Banking System: Competition and Local Parity

The dual banking system continues to provide a healthy measure of competition which is necessary to prevent the federal regulatory system from exercising complete control over the banking industry. As one commentator has noted, the federal and state banking agencies "can be viewed as firms producing different brands of regulation and engaged in a special competition for market shares." [Scott, The Dual Banking System: A Model of Competition in Regulation, 30 Stan. L. Rev. 1, 32 (1977)]. Thus, under the dual banking system, it is not possible for one banking agency to exercise a regulatory monopoly.

The important role which competition plays on the local level has been expressed by Colorado's Banking Commissioner, who stated:

> Abolishing the [state regulatory authority] would be tantamount to advocating monopolistic control by the federal government over Colorado banking activities, would ill-serve the interests of the citizens of Colorado, and would set an ominous precedent for further encroachments by the federal government into the affairs of Colorado and the other states. . . . Abolishing the dual banking system in Colorado would result in fewer banks in the State. The smaller banks would be the likely losers, which would also mean rural communities, where most of the smaller banks are located, . . . The reduction in competition would likely result in higher costs to the citizens of Colorado.

[DOB 2/9/93 Memo re: The Impact of Abolishing the Colorado Division of Banking].

Colorado bankers have expressed a similar sentiment. Of the 55 regulated financial entities which responded to a survey conducted as part of this review, over 90% stated that the dual banking system continues to be a critical component of our banking system. The reasons which the industry touted most often in support of this system include:

(1) the state regulatory authority's superior understanding of and responsiveness to the local economy;

(2) the accessibility and responsiveness of the state regulator, and its ability to act quickly;

(3) the protection which the dual system affords against the national government's monopolistic and consolidation tendencies;

(4) its creation and sustenance of a competitive environment;

(5) the choice which it offers banks in chartering; and

(6) the parity and equal regulatory footing which it affords to small state banks (which they would not otherwise enjoy vis-a-vis large national banks).

Bankers also noted that the dual banking system permits states to control their local economy and banking industry. As Commissioner Walker stated, "[t]he continuing strength of the dual banking system depends on the wisdom of state legislatures to guard zealously the state banking system because the states are the most competent administrators of their own domestic concerns."

(4) Redundant Regulation

Although the dual banking system bestows numerous benefits upon states and their economies, it also exacts a price from state-chartered banks which is passed on to their consumers by way of a significant regulatory burden. However, in Colorado, the cost of being a state-chartered bank is approximately 30% less than the cost of being a national charter.

Perhaps the most prevalent industry complaint nationwide is that state and federal examinations are often duplicative, sometimes counterproductive, and always time-consuming and costly. Bankers state that federal regulation has reached the crisis stage, and their industry-chartered studies indicate that the cost of the industry's adherence to regulation nationwide ranges from 13.6% to 45% of banking pre-tax income. As a consequence, bankers complain that their ability to compete is severely restricted. [Am. Banker, S. Klinkerman, Banks Accused of Inflating Compliance Cost Estimates, April 6, 1993, p.1]. A few commentators conclude that some of this burden could be significantly reduced by the elimination of the dual banking system.

However strident the industry may be about the regulatory burden, bankers nevertheless concede the importance and necessity of regulation, including safety and soundness examinations. According to the American Bankers Association:

> No one is more supportive of safe and sound bank operation than the banking industry. After all, it is our industry that has paid every penny of the cost of bank failures through deposit insurance premiums (which have increased dramatically in recent years). It is in our interest to maintain a safe and sound banking system, but one which is not burdened by unnecessary cost and regulation.

Having recognized the necessity of a certain amount of regulation, this association proposes that duplicative regulation be minimized by coordinating and streamlining state and federal examinations.

The extent to which states such as Colorado can reduce their share of regulatory burden depends almost wholly upon the rapport and communication which their regulatory authority has established with their federal counterparts. The Colorado Division of Banking has recently entered into a written agreement with the FDIC, and has been operating under an oral agreement with the Federal Reserve Bank, to coordinate and conduct cooperative exams of state-chartered banks. The primary purpose of such an agreement is to foster close supervisory cooperation between the supervisory authorities. However, the collateral benefit of this arrangement is to reduce unjustifiable and duplicative examinations which burden banks.

While the compelling need to enhance cooperation between the federal and state regulatory authorities arises from the goal of reducing regulatory burdens upon the industry and administrative burdens upon the regulators, this need must be balanced by the obligation of state and federal banking authorities to give full expression to the will of the people concerning bank supervision. Therefore, from a policy perspective, the continuing necessity for the dual supervision of banks balances the burdens which it imposes. The rationale for satisfying federal and state regulatory requirements pursuant to their independent regulatory authority was expressed by Kenneth Walker, Regional Director of the FDIC:

> [B]oth regulatory agencies have a common goal, that is, the determination of the overall condition of the regulated institutions . . . However, while a common goal exists between the agencies, the perspective from which the examination information is analyzed differs. The FDIC, as the insurer, is interested in the overall condition and how it may ultimately effect the Bank Insurance Fund, while the State Banking Department, as the chartering authority, is interested in the overall condition and how it may effect the integrity of the banking system in Colorado. . . . While both agencies review for compliance with law and regulations, State examinations place more emphasis on adherence to State regulations and FDIC examinations entail a more extensive review of adherence to federal regulations.

[Correspondence from Kenneth L. Walker to DORA, dated 3/23/93].

The Division of Banking is statutorily charged with the supervision of state-chartered institutions, the monitoring of their safety and soundness, and the maintenance of depositor security. This duty to supervise and examine cannot be supplanted merely because the industry must bear the regulatory burden imposed by supervision. However, the Division recognizes the continuing need to seek coordination of its regulatory authority to the maximum extent possible with federal agencies. Its recent efforts have been rewarded with high marks from 75% of the industry, which responded that there is sufficient coordination between the state and federal regulatory agencies, with a marked improvement occurring within the last few years. [DORA January 1993 survey].

H. Conclusion

The last few decades are replete with examples of change which the national and local banking community has and continues to confront. The volatility of this change has been buffered to some degree by the dual banking system. As the federal government forges ahead to consolidate banking into a national, rather than regional, enterprise, the dual banking system continues to protect the regulatory parity of small independent banks and the rights of states to control their own economies. Although its vitality as a source of innovation has been checked by federal legislation, it continues to provide a forum for state bank experimentation.

Given the continuing metamorphosis of the financial services industry, it is conceivable that the dual banking system may be retired in the future as an antiquated regulatory model. However, in light of the state of tremendous flux which the federal regulatory system is currently experiencing, the state regulatory system constitutes the best mechanism to protect Colorado's interest in its financial institutions and their regulation.

SUNSET REVIEW

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CHAPTER 5

SHOULD THE DIVISION OF BANKING BE CONTINUED?

INTRODUCTION

The central question which a sunset review seeks to answer is: "Whether regulation by the agency is necessary to protect the public, health, safety and welfare; whether the conditions which led to the initial regulation have changed; and whether other conditions have arisen which would warrant more, less or the same degree of regulation."

Over the last decade, the Division of Banking has been the subject of two additional reviews which determined that the Division of Banking should continue. The first, a sunset review, was conducted 1983. At that time, it was determined that the Division was conducting necessary regulation and that its performance was satisfactory to sustain its mission.

The second report was an exhaustive State Auditor's Performance Audit, conducted in 1988, which concluded that "regulation is critical in maintaining a sound financial system." However, the audit faulted the Division's unsatisfactory performance of its regulatory mission as contributing to the high rate of bank failures, noting that "when a bank or a savings and loan fails, that failure is prima facie evidence that the supervisors (state banking regulators) failed in the diligent execution of their responsibilities." This report concluded that the Division was riddled with structural, operational, and administrative problems, and that the statutes and rules which it administered also required an overhaul.

The 1988 audit was conducted at a time when the national and local economies were in decline, circumstances for which the Division was clearly not responsible. However, the recent industrial bank crisis had tarnished the reputation of the Division, which was under intense scrutiny from the industry and public. Sweeping changes were recommended in the audit, and task forces were formed to follow up on the audit recommendations. After a prodigious amount of work was conducted, many improvements were adopted through legislation, rule or policy-making.

The mission by which the Colorado Division of Banking is currently guided is multi-faceted and broad in scope. It is defined by statute and the Banking Board in the following manner:

> It is hereby declared to be the policy of the state of Colorado that, to protect the public interest, the business of all state banks be supervised and regulated in such manner as to:
>
> (a) Preserve and promote:
>
> (I) Sound and constructive competition among financial services institutions;
>
> (II) A dual federal and state banking system;
>
> (III) The security of deposits;
>
> (IV) The safe and sound conduct of the business of state banks; and
>
> (V) A statewide safe and sound banking system;
>
> (b) Seek:
>
> (I) Regulatory coordination and cooperation; and
>
> (II) Regulatory parity among financial services institutions; and
>
> (c) Encourage diversity in financial products and services.

Section 11-11-101.5, C.R.S. (1992 Cum. Supp.).

This mission articulates the one basic finding shared by both reports, that the regulation of banks and their counterparts is necessary to protect the public. Assuming this finding continues to be supportable, the focus must shift to determine whether the Division has performed its regulatory function in a satisfactory manner.

WHY REGULATE BANKS?

As Kenneth Walker points out, the regulatory emphasis of the federal and state agencies differ to the extent that one is aimed at protecting the government insurance fund, while the other is targeted at protecting the integrity of the banking industry.
From the perspective of federal agencies, banking institutions are politically perceived as having a "public" character or at least as having "public" attributes since they provide public services. They are the holders of the national savings, the transmitters of monetary policy, the primary vehicles for effecting an efficient payment system through the economy, and the source of backup liquidity in the economy. Since the system and its depositors are typically governmentally subsidized through deposit insurance or a government lender-of-last resort entity, federal regulators believe that prudential regulation is designed to protect the integrity of and to support the "safety and soundness" of the banking system with the ultimate goal of shielding the government in its role as subsidizer. [Corrigan, "Are Banks Special?" Fed. Res. Annual Report 1982].

State agencies do not insure bank deposits and, therefore, their focus is not directed toward protecting the government as insurer. State agencies are primarily concerned with the penultimate policy goal of protecting the integrity of the banking system, and they share the common concern that banks should not be permitted to jeopardize their condition by engaging in excessive risk taking and poor risk management. Consequently, state and federal regulations alike focus upon the prudential supervision of banks, which are designed to ensure the safety and soundness of institutions -- to see that they do not take imprudent risks and that they manage their assets and sources of funds in a prudent and honest manner. [R. Harrington, Asset and Liability Management by Banks (1987)].

Prudential supervision is not intended to prevent all bank failures, but it should prevent failures or other bank problems that pose a serious risk of undermining public confidence in the banking system. [G. Benston, R. Eisenbeis, P. Horvitz, E. Kane & G. Kaufman, Perspectives on Safe and Sound Banking (1986)]. Other primary objectives of banking regulation are to provide a stable monetary framework within which businesses and individuals can conduct financial transactions, and to protect consumers in a myriad of financial transactions. In addition to these policy goals, bank regulation has been historically predicated upon additional justification, including taxation of banks as monopoly suppliers of money, the prevention of centralized power, the avoidance of competition (or "overbanking"), bank solvency and the effects of failures on the economy, control of the money supply, the provision of banking services as a social goal, support of housing and other attempts to allocate credit as social goals, and the prevention of invidious discrimination and unfair dealing against persons. [K. Spong, Banking Regulation: Its Purposes, Implementation, and Effects (3rd ed. 1990)].

However, the changing economic environment and the push for deregulation appears to have made some of these reasons irrelevant or obsolete. For instance, regulation historically sought to prevent big banks from pooling power by imposing geographic restrictions on entry into the banking market. With the onset of bank holding companies, intrastate branching, and the inevitability of interstate branching, there is now debate as to whether centralized power necessarily poses the threat to local banks which, historically, justified regulatory intervention. [G. Kaufman & R. Kormendi, Deregulating Financial Services: Public Policy in Flux (1986)].

As this report has previously discussed, the financial industry and its regulators are presently navigating an undetermined course. Currently, regulatory restrictions on bank powers appear to be moving away from deregulation and back towards reregulation. Despite this change, the determination made by one government committee during the beginning of the 1980's continues to provide a paramount policy basis for prudential regulation. This committee observed that:

> The dilemma for the regulatory authorities, whether statutory or non-statutory, is to devise effective methods of regulation which do not so stifle competition between the financial institutions as to lose their customers the advantages usually associated with it in terms of price, innovation and quality and variety of service. Ideally, regulation and competition should be complementary, the one providing a framework within which the other can then be allowed to operate safely.

[Committee to Review the Functioning of Financial Institutions, 1980 Cmnd. No. 7937, at 289].

In general, bank regulation continues to be necessary to foster a competitive but "safe and sound" banking environment. In particular, the mission of the Division of Banking is to achieve the goal of protecting the public interest while promoting a healthy, competitive, and diverse financial system.

MARKING THE DIVISION'S PROGRESS: THE 1988 STATE AUDITOR'S REPORT

The 1988 audit concluded that the Division was plagued with excessive and fundamental deficiencies. Far-reaching recommendations were made with respect to virtually every facet of the Division's operation. The criticisms which were levelled at the Division fall into four primary areas:

1. Significant flaws were noted in all phases of the regulatory process. For instance:

   * The Division did not conduct statutorily-required background checks of bank organizers during the chartering process.

   * The goals of on-site examinations were seriously jeopardized by the Division's failure to complete the number of examinations required by statute, the failure to develop policies and procedures for scheduling examinations, the failure to conduct UCCC compliance exams, and the failure to establish standards for testing loan quality.

   * Off-site monitoring was significantly compromised by the Division's lack of automation.

   * Enforcement measures were unpredictable and problematic.

   * The Division's procedure regarding the possession of troubled industrial banks arguably compromised deposits and increased the risk of losing assets which should have offset losses.

   * Liquidation procedures with respect to failed industrial banks were flawed.

2. The Division was not satisfactorily performing its statutory responsibility to protect public deposits pursuant to the PDPA. Specifically:

   * The Division fell short of its duty to determine the existence and amount of public funds deposited in three ways. The term "public fund" was ambiguous, the collateral reporting process was manual, not automated, and routine examinations of all institutions for the existence of public deposits were not performed.

* The Division was not determining the adequacy of capital. Here, too, it was neither examining the existence of pledged collateral, nor was its collateral change process automated. Moreover, the statutes did not provide adequate protection for public funds held in a depository's own trust department, and the amount of required collateral to be pledged was insufficient.

* The Division was not adequately monitoring public depositories off-site, nor had it established standards for determining when a public depository's eligibility should be suspended or terminated.

3. Division resources were inadequate. Those that existed were not being used wisely. Three troubled areas were isolated:

   * Funding. Budgeting, internal controls over cash receipting and assessment billings were inadequate.

   * Staffing. The Division was faulted for its diversion of examiner duties, its failure to train and evaluate employees, its inefficient team structure, and the overall existence of low morale.

   * Equipment. The 1988 Division operated without computers and without a recordkeeping system. Also, the Division operated without any written policies and procedures.

4. The Department structure was analyzed with an eye towards consolidation with other agencies regulating financial institutions. Other noted deficiencies concerned regulatory oversight. Specifically, the audit was critical that:

   * There were no boards or commissions overseeing the regulation of industrial banks, trust companies, credit unions, savings and loan associations, and securities brokers/dealers.

   * The role of the Commissioner as Chairman of the Banking Board presented a conflict.

   * The Banking Board was not involved in policy-making for the Division.

5. In addition to the deficiencies relative to the Division's operation and role, the audit criticized the existing statutes for their failure to address specific regulatory issues. For example, the audit concluded that the statutes should be amended to:

   * Allow the Division to accept federal exams of strong institutions.

   * Allow the Banking Board to establish the required frequency and scope of exams by rulemaking.

   * Require the submission of annual audit reports.

   * Establish civil money remedies.

This attenuated survey of criticisms illustrates the extent to which the Division's basic mission of protecting the public interest was seriously impeded. The Division and General Assembly moved quickly to address most of these problem areas. Legislation was immediately passed to give the Banking Board policy-making power and to confer administrative authority upon the Commissioner. Subsequent legislation delineated the scope of each entity's authority and expanded the Banking Board's discretionary regulatory powers. For their part, the Banking Board and Commissioner acted expediently to promulgate rules, regulations, policies and procedures. When one grasps the magnitude of the problems facing the Division five years ago, the relative speed with which the Division has recuperated is remarkable.

RATING THE PERFORMANCE OF THE DIVISION OF BANKING

The Regulatory Process

In 1989, the Division agreed that its regulation of state-chartered institutions suffered at virtually every turn. Specifically, it noted that: examinations were not conducted consistently; workpapers were not developed for use in examinations; inconsistent actions were taken to resolve identified or potential problems; off-site monitoring was crisis-driven; enforcement tools were lacking; regulatory decisions were made with limited financial information and analysis; policies were limited and outdated; assessments were frequently erroneous; training was erratic at best; and records were managed poorly. [DOB 1989-1990 Budget Document].

There is no dispute that the Division has made great strides in improving its regulatory function. Most important is the fact that the Division has instituted changes which improve its ability to examine and monitor the safety and soundness of its regulatory charges. These improvements have also furthered the Division's ability to preserve the security of deposits and to seek regulatory cooperation and parity among financial institutions. The increased satisfaction of the regulated industry and the continued willingness of federal regulatory agencies to conduct cooperative examinations are objective indicators of the Division's advancement as an effective regulator.

The Division's most significant accomplishment in this area is arguably its institution of risk-based scheduling of examinations. The statute was amended to vest the Banking Board with discretion to determine the extent to which examinations must be conducted, enabling the promulgation of Policy 80-1, commonly referred to as "the mandate." [Appendix 6]. The mandate requires the Commissioner to conduct on- and off-site examinations as extensively and frequently as the riskiness of its financial condition necessitates. This method replaced the former system, which required the Division to examine each state-chartered institution on an annual basis, a requirement with which the Division could never comply. The consensus regarding the effectiveness of risk-based scheduling within the Division is generally favorable.

The consensus of the regulated industry is that the Division's risk-based examination policy is fair to excellent. And, judging by the results of a survey conducted by the Division within the last few years, the regulated industry also gives the Division high marks for its ability to conduct examinations. On a scale of 1 to 5, roughly 60% of state-chartered banks and trust companies responded that the Division possesses good ability ("4") to examine various components of a financial institution (i.e., loans, investments, liquidity, operations, management, off-balance sheet items, EDP). Over 10% of the respondents view the Division's ability as excellent, while roughly 15 to 20% of the respondents rated the Division's examining ability as fair. This overall positive grade was reinforced by the majority's opinion that the ability of state regulators matches or exceeds the ability of federal regulators.

Although the Banking Code contained capital standards for many years, the Banking Board, through its rule-making authority, established minimum risk-based capital requirements for financial institutions which conform to federally-mandated minimum risk-based capital requirements. These standards were implemented to help ensure that banks are adequately capitalized and to assist regulators in determining the capital rating for banks. The Board also promulgated rules delineating loan and investment requirements to which financial institutions must adhere, although these requirements also had been set forth in the Banking Code. And, it imposed a requirement that all financial statements be prepared in accordance with generally acceptable accounting practices (GAAP) to establish consistency in accounting practices.

Off-site monitoring was also implemented as "a cornerstone for effective risk-based scheduling" to analyze financial information on an ongoing basis between exams. [DOB February 1989 Thirty Point Plan for Effective Bank Regulation]. Off-site monitoring is critical since it allows the Division to spot problem areas and to determine the financial condition of the institution for purposes of examination scheduling. Currently, the Division conducts its off-site monitoring with the following applications:

1) SSA - A download from the Federal Reserve Bank of examination statistics and information concerning the condition and activities of banks and bank holding companies;

2) Colorado SSA - Division examination statistics and narrative information concerning the condition and activities of banks;

3) UPBS System - A download from the FDIC of quarterly call report information and limited organizational information on banks which provides the following:

    a) CAEL Reporting - Assignment of 4 of the 5 components of the CAMEL rating based solely on financial information;

    b) Threshold Report - Examines 1 to 7 ratios for select banks or all banks to determine if the ratio(s) meets a selected threshold and reports banks which fail one or more threshold tests. Includes capital adequacy for PDPA banks;

    c) Trend Analysis - Regression analysis of 1 to 7 ratios per bank to produce graph to demonstrate the past 5-year trend and to project trends in the next 8 quarters; and

    d) Ad Hoc Reporting - Ability to generate special reports based on selected UPBS data.

Off-site monitoring has increased the Division's ability to examine institutions effectively and is commensurate with that of the FDIC and Federal Reserve. However, the Division agrees that its ability to perform this monitoring efficiently can be enhanced through improved software programs and continual automation training.

Another significant examination tool was added to the Division's arsenal when all state-chartered banks and trust companies, and nationally-chartered eligible public depositories, were required to submit either an annual director's examination or CPA audit to the Division for monitoring purposes. The submission of quarterly call reports for purposes of off-site monitoring is also required of these institutions. In addition, banks and trust companies are obligated to report particular information to the Division upon a change of their executive officers and directors.

Safety and soundness examination workpapers and reports have been standardized so that examinations are consistent. All examination reports are now completed on a timely basis and mailed to the examined institution within forty-five days. Financial institutions indicate their appreciation of this prompt reporting; they, in turn, are now able to implement recommended changes in a timely fashion.

Another important initiative which the Division has undertaken is the coordination and streamlining of examinations with the FRB and FDIC. The Division has achieved a good working relationship with the FRB, agreeing to schedule joint or alternating exams and to accept the examinations of one agency in lieu of the other under certain circumstances. The Division has recently reached a similar agreement with the FDIC. This particular agreement stems in part from the Division's improving regulatory function, and in other part from the FDICIA's requirement that the FDIC take affirmative steps with state regulators to streamline the examination process, including the acceptance of state examinations on an alternating basis. [12 U.S.C. Section 1820(10)(d)(3)]. These strides have been made in spite of a February 1993 General Accounting Office report which questioned the wisdom of federal agencies accepting state regulatory agency examination results.

The mechanics of scheduling examinations with federal agencies is often difficult because these entities are somewhat inflexible about accommodating the Division's examination schedule. The FDIC typically insists upon taking the lead during joint on-site examinations, although the Division anticipates that the FDIC will agree to alternating leads this year. On balance, the Division and the industry report that the trouble spent coordinating examination efforts is minimal when compared with the savings and efficiency which these exams generate.

The Division has also instituted and conducted Uniform Consumer Credit Code compliance examinations at state-chartered banks since 1990. To date, the UCCC program has identified common transgressions, educated the industry about the regulatory requirements of the statute, and protected Colorado consumers by enforcing compliance through the imposition of statutory penalties. Over $249,000 has been returned to Colorado citizens since August 1991 as a result of the Division's UCCC's regulatory program.

Formal and informal enforcement provisions have been beefed up significantly to ensure safety and soundness. For instance, the Division's powers to enter into Memoranda of Understanding (MOU), to send letters of reprimand and informal commitment letters, to impose civil money penalties, to issue cease and desist orders, and to remove or suspend bank directors and executives under certain circumstances have been enhanced.

The Division has succeeded in fleshing out many chartering procedures by way of statute and rule-making authority. These procedures help ensure that all applicants are fit to own and operate a financial institution, and that all applications are processed in a consistent and timely manner.

Perhaps the most telling indicator of the scope of the Division's achievements is its accreditation as of January 1991 by the Conference of State Bank Supervisors. This accreditation is achieved by meeting rigorous standards required by a nationally recognized organization. After accreditation is granted, these same standards must be adhered to in order to receive continuing accreditation which is granted on an annual basis. The Division successfully renewed its CSBS accreditation in 1992 and is currently applying for continuing accreditation for the upcoming year. The Division's receipt of this prestigious professional certification is an accomplishment which reflects a high level of proficiency in bank regulation.

The bottom line is that the Division has dramatically increased its ability to perform its mission in a satisfactory manner since 1988. The impediments which the Division continues to experience in its regulatory function appear to stem mostly from inefficiencies resulting from software and limited automation training.

<u>Public Deposit Protection</u>

The PDPA charges the Division of Banking with the responsibility of ensuring the safety of public funds deposited with banks. This is accomplished by requiring eligible public depositories to collateralize uninsured public deposits through the pledging of approved securities.

Colorado is one of forty-three states that have enacted statutes to protect public deposits by collateralization. The important public policy underlying these statutes is that, while a depository is necessary to operate the finances of government, the collapse of a bank should not jeopardize the safety of money held in trust for the benefit of taxpayers. Moreover, since governments must provide the resources necessary to ensure the maintenance of public order in the event of severe economic crisis, they seek to ensure that in such a crisis, the failure of banking institutions will not jeopardize the general health and safety of the population. [Government Finance Officers Association Committee on Cash Management, Collateralizing Public Deposits (May 1987)].

Colorado has adopted the statutory model which requires banks to collateralize all uninsured public deposits fully as a condition for doing business with public entities. The dollar amount of collateral that a bank must pledge is based primarily upon the bank's financial condition, measured by the total capital to risk-weighted asset ratio. Therefore, a bank with a total capital to risk-weighted asset ratio of 8% or more must pledge collateral with an aggregate market value of 102% of the bank's uninsured public deposits. This requirement increases as the bank's financial condition deteriorates; hence, a bank with a total capital to risk-weighted asset ratio of 6% or less must pledge a minimum of 160% of uninsured public deposits, and a bank with a ratio or 5% or less must close all of its public deposit accounts.

In 1989, the Division agreed that its regulation of public deposits was limited by its inability to identify public deposits effectively and to value and track pledged collateral. [DOB 1989-1990 Budget Document]. Therefore, although the PDPA had been in force since the mid-1970's, it was not until 1988 that the current stringent level of supervision was implemented by the Division. This program derived from the recently reenacted PDPA statute which sets forth a comprehensive scheme to protect and collateralize public funds. The statute was amended in 1989 in response to the 1988 audit, which criticized the Division's lack of procedures for the examination of public depositories in a timely and prudent manner.

In the last five years, numerous statutes and regulations have been promulgated that outline procedures which the Division must follow when monitoring and examining public depositories. In addition, public depositories are now required to comply with rigorous reporting and collateralization requirements. The primary improvements which have been effected post-1988 have cured most all of the audit criticisms. Specifically, the Banking Board possesses the authority to:

* designate public depositories and establish standards when their eligibility to accept public deposits must be suspended;

* establish a list of eligible collateral for uninsured public deposits;

* establish requirements regarding where eligible collateral may be held;

* levy civil money penalties upon banks for their failure to adhere to statutory requirements;

* establish by mandate the frequency of examinations, based upon the financial condition of the institution; and

* establish procedures for the liquidation of collateral upon a depository's default.

Banks are required to hold public fund deposits in specially-numbered accounts for tracking purposes, to pledge and release collateral through monthly collateral appraisal reports which are submitted to the Division, to submit quarterly call reports and other schedules to the Division for purposes of monitoring public deposits and collateral, and to execute depository pledge agreements if depositories wish to hold collateral in their own departments.

The PDPA program has experienced dramatic improvement as a result of these changes, and Division figures illustrate the continued need for sound and consistent PDPA regulation. One field examiner is assigned to examine all nationally-chartered public depositories on-site and to examine all state-chartered banks which have not been examined for PDPA purposes during safety and soundness examinations. This examiner is required by the mandate to conduct a target examination upon all 1, 2, and 3 CAMEL-rated institutions once every three years. All 4 and 5 CAMEL-rated institutions receive full-scope examinations annually. Full-scope PDPA examinations must meet specific and comprehensive criteria, while the scope of target examinations is left to the discretion of the supervising examiner.

At the beginning of FY 1991-1992, the Division forecast that it was required to conduct forty-two full-scope and sixty-one target exams based on the ratings of the public depositories. However, owing to bank ratings which changed during the course of the year, the Division was in fact required to conduct another eight full-scope PDPA exams and six additional target examinations. As a result, even though the Division met the mandate as it existed at the beginning of the fiscal year, five PDPA target examinations which were added to the mandate during the year were not timely completed, resulting in the Division not meeting its PDPA mandate. However, to ensure that there was no resulting risk to the safety and soundness of public funds, the Division conducted five off-site examinations. The Division also estimates that it will have complied with its PDPA mandate in FY 1992-1993, with the exception of conducting 9 exams. However, all but eight of these examinations were delayed so that they could be coordinated with previously-scheduled full scope examinations in the first half of FY 1993-94, while the remaining exam was not completed since the bank is merging into an existing state-chartered bank.

Three hundred thirty seven state-chartered and nationally-chartered banks are currently certified to hold public deposits. The Division also regulates twelve banks which are certified to hold the collateral pledged to protect those banks' public deposits. Eligible public depositories presently hold between 1.3 and 1.6 billion dollars in public deposits for over 3,500 public entities in Colorado. In 1992, the Division uncovered a total of $42,118,295 in unreported public deposits in banks. Of this total, approximately $30,000,000 exceeded the protection afforded by FDIC insurance. Therefore, PDPA examinations have protected these public funds by requiring pledged collateral.

One important issue which the Division has recently addressed is whether the current list of eligible collateral includes instruments or obligations which satisfy the statutory criteria set forth in Section 11-10.5-107, C.R.S. At present, PDP-3, the list of eligible collateral, includes numerous instruments and obligations which have been determined by the Banking Board to qualify as safe and sound collateral for public funds. In April, however, the Banking Board requested an Advisory Committee and the Division to revisit the list to determine whether it can be expanded to include additional instruments or obligations and, more significantly, to review whether the already-approved instruments and obligations continue to comport with the mandated statutory criteria.

This good progress has occurred in spite of the limited state of the Division's automation. In 1989, the Division agreed that its manual tracking system was wholly inadequate. It therefore requested hardware and software which would provide an accurate means of pricing, tracking, pledging, and releasing collateral. At present, the Division has successfully automated the monthly collateral appraisal report, a document which inventories the amount and value of all securities that the banks pledge against public deposits. The Division also purchased a fax machine so that it can post and release pledges on a daily basis upon the request of banks. The implementation of these automated systems has unquestionably enhanced the Division's ability to protect public deposits.

However, other information which should be computerized and available to the Division for analysis is still handled manually. For instance, the amount and types of public funds which each eligible depository has on deposit are manually tracked. Nevertheless, the Division agrees that, while the manual nature of this function impacts its efficiency, it does not impede its effectiveness.

Division Resources

Incredible as it may seem, the Division of Banking in 1988 was regulating a completely automated industry with one personal computer. A records management system was non-existent. Therefore, it was not unusual for pieces of paper to be scattered throughout the office only to be lost or discarded. Just as astonishing is the fact that there were no written policies and procedures in place.

The 1988 Division was also criticized for using examiners to perform clerical functions. Employees were not properly trained to perform their duties, nor were they evaluated. The examination team structure was criticized as inefficient. Budget and assessment functions were also deficient.

Since then, the Division has adopted a comprehensive policies and procedures manual. It has also implemented a manual records management system which, despite its shortcomings, organizes and updates files on a daily basis. Formal employee evaluations have also been instituted. A training manual has not been developed internally, although the Division has adopted the Federal Reserve Bank's manual on training as of July, 1993. Although the majority of training is accomplished "on the job," the majority of staffpersons have received formal and classroom training according to individual plans which are formulated in conjunction with each employee's PACE plan. In FY 1992-1993, the Division spent over $20,000 to provide 1,188 hours of classroom and in-house training to Division staff. And, budget and assessment problems have been remedied.

In 1992 the Division began to operate as a cash-funded entity. Although its budget is not dangerously lean, its ability to increase funding is restricted since its constituents view controlled fees and assessments as incentives to membership in the state-charter system.

The tight budget also impacts the resources upon which the Division relies. For instance, the Division is blessed with a group of richly-experienced examiners who have been with the Division, on average, for over 15 years. Several of these well-experienced senior workers have been promoted to the position of on-site managers, or lead workers, a situation which is created by a personnel system which predicates promotions upon supervisory experience. However, in order to accommodate these promotions, the vast majority of the examining staff undertook voluntary demotions. As this situation demonstrates, a number of serious problems may develop if the Division experiences further cuts in its resources.

Automation

Perhaps the biggest challenge which the Division encounters on a daily basis is the limiting nature of the present stage of its automation. The limitations inherent in the Division's automation adversely affects the efficiency of the Division's functions, from scheduling to on-site examinations to off-site monitoring to clerical functions.

The Division realized in 1989 that "the key to improving the Division is better utilization of resources through automation." It continued:

> The automation of the examination process coupled with a realistic mandate based on risk (risk-based scheduling) will allow better utilization of resources. While an increase of four additional field examiners is being proposed, without automation and risk-based scheduling this increase would be significantly higher.

To effect automation, the Division was permitted to levy a one-time assessment upon its regulated institutions for that specific purpose. The Division purchased computers and printers. However, the Department-generated software is neither easy to use, nor is it comprehensive. Part of the Division's information is automated through software, part is automated through a number of list processing documents, and the balance is manually maintained. Consequently, although the Division possesses all of the information necessary to perform its regulatory function, it is lacking in efficiency because of its many non-integrated automated lists processing and its manual systems.

The Division has been operating without an automated integrated data base. This deficiency has prevented the Division from entering information into one data base which, in turn, can be pulled up for review on any computer. However, the Division is currently anticipating that it will be linked up to the Department's computerized LAN system, which should go a long way towards resolving this problem.

The Division's state of automation has also plagued the critical scheduling function. Since risk-based scheduling has been introduced, the scheduler has had to gauge examination requirements by way of a manual system. This already complicated function runs the risk of being unreliable when manually operated since bank CAMEL ratings shift from time to time. Of course, because these rating changes require the scheduler to modify the examination schedule since the mandated frequency of examinations will have expanded or contracted, a manual system increases the chance that required examinations will not be properly tickled and scheduled. However, the Division has been able to manage properly the risk of missing a necessary examination because of the examination coordination program it has with the federal regulators. And, significantly, the Division is currently attempting to develop a software program to address this area of concern.

With few exceptions, the countless documents which the Division receives and generates on a daily basis are also handled manually. However, the Division has developed a manual system to track all documents, as well as lists processing. Workpapers are not automated for all types of exams. While there is disagreement within the Division, some Division staff believe that those workpapers which are automated must be revised before they will be satisfactory.

To the Division's credit, it continues to attempt to secure these automated components. However, even given these improvements, the extent to which improved automation is needed for the Division's efficient regulatory function cannot be adequately emphasized.

Allocation of Examiners

Another potential area of concern which may arise if the Division's budget is cut is the Division's allocation of examiner resources. In 1983, the Deputy Commissioner and Chief Financial Institution Examiner supervised teams of twenty-eight field examiners which were headed by three section leaders. [DOB memo; DORA 1983 Sunset Review, Appendix E]. In 1988, twenty-three field examiners conducted safety and soundness banking reviews under the lead of three section leaders, the Chief Financial Institution Examiner, and the Deputy Commissioner. [1988 Report of the State Auditor, Appendix A, p. 132]. Today, the Division operates with 19 safety and soundness field examiners, a 34% decrease from the resources utilized ten years ago.

The reduction in the ranks of field examiners available to perform safety and soundness examinations can be explained in a number of ways. For instance, the proliferation of specialty exams and programs require their own set of examinations and examiners. The UCCC specialty exam was not in place in 1983 and 1988, nor was an examiner isolated to perform trust examinations apart from bank safety and soundness examinations. A problem bank supervisor position has been created to perform specialized services since 1988. Therefore, the reduction which the core safety and soundness pool has experienced is attributable to the growth of specialty programs and to the Division's commitment to conduct the examinations on a scheduled, consistent basis.

According to Division management, safety and soundness examiners now have fewer examinations to conduct than formerly. In 1982, the Division regulated 189 commercial banks which were required to be examined annually, and 154 industrial banks which had to be examined twice a year. Accordingly, ten years ago, the Division's safety and soundness team was required to conduct 497 examinations in a twelve-month period.

In contrast, although the Division was required in FY 1992-1993 to conduct 408 safety and soundness and specialty examinations, the Division is currently required to conduct safety and soundness examinations at 156 commercial banks, 7 industrial banks, and 10 trust companies. Owing to risk-based scheduling, these examinations are not necessarily required to be conducted annually, but are based on the institution's financial condition.

Therefore, in FY 1992-1993, the Division's safety and soundness staff examined commercial and industrial banks by conducting 47 full-scope mandated examinations, 15 non-mandated full-scope examinations in lieu of mandated target examinations, 18 mandated target examinations, and 3 non-mandated target examinations. The Division did not perform 13 safety and soundness examinations which were no longer required, and it accepted 64 examinations from federal agencies in lieu of conducting its own safety and soundness examinations. In sum, except for the federal examinations which were accepted in lieu of Division examinations, the Division's pool of safety and soundness examiners conducted 92 full-scope and target safety and soundness examinations of commercial and industrial banks, trust companies, money order companies, and debt adjusters.

Therefore, even though the number of safety and soundness examiners has diminished by approximately one-third during the past decade, the number of examinations which these examiners conduct has diminished even more significantly. However, the FTE's necessary to conduct the current level of examinations should not be discounted since the Division's regulation of assets presently under supervision exceeds $16 billion. [83rd Annual Report of the State Banking Commissioner].

The Division also points out that it is only required to examine 1 and 2-rated financial institutions by achieving a 30% loan penetration according to its mandate, and to achieve a 55% loan penetration for those institutions with a CAMEL rating of 4 or 5. Even so, during the first twenty safety and soundness examinations which were conducted in 1993, the Division's examiners achieved an average of 59% loan penetration. Moreover, the Division continues to utilize its safety and soundness resources in effective ways by performing examinations upon multiple unit banks (banks owned by the same bank holding company) in one central location where all necessary financial information has been gathered. Under these circumstances, the Division was recently able to conduct an on-site examination of a bank with seven unit banks in two weeks rather than in the estimated ten weeks which seven separate examinations would have taken.

In an effort to keep up with its mandated workload, the Division is structured so that specialty examiners can be diverted for safety and soundness examinations on an as-needed basis. This flexibility is desirable, particularly since the Division is presently attempting to coordinate specialty examinations with safety and soundness examination dates and to coordinate these examinations with the schedules of federal regulators. During FY 1992-1993, the Division estimates that it completed at least 92% of its mandated examinations, plus an additional 73 examinations which were not mandated.

In spite of limited examiner resources, the Division's regulatory functions continue to draw praise from the industry, and the health of its regulated industries continues to improve.

Division Structure

The structural faults which were found to exist in 1988 have been successfully corrected by statute.

As this report has previously noted, the roles of the Banking Board and Commissioner were delineated and clarified to eliminate the conflict which arose regarding the Commissioner's position. The Banking Board has also actively undertaken its new role as policy-maker for the Division, and the industry reports its satisfaction with both the policies promulgated by the Board and the evenhanded manner in which the Board administers its authority. The Commissioner and the Banking Board continue to be satisfied with their present roles and responsibilities and report no need for modification.

Moreover, the Banking Board was reconstituted to include representation of industrial banks and trust companies. Therefore, the oversight capability of the Board has also been improved.

In 1988, the state auditor also recommended the possibility of consolidating the Divisions of Banking and Saving and Loan (now named the Division of Financial Services). As rationale for this recommendation, the auditor stated that overhead costs would be reduced by approximately $80,000, two agencies would be combined into one agency of manageable size with the same mission, cross-utilization of staff and coordinated automation would be promoted, and the public would receive a favorable impression from streamlining. This recommendation was not followed.

This issue continues to cause consternation among much of the banking industry. The vast majority of Colorado bankers are indignant over their belief that credit unions are permitted to compete unfairly by their exempt tax liability status as nonprofit entities and by escaping from heightened regulatory scrutiny. They think that credit unions have spoiled the "level playing field" on which financial institutions are supposed to compete. Therefore, some bankers have expressed a desire that the Divisions of Banking and Financial Services be consolidated.

However, the banker's ideal of regulating credit unions by the Banking Board is anathema to state-chartered credit unions, which threaten to abdicate their state charters for federal charters if ever subjected to regulation at the state level by bankers.

There appear to be several reasons why the existing regulatory framework should continue without interruption. Besides the potential exodus of credit unions from state to federal charters, the consolidation of the two agencies would result in insignificant savings and, possibly, increased costs to the regulated industry. Moreover, potential political problems abound, particularly since regulation of these industries is incompatible. As Commissioner Walker stated in 1991:

> If consolidation of the two Divisions were to take place, . . . [t]he [credit union] commissioner would be placed in the untenable position of being subject to strong political pressures from the banking industry to make certain decisions concerning the credit union industry to protect the competitive position of the banking industry, and to strong policy pressures from the State Banking Board.

Another deterrent to consolidation is that agency gridlock will result from increased administrative burdens. [11/6/91 Memorandum by Barbara Walker, "The Dangers in Consolidating the Division of Banking and the Division of Financial Services"].

Thus, even assuming that bankers do presently operate at a regulatory disadvantage, the consolidation of the two agencies would only appear to promote the interest of one regulated group over the other. Since the goal of consolidating to equalize the playing field between the two groups does not appear to be realistic, the Division should continue to fulfill its mission of promoting parity between financial institutions within the present regulatory framework.

CONCLUSION

The Colorado Division of Banking has managed to rebound from the industrial bank crisis and the 1988 State Auditor's Report in a period of only five years. Its regulatory functions have improved significantly in a variety of ways, as evidenced by CSBS certification, the cooperative attitude exhibited by federal regulatory agencies, industry recognition of its proficiency, and, perhaps most significantly, the increasingly robust health enjoyed by its constituents.

Division resources continue to be tightly monitored, and automation limitations prevent the Division from executing its mission to monitor the safety and soundness of financial institutions in the most efficient manner possible. Nevertheless, while everyone is in agreement that room for improvement exists, overwhelming consensus exists among the Division, the regulated industry, state government officials, federal regulatory agencies, and consumers, for the continuation of the Division and its role as regulator. This support is unanimous in spite of, or perhaps because of, the regulatory uncertainties which financial institutions and their regulators may face in the future. Therefore, given the strong role which the Division continues to assume on the stage of bank regulation, it is clear that the Colorado Division of Banking should be continued to carry out and to improve the quality of its regulatory work.

Recommendation 1: **Continue the Colorado Division of Banking.**

The General Assembly should continue the Colorado Division of Banking. In light of the complex issues and prospect of significant federal regulatory changes which may directly affect state agencies, the next sunset date for the DOB should be July 1, 2002.

CHAPTER 6

RECOMMENDATIONS FOR RESOLVING STRUCTURAL AND OPERATING ISSUES

INTRODUCTION

The previous discussion illustrates that the Division functions have improved remarkably over a short period of time. However, the extensive scope of the mission with which the Division is charged requires its continued progress.

The improvements which the Division can make will further the following goals:

I. The need to preserve and promote a statewide safe and sound banking system;

II. The need to promote regulatory parity and sound competition among financial institutions;

III. The need to protect Colorado consumers; and

IV. The need to promote organizational competence.

Recommended resolutions for each of these areas is discussed below. For the sake of the reader's reference, each recommendation is designated either as administrative or statutory.

I. THE NEED TO PRESERVE AND PROMOTE SAFETY AND SOUNDNESS

The safety and soundness of all state-chartered financial institutions is the core objective which the Division of Banking seeks to preserve and promote in order to protect the public interest. The failure or neglect to preserve and promote this goal through regulation and supervision potentially results in institutional financial difficulty or failure and, consequently, in harm to the public. Therefore, regulators seek to monitor and supervise financial institutions to prevent unsafe and unsound practices usually resulting from loan losses or poor management.

The Banking Board has formally stated that the safety and soundness of financial institutions justifies and requires a state examination process, the objectives of which are to assess financial conditions, management capabilities, and internal controls, and to evaluate administrative and financial policies and procedures. [DOB Policy No. 10-5]. In addition to examinations, however, other regulatory safety and soundness controls have been implemented by statute and regulation, including, for example, provisions relating to chartering, capital requirements, permissible investments, acquisitions, liquidation, and enforcement powers.

These legislative and agency efforts have substantially shored up the means by which the Division safeguards the public against loss. However, certain additional measures should be implemented or strengthened to ensure the adequate regulation of institutional safety and soundness. The following recommendations are directed towards the goal of preserving and promoting safety and soundness.

Automated Monitoring and Scheduling Systems Should Be Implemented to Ensure Total Regulatory Efficiency

The Division properly notes that there is more to off-site monitoring than the ability to access automated data. For instance, the Deputy Commissioner and the supervising examiners meet weekly to discuss the condition of banks, resulting in a quarterly review of each supervised institution. Special action banks are likewise discussed within the Division at least quarterly, and the Banking Board reviews information regarding these banks monthly. In addition, supervisors sometimes visit banks on-site to discuss areas of concern with bank personnel.

However, when the Division initially switched over to risk-based examinations and scheduling, it realized the critical contribution which automation plays in on- and off-site monitoring, stating:

> Off-site monitoring is a cornerstone for effective risk-based scheduling and will entail the analysis of call reports and other data on an ongoing basis between the on-site exams. It will allow the Division to be more effective in spotting problems in banks between exams and will allow for exam schedule modifications if necessary. It will also allow the Division to be more efficient in the use of its resources while at the same time providing less inconvenience and greater service to the banking community.
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> . . .
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> Automation will [also] allow the Division's examiners to access and analyze important data in a way they have not been able to do in the past. As part of each on-site exam, the Division examiner will have access to an automated data base covering call and audit reports, FDIC and Federal Reserve Monitoring information, as well as histories from prior exams. Examiners will therefore be able to spend more time analyzing more significant kinds of data and spend less time doing manual and clerical functions. As a result, the depth of the exam analysis will be increased without an increase in resources or time spent in the bank. The quality of the exam product will be improved and will be more helpful to bank management in correcting or preventing problems.

[DOB Thirty Point Plan for Effective Bank Regulation (Point Five), February 1989].

The majority of the Division's off-site monitoring is currently conducted by three supervisors and the Deputy Commissioner, who review federal regulatory agency examination reports, director's exams or CPA audits from financial institutions, the FDIC's UBPR quarterly report, FRB's Special Supervisory Action automated data, and correspondence from banks and federal agencies. The monitoring which they conduct by way of automation is provided through access to the FDIC's UBPR, the FDIC's database, the FRB's special supervisory action data, and to computerized regression analysis which, according to the Deputy Commissioner, is effective but difficult to access because of Division equipment. The Division can also analyze financial information and manipulate it for purposes of trend analysis.

There is no question but that the Division's off-site monitoring capabilities have improved measurably. Nevertheless, because these capabilities are predicated upon the Division's ability to access and analyze automated data, the Division's efficiency in conducting fully automated monitoring would be enhanced by the implementation and use of an integrated historical database.

Specialty examination procedures are equally impacted by automation deficiencies. The PDPA program must manually track the types and amount of public deposits received by eligible public depositories.

The scheduling function is likewise accomplished manually and through list processing. Although the scheduling procedure requires the scheduler to utilize the computerized examination database information to set examinations, and to review workload statistical reports to determine staffing needs, the scheduler does not have the benefit of fully automated tools. Instead, safety and soundness and specialty examination forecasts and schedules are tracked on list processing and in notebooks which contain past scheduling assignments. Projected examination dates are manually modified as institution ratings change. The scheduler also manually makes and tracks staff assignments. However, as noted previously, the Division is currently attempting to secure an automated program for the scheduling function.

An integrated historical data base will permit the Division to track more efficiently examination dates, CAMEL ratings, examination scope, asset size, examining agency and hours required to complete examinations. It will also permit the Division to centralize financial information from call reports and audits, and to garner key ratios based on these reports.

In addition to enhanced monitoring function, an integrated historical data base will permit Division employees to locate and pull up in one location all information with respect to its regulated institutions. Presently, the Division tracks the history and status of the entities which it regulates by manual recordkeeping and automated list processing. An historical data base will accommodate this information in an integrated computerized data base. Under this scenario, all information relating to each regulated bank is entered into the computer system so that each Division staffmember can pull up the file for Bank X and view all pertinent information relating thereto in one location, from its chartering to its past and present financial condition and examination ratings. Information is continually input into the system.

An integrated automated historical data base will permit the Division to become more efficient in its off-site monitoring, a critical regulatory function.

(Administrative)
<u>Recommendation 2:</u> **The DOB should develop an integrated automated master file of historical performance data which contains and tracks pertinent information, such as CAMEL ratings, bank asset size, and any other pertinent information.**

<u>Formalize Commercial Bank Charter Investigation Procedures</u>

Pursuant to Section 11-3-109, C.R.S., applicants who wish to receive a state commercial bank charter must submit certain information to the Banking Board for its determination of whether to grant or deny the charter. The Banking Board must give notice to each interested party, including all banks within three miles of the proposed bank's location, of a public hearing at which the applicant is required to meet the burden of proving that there exists a public need and adequate volume of business for the proposed bank. However, the Banking Board may grant the charter without a public hearing if it has not received any written protests to the charter and <u>if the applicants for the charter are known to the Board</u>. Section 11-3-110(3)(c), C.R.S.

The Banking Board's action on an application is predicated on work which has been carried out by the Division. Upon receipt of an application, the Division is required by statute to conduct a "careful investigation" of the application to determine that the following requirements have been met:

(a) That the applicant has proceeded in a lawful manner;

(b) That the bank's proposed name is not deceptively similar to another or misleading;

(c) That the potential officers or officers are qualified by character and experience and that the qualifications and financial status of officers, directors, incorporators, and other persons in control of the bank are consistent with their responsibilities and duties;

(d) That the proposed capital satisfies the standards an guidelines in the rules and regulations promulgated by the Banking Board; and

(e) That the proposed articles of incorporation are appropriate.

Once this careful investigation has been completed, but before the hearing is held, the Division must present a report to the Banking Board detailing the application's sufficiency or deficiency. Section 11-3-110(1) & (2), C.R.S.

The supervising examiner who conducts the Division's charter application investigations typically speaks with attorneys, bankers, other regulatory agencies, the public and, when appropriate, with the Colorado Bureau of Investigations during the course of the investigation. The investigating examiner follows formal policies which have been promulgated for certain applications such as national to state bank conversions, changes in control, bank to bank mergers, and detached facility applications, and he also follows informal procedures which have been developed in-house when investigating and processing commercial bank charter applications. Nevertheless, the commercial bank charter application investigation policies and procedures are not conducted pursuant to formal Division policy.

This is important only because the Banking Board may dispense with the formal hearing process when the applicants are known to the Banking Board and objections have not been received from surrounding banks and other interested parties. In these circumstances, the Division's investigation serves as the singular means by which the applicant's credentials and the legitimacy of the new enterprise is verified. In these cases, the applicant is not required by statute to attend a public hearing although, to the Banking Board's credit, it habitually conducts its determinations in public proceedings with the applicants present. Nevertheless, because this commendable practice is not required by statute under certain circumstances, the Commissioner should ensure that procedures are formalized for the investigation of commercial bank charter applicants. This will prevent any possible appearance of impropriety or favoritism accorded to applicants who do not proceed through the formal hearing process, and ensure the uniformity and thoroughness of the process by which such applications are investigated.

(Administrative)
Recommendation 3: **The Commissioner should formalize procedures which the Division must follow when investigating charter applications pursuant to Section 11-2-110(1).**

Amend Section 11-3-110(1)(c) to Eliminate Statutory "Character" Requirement

The foregoing discussion demonstrates that officers and directors of state-chartered commercial banks are required by Section 11-3-110(1)(c), C.R.S., to be "qualified by character . . . ." While this statutory provision promotes the goal of elevating persons of high character to positions of responsibility to oversee and direct the safety and security of public and private deposits, its language is ambiguous and subject to various interpretations. Therefore, to eliminate the possibility of inconsistent or arbitrary interpretations regarding an individual's character, the General Assembly should amend the statute to eliminate the reference to character, and the Banking Board should be directed to engage in rule-making which defines and clarifies the qualifications that commercial bank officers must meet.

(Statutory)
Recommendation 4: **The General Assembly should amend Section 11-3-110(1)(c) to read:**

"That the persons who will serve as directors or officers, insofar as such persons are known, possess the qualifications and experience as required by rules promulgated by the Banking Board and that the qualifications and financial status of the incorporators, directors, officers, and persons in control of the bank, as defined in section 11-2-109(4), are consistent with their responsibilities and duties."

Additional Enforcement Measures

The Division's statutory authority to assess civil money penalties against banks which violate cease and desist orders, the banking code, rules, or regulations has greatly enhanced its ability to enforce these provisions. See Section 11-2-117, C.R.S. A corollary to this provision is found in Section 11-2-119, C.R.S., in which the Banking Board is permitted to suspend or remove any person from his or her participation in the conduct of bank affairs if it makes a determination which, in part, establishes that the person has committed the same conduct outlined in Section 11-2-117, C.R.S. or has engaged or participated in any unsafe or unsound practice in connection with a bank.

It is logically inconsistent that the Banking Board should be permitted to impose the more severe penalty of removing an individual from duty for engaging in unsafe and unsound behavior, but that it is not permitted to impose the less stringent sanction of a civil money penalty after notice and a hearing. Although section 11-2-117 infers that the Banking Board may assess civil money penalties against any bank or person who violates the code, rules, or regulations by engaging or participating in unsafe and unsound conduct in an amount which may not exceed one thousand dollars per day for each day the person assessed remains in violation. However, it does not spell out this authority clearly. Therefore, Section 11-2-117 should be amended to permit the Banking Board to impose penalties against persons and banks which engage in unsafe and unsound banking practices.

(Statutory)
Recommendation 5: **The General Assembly should amend Section 11-2-117(1)(a)(I) to provide that the Banking Board may, after notice, hearing, and a determination that no other appropriate governmental agency has taken similar action against such person for the same act or practice, assess against and collect a civil penalty from any person or state bank which has engaged or participated in any unsafe or unsound practice in connection with a bank.**

Continue to Improve Automation of PDPA Monitoring

As previously discussed, the Division's limited automation also impacts the Division's efficient monitoring and valuing of eligible collateral. On at least three occasions during the last year, the Division has either recommended against approval of instruments or obligations, such as surety bonds and certain collateralized mortgage obligations, as eligible collateral because of the inability of limited staff to adequately manually identify and monitor the status and valuation of existing or newly-requested eligible collateral, or has recommended that approval be contingent upon the Division's resources to monitor and value adequately such collateral. While no one automated system will allow the Division to price every conceivable security the Banking Board may consider to be pledgeable, the present state of automation impacts the Banking Board's ability to approve certain instruments and obligations as eligible collateral, and it impacts the Division's efficient monitoring and evaluation of the market value of the obligation or instrument. The Division should endeavor to correct this limitation should by continuing to improve its PDPA automated monitoring capabilities.

(Administrative)
Recommendation 6: **The Division should continue to improve its automated PDPA monitoring system to ensure that the Banking Board has at its disposal adequate resources to monitor and evaluate the market value of the obligation or instrument pursuant to Section 11-10.5-107(1)(e).**

Strengthen Communications Between the Division and the UCCC Administrator

The UCCC Administrator and Division are directed by statutory mandate to consult and assist one another to maintain compliance with the code. The Division and the Administrator do communicate from time to time and have engaged in a cooperative relationship which is mutually advantageous for each regulatory program.

However, the UCCC Administrator is required by Section 5-6-104(5), C.R.S., to report to the Commission on Consumer Credit, the General Assembly, and the Governor at the end of every calendar year about the UCCC program and its operations and procedures, including actions which have been undertaken, problems which have been encountered, and descriptions of the examination and investigation procedures and policies of the office. The Division has not historically tendered any type of report to the UCCC Administrator regarding the progress of its compliance program.

The Administrator will be fully apprised of the Division's UCCC activities and will be able to inform other branches of state government about the Division's UCCC compliance program should the Division submit a copy of its annual report containing relevant information regarding its UCCC regulatory program to the UCCC Administrator. The UCCC Administrator's receipt of this annual report will enhance the communication which already exists between the two programs.

(Administrative)
Recommendation 7: **The Commissioner should direct the Division to submit to the Administrator of the UCCC all information contained in the Division's annual report regarding its UCCC compliance program.**

Strengthen Trust Company Safety and Soundness Exams

There are ten state-chartered trust companies which must be examined by the Division for safety and soundness. Depository trust companies must receive a full-scope and target examinations once every three years if they possess a 1 or 2 CAMEL rating, once every 2 years if they possess a 3 CAMEL rating, and once at least every twelve months if rated 4 or 5. The mandate provides that 1 and 2 rated non-depository trust companies must receive full-scope and target examinations every two years, while 3-rated institutions must receive a full examination at least annually and 4 and 5 rated institutions must receive full-scope and target examinations annually. The mandate recently increased the frequency with which non-depository trust companies must be examined, a necessary change in light of the Division's role as sole regulator of these entities.

The Division monitors trust companies off-site by reviewing quarterly call reports and financial statements, balance sheets, and UBPR's for FDIC-insured trust companies. On-site, trust companies are examined for their corporate viability and their ability to manage trust assets and investments. However, while the Division has promulgated Policy No. 80-8 which sets forth guidelines for examination of state-chartered trust departments, there are no similar rules, regulations, policies or procedures which address the minimum standards with which trust company examinations must adhere (outside of the manual and trust rating system adopted by the Division).

Members of the trust company industry complain, and some but not all members of the Division concede, that the trust company on-site examination is not satisfactorily tailored for trust companies. For instance, the current examination does not always focus upon critical areas, such as whether there is activity in suspense or other holding accounts in which there is movement of money awaiting distribution, investment, or reimbursement. These accounts are good examples of distinct trust categories which should be subject to mandatory, predictable scrutiny during examinations since they are the most likely vehicle through which management can commit fraud or misfeasance by illegally commingling trust funds.

It should be noted that the Division is currently updating its minimum program for trust department and trust company examinations to include specific, distinct areas exclusive to trust operations which must be examined. This progress is welcomed by the industry, which concedes that federal examinations are likewise inadequate.

(Administrative)
Recommendation 8: **The Division of Banking should promulgate policies and procedures which establish minimum standards for trust company full-scope and target examinations.**

Require Collateralization of all Managed Fiduciary Funds on Deposit

One important consumer safeguard associated with Colorado's depository trust companies is that, because they are engaged in the business of receiving non-fiduciary deposits, all fiduciary and non-fiduciary deposits in state-chartered depository trust companies are FDIC-insured up to the maximum amount of $100,000. [See 12 U.S.C. 1815(a)].

Under the FDIC's recently revised regulations, deposit accounts maintained by fiduciaries (i.e., agents, nominees, custodians, conservators, guardians, or trustees) are insured in the amount of up to $100,000 for the interest of each principal or beneficial owner in such accounts. To qualify for this insurance the depository institution must observe recordkeeping requirements, including a record that the account is fiduciary in nature and records, maintained in good faith and in the regular course of business, indicating the name and interest of each person on the account. [See 12 C.F.R. 330.4(b)].

Because fiduciary accounts are not maintained for the benefit of the fiduciary-depositor, but for others, the FDIC has permitted deposit insurance to pass through fiduciaries to the beneficial owners of the account so that each beneficiary receives up to $100,000 in coverage. Therefore, despite the explicit $100,000 limit on federal deposit insurance for any one deposit account, a single deposit account well in excess of $100,000 may be fully protected with "pass-through" insurance. The beneficial owners of an account worth millions of dollars may be fully insured.

The deposits of most pension plans, profit-sharing plans, and other trusteed employee benefit plans are entitled to pass-through insurance and are thus insured in the amount of up to $100,000 for the interest of each beneficiary, provided that the FDIC's recordkeeping requirements for fiduciary accounts are satisfied. This insurance coverage is separate from and in addition to the insurance coverage provided for any other deposits maintained by the plan sponsor, the trustee, or plan beneficiaries in different rights and capacities in the same insured bank.

Most trust funds held by Colorado depository trust companies are self-directed by the beneficiaries or by their brokers and, hence, the trust company simply operates as the custodian that performs ministerial acts such as transferring trust funds at the direction of the beneficiary or broker. Under these circumstances, the trust company is not using its discretion to direct the investment of the funds and, therefore, money placed on deposit in excess of the $100,000 limit is done so strictly at the discretion and peril of the depositor or broker.

However, Section 11-23-113 permits Colorado trust companies that hold or direct funds in a fiduciary or discretionary capacity to deposit funds in their own accounts, for the purpose of pledging their assets to secure deposits, while the funds await investment or distribution. The Banking Board has the statutory power to require trust companies to collateralize those deposits exceeding federally insured amounts so that the beneficial owner of managed fiduciary funds will not suffer any loss upon the failure or insolvency of the fiduciary trust company. [Section 11-23-117(1)(l), C.R.S.]. This power mirrors a federal regulation which mandates that national banks that hold funds awaiting investment or distribution may deposit such funds in the commercial or other department of the bank so long as it sets aside under the control of the trust department certain collateral security. [12 C.F.R. 9]. Absent this protection, the injured beneficial owner must recover his damages by instituting a civil action for breach of fiduciary duty (i.e., breach of the prudent man rule).

The Banking Board should be directed to exercise its statutory power to promulgate rules and regulations requiring trust companies which operate as trustees or fiduciaries under discretionary trusts to collateralize those non-insured funds which it deposits into its own accounts while such funds are awaiting investment or distribution. This requirement will prevent beneficial owners of funds which are managed by fiduciaries possessing discretionary power from incurring economic harm in the event of the trust company's insolvency. Moreover, such a provision will achieve parity with the federal requirement and will not be any more stringent or burdensome than the federal counterpart which governs nationally-chartered banks.

Significantly, however, trust companies which deposit self-directed funds into its own accounts at the direction of the owner or broker should be exempt from adhering to the collateralization requirement. This exemption has been successfully employed in Florida's statute to protect depository trust companies from the unfair requirement that they collateralize accounts in which investment decisions are self-directed. [See Fla. Stat. Section 660.37 (1992)].

(Administrative)
Recommendation 9: **The General Assembly should direct the Banking Board to engage in rule-making, pursuant to Section 11-23-117(1)(l), C.R.S., to require depository trust companies holding discretionary fiduciary funds pursuant to Section 11-23-113 to collateralize all funds deposited in excess of federally insured amounts. The rule should provide:**

"State-chartered trust companies holding funds awaiting investment or distribution where the trust company exercises discretion may, unless prohibited by the instrument creating the trust or by state law, deposit those funds in the commercial or savings or other department of the bank. This right is subject to the limitation that the trust company shall first set aside under control of the trust department as collateral security specified readily marketable securities as required by the Banking Board by rule."

Require Collateralization of all Fiduciary Funds Deposited by Banks

Pursuant to Section 11-10-102, banks acting as fiduciaries possess the same investment powers as individual fiduciaries under like circumstances. Accordingly, in circumstances in which banks invest trust funds into their own accounts when acting as fiduciaries, banks should also be required, in the interest of parity, to collateralize in full that amount on deposit which exceeds the FDIC limit of $100,000. As discussed with respect to the previous recommendation, this provision will cause state-chartered banks to comply with the same collateralization requirements imposed upon national banks in like circumstances.

It should be noted that the Banking Board is not charged with a specific statutory corollary to Section 11-23-117(1)(l), the provision which vests the Banking Board with the specific statutory power to require trust companies to collateralize deposited fiduciary funds awaiting investment or distribution in excess of federally insured amounts. However, the Banking Board is vested with the statutory authority to "[m]ake all final decisions with respect to requests to exercise trust, fiduciary, and agency powers" [Section 11-2-103(2)(e), C.R.S] and to perform any acts and make any decisions incidental to or necessary for carrying out its functions as set forth in this code. [Section 11-2-103(13), C.R.S.] Consequently, the Board should engage in administrative rule-making to ensure that banks adhere to the same fiduciary standards with which their national counterparts and trust companies must comply.

(Administrative)
Recommendation 10: **The General Assembly should direct the Banking Board to engage in rule-making to require banks that invest fiduciary funds at their discretion as a fiduciary in their accounts to fully collateralize all funds deposited in excess of federally insured amounts. The rule should provide:**

"State-chartered banks holding funds awaiting investment or distribution where the bank exercises discretion may, unless prohibited by the instrument creating the trust or by state law, deposit those funds in the commercial or savings or other department of the bank. This right is subject to the limitation that the bank shall first set aside under control of the trust department as collateral security specified readily marketable securities as required by the Banking Board by rule."

Conduct Bank Holding Company Examinations

In 1988, the General Assembly authorized the expansion of interstate banking to Colorado, and it determined that primary consideration should be given to the protection of Colorado bank depositors. [Section 11-6.4-101, C.R.S.]. Consequently, Article 6.4 of Title 11, Acquisition of Control of Banks and Bank Holding Companies, was enacted, giving the Banking Board authority "to examine records and affairs of any bank holding company filing an application to acquire control of a Colorado bank or Colorado bank holding company . . . ." [Section 11-6.4-104, C.R.S.]. Pursuant to this statute, any such bank holding company is"subject to the jurisdiction of the banking board with respect to its operations and affairs in the state of Colorado. The banking board may utilize the applicable powers conferred by this code to carry out the duties imposed by this section."

The Division does not conduct on-site examinations of bank holding companies. It does receive and review bank holding company examination reports prepared by the FRB, and it has entered into an agreement with its certifying authority, CSBS, by which it has access to examinations of bank holding companies conducted by other state banking regulators. Nevertheless, CSBS continues to recommend that the Division should conduct on-site examinations of these entities, and it notes that the Division's decision not to examine holding companies "continues to be influenced by budget limitations, including restrictions on out-of-state travel." [CSBS Annual Review #2 of the Colorado State Banking Department for 1992]. The Division contests the need to conduct on-site examinations of bank holding companies, and it likewise contests CSBS's assertion that it is limited by budget and travel restrictions.

Notwithstanding budget limitations, out-of-state bank holding companies will be authorized by statute as of July 1, 1993 to acquire control of any Colorado bank and Colorado bank holding company either by acquisition or by de novo charter. [Section 11-6.4-103, C.R.S.]. Although Colorado may not see many of its banks so acquired, this statutory provision nevertheless liberalizes the extent to which out-of-state entities may conduct interstate banking by controlling state-chartered institutions. A significant by-product of this development is that state-chartered institutions will be dependent to some degree upon the decisions and financial integrity of its out-of-state holding company.

Under these circumstances, the state regulating agency should actively pursue its mission and regulatory authority to preserve the safety, soundness, and security of the state banking system and deposits. The statutory provision should be tailored to give the Banking Board the discretion to determine the frequency and scope of these examinations, and the prudent exercise of this discretion should eliminate any danger that these examinations will become unnecessarily burdensome to the industry. In fact, the Banking Board has recently required the Division to examine money order licensees by rotating on-site examinations with the Divisions' acceptance of audits and examination reports from other state regulatory agencies. Further, the cost of examining these entities can be deflected by enactment of a statutory provision which is already in effect with respect to examinations of controlling shareholders and its affiliated entities.

(Statutory)
Recommendation 11: **The General Assembly should adopt a new Section 11-6.4-104(2.5), C.R.S. to provide:**

"The commissioner shall examine, as often as deemed advisable and to the extent required by the banking board, the books, records, and affairs of any bank holding company which acquires control of a Colorado bank or Colorado bank holding company pursuant to this article for the purpose of determining the safety and soundness of the state bank. If the bank holding company's records are located outside this state, the bank holding company shall either make them available to the Division representative at a convenient location within this state or pay the reasonable and necessary expenses for the commissioner or her representative to examine them at the place where they are located. The commissioner may designate representatives, including comparable officials of the state in which the records are located, to inspect them on her behalf. If a bank holding company refuses to permit the commissioner to make an examination, the banking board may fine such bank holding company an amount not to exceed one thousand dollars for each day any such refusal continues. In lieu of any examination required by this subsection, the commissioner may accept either a report of examination from the Federal Reserve Bank, or an audit for the previous fiscal year prepared by an independent certified public accountant, independent registered accountant, or other independent qualified person. If the commissioner accepts an audit prepared by such independent person, no costs thereof shall be borne by the commissioner and all costs of such audit shall remain the obligation of the bank holding company. If the commissioner conducts an examination, a report in detail disclosing the results of such examination shall be prepared and a copy of such report shall be mailed to the bank holding company examined and state bank which it controls."

II. THE NEED TO PROMOTE REGULATORY PARITY AND SOUND COMPETITION AMONG FINANCIAL INSTITUTIONS

The policy of the State of Colorado, and the statutory mission of the Division of Banking, is to seek regulatory parity while promoting sound competition among financial institutions. These competing goals are linked since the promotion of sound competition is hindered when regulated industries are subjected to uneven regulatory scrutiny. Therefore, the Division's objective is to regulate its charges in a consistent, equitable, and balanced manner to encourage their competition on a level playing field.

Of course, varying degrees of risk associated with particular business practices of financial institutions may require different degrees of regulation. Nevertheless, the Division seeks to operate by the principle that all regulated financial entities should be regulated as equally as circumstances permit.

For the most part, the existing statutes successfully promote the policy goal of seeking parity. The suggestion that follows is directed towards ensuring that the financial institutions subject to the Division's jurisdiction are subject to comparable standards and receive equal treatment and consideration from its regulators.

Amend Trust Company Emergency Liquidation Procedure

The language in the statute governing the involuntary emergency liquidation procedure for trust companies is unnecessarily limiting and should be clarified. For the sake of fairness and regulatory parity, this statutory provision should be amended.

Section 11-23-122(2)(d) provides in pertinent part:

> If, in the opinion of the banking board, an emergency exists which may result in serious losses to the depositors, it may take possession of a trust company without a prior hearing.

This statutory provision was amended in 1989 to ensure that the involuntary liquidation procedures for trust companies were identical to the procedures used for banks and, therefore, the language from the banking code was copied. However, the use of the term "depositors" is an oversight since not all trust companies have depositors. Consequently, the power of the Banking Board to take possession of a trust company on an emergency basis to protect customers of a trust company that is not federally insured is subject to inconsistent interpretation. The provision should be amended to substitute "customers" for "depositors."

(Statutory)
Recommendation 12: **The General Assembly should amend Section 11-23-122(2)(d), C.R.S. to read in pertinent part: "If, in the opinion of the banking board, an emergency exists which may result in serious losses to the customers, it may take possession of a trust company without a prior hearing."**

III. THE NEED TO PROTECT COLORADO CONSUMERS

Today's consumers are exposed to a wide variety of financial products and services. Some of these financial services provide tremendous convenience and economic advantages, while other don't live up to their billing or, worse, result by design or chance in economic loss. Many consumers lack economic muscle, which means that we also face the mean prospect of uneven access or total inaccessibility to financial services. As recent lawsuits involving failed banks, savings and loans, and financial planning services have amply illustrated, all consumers run the risk of being victimized by unscrupulous or negligent individuals and financial institutions.

The foremost duty of the Division now, more than ever, is the protection of the public interest. Although the Division has successfully met this challenge to date, new threats to the public interest are constantly evolving, requiring the Division to be diligent in its role as protector. The following recommendations address situations which have recently provoked the public or which potentially jeopardize its interest.

Commission Task Force to Study Community Issues, Including Bank-Lending Bias and the Needs of the Unbanked Public

I. Discriminatory Lending Practices

A recent study conducted for the Denver Community Reinvestment Alliance (DCRA) concludes that the lending practices of 400 metro-area lending institutions are motivated by racial discrimination. Of the 42,259 loan applications submitted by black, hispanic, and white applicants, banks rejected 32% of the black loan applicants, 26% of the hispanic loan applicants, and 11% of the white applicants. These figures assume heightened tones of racism considering that, of the rejected loan applicants who were in the $50,000/year or more income bracket, 8% were white, 19% were hispanic, and 23% were black. [See Tables 11 and 12]. The DCRA study also concludes that blacks and hispanics are denied home mortgage loans two to three times more often than whites. [DCRA Study/Frank Ford, Colorado Center for Community Development at UCD, March 19, 1993; M. Eddy, Bank-Lending Bias Charged, Denver Post, Apr. 5, 1993, at C-1].

The DCRA study also alleges, but does not document, that bank policies and practices discriminate against people with disabilities in the areas of residential and commercial lending and employment and physical access to services.

Table 11

1991 LOAN REJECTION RATES BY RACE AND INCOME - ALL BANKS DENVER METRO

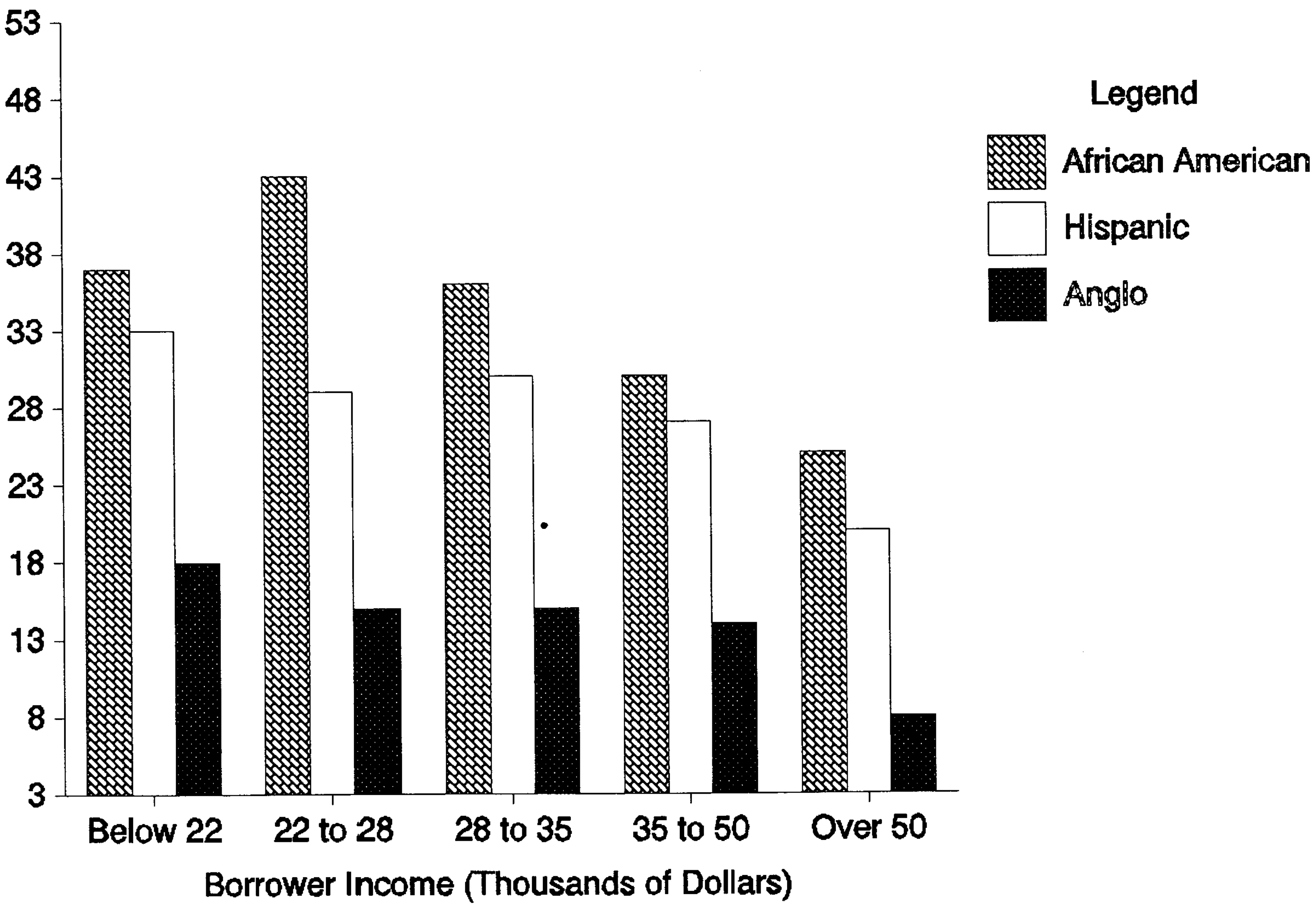

Table 12

LOAN REJECTION RATE BY RACE AND INCOME

Source: 1991 Home Mortgage Disclosure Data

All Banks Reporting Loans in the Denver Statistical Metropolitan Area
Prepared by Frank Ford, Colorado Center for Community Development
University of Colorado at Denver, March 19, 1993

	Less than 22,000			$22,000 to $28,000			$28,000 to $35,000			$35,000 to $50,000			Over $50,000			TOTALS
	Total Applic.	Applic. Denied	Rejection Rate	Total Applic.	Applic. Denied	Rejection Rate	Total Applic.	Applic. Denied	Rejection Rate	Total Applic.	Applic. Denied	Rejection Rate	Total Applic.	Applic. Denied	Rejection Rate	
African American	346	130	38%	167	70	42%	208	72	35%	305	86	28%	322	73	23%	1348
(Ratio to Anglo)			(2.11:1)			(3.0:1)			(2.5:1)			(2.55:1)			(2.88:1)	
Hispanic	749	231	31%	464	131	28%	455	127	28%	662	163	25%	571	109	19%	2901
(Ratio to Anglo)			(1.72:1)			(2.0:1)			(2.0:1)			(2.27:1)			(2.38:1)	
Anglo	4733	832	18%	2830	410	14%	4084	561	14%	8976	1004	11%	17387	1449	8%	38010
	5828			3461			4747			9943			18280			42259

	Total Applic.	Applic. Denied	Rejection Rate
All African American	1348	431	32%
(Ratio to Anglo)			(2.91:1)
All Hispanic	2901	761	26%
(Ratio to Anglo)			(2.36:1)
All Anglo	38010	4256	11%
	42259		

Colorado's Division of Civil Rights has also released findings, based on a report commissioned to study minority borrower access to mortgage credit, which concludes that minorities are more likely to be denied mortgage loan applications than whites in all income brackets, even when the loan to income ratio is equal to or less than that of whites. [K. Flaming & R. Anderson, "Mortgage Practices in Colorado: A Report to the Public Based on Home Mortgage Disclosure Act Data and A Community Reinvestment Act Study" (June 1993)]. The Division of Banking reports that approximately 4% of the financial institutions subjected to the study were state-chartered banks. Most of the remaining institutions which were studied were comprised of unregulated mortgage companies (approximately 80%), national banks and thrifts, and credit unions (16%), over which the Division has no jurisdiction. Nevertheless, the statistics cited by the Colorado Division of Civil Rights support the disturbing fact that lending discrimination and redlining practices continue in Colorado.

At the federal level, federal member and FDIC-insured banks must comply with the Community Reinvestment Act (CRA), legislation which outlines and monitors certain social responsibilities with which banks must comply. Specifically, CRA requires banks to delineate and describe their local communities; to explain how the bank provides credit to the community; to provide information to consumers regarding its community efforts; and to maintain for the public a CRA file that contains information regarding the bank's lending practices. Federal regulators examine banks for CRA compliance, specifically evaluating certain areas such as the bank's marketing programs, and its credit extension or denial record. The Colorado Division of Civil Rights report found that some financial institutions are able to provide the public with required CRA material handily, while others are ill-prepared to do so.

Banks typically deride the CRA as "social" legislation which, they charge, hasn't anything to do with safety and soundness and only succeeds in adding to over-regulation. The Colorado Bankers Association objects to CRA regulatory mandates and strongly objects to any proposals which would require banks to comply with state-mandated CRA requirements. To date, New York is the only state in the union which has passed a state counterpart to the federal CRA.

However, the lending practices as outlined by these latest study compel the conclusion that discrimination is alive in Colorado to the detriment of consumers. These practices are in stark derogation of state law and policy. Although discriminatory lending is not confined to state-regulated banks, the Division's mission to protect the public interest requires meaningful action.

II. The Needs of the Unbanked Public

In 1990, the PITON Bank Group conducted a study to ascertain the credit and banking needs of four low-income metropolitan neighborhoods: Barnum, Five Points, Westwood, and Whittier. The group initiated the project on the premise that the lower income neighborhoods in Denver and across the country have withered in large part because they do not have true access to banks and banking services and, thus, are underserved, or "unbanked." It sought to identify ways to meet the financial needs of the residents and businesses in these neighborhoods and to focus on the barriers which prevent financial institutions from meeting credit and financial needs.
In general, the study concluded that demand and opportunity for banking and credit services are strong within the four targeted neighborhoods. There is a high demand for banking and credit services, including traditional and non-traditional home mortgage, home improvement, and small business loans but, according to the report:

> There is a prevailing attitude among these neighborhoods that banks have ignored them and haven't made the effort to understand or learn about the community or their banking needs. . . . [M]any feel that banks need to provide information and education about their products and services to the communities. . . .

[Executive Summary, Banking and Credit Needs Assessment (December 19, 1991)].

Perhaps the most disturbing statistic from a regulator's perspective is that the "unbanked" do not receive financial services from regulated entities since checking accounts are perceived as being too expensive, restrictive, difficult to use, and not necessarily accessible to low income consumers. Changes made by banks in the 1980's resulted in more expensive and less convenient banking services for many consumers, contributing to an increase in unbanked consumers. [J. Caskey, Check-Cashing Outlets in the U.S. Financial System, Fed. Res. Bank of K. C. Econ. Rev. (November/December 1991)].

In Denver, 31% of the Whittier respondents and 39% of the Five Points respondents stated that they did not have an account at a bank, savings and loan, or credit union, while this unbanked rate was 15% in Barnum and Westwood. The supermarket is used a the primary financial services center for 22% of Five Points residents, for 42% of the unbanked, and 37% of the poor. In addition, 48% of the unbanked use a paycheck cashing card because of the real or perceived difficulty of cashing paychecks at a bank without benefit of an account. While this 1991 information is confined to a narrow sector of the population and is, by now, stale, it demonstrates a critical need among those who do not possess economic power for reliable, accessible financial services and products.

The unbanked presently rely on certain unregulated resources, which raises the possibility that they are paying a high or unfair price for the services they receive. For example, check cashing operations in Denver have mushroomed in the recent past. Check-casher operations are traditionally concentrated in lower-income urban areas as cheaper and more convenient financial sources than banks, although they appear to be expanding beyond this base. An informal telephone survey of these metropolitan businesses verifies that all such operations presently charge fees for their services, and a few charge exorbitant rates. Outlets which cash government checks charge fees which range from 1.5 to 6% of the amount of the check. Two party checks are cashed for fees ranging from 3 to 16%, although one outlet charges 23% for "advancing" funds on a two-party check. Personal checks are cashed for fees running up to 10%

The public policy concern is that most consumers primarily served by check cashers can least afford to bear excessive fees. Therefore, some states currently regulate check cashers by setting ceilings on check-cashing fees. Other common regulatory requirements include licensing, bonding, examination, and consumer disclosure schemes. These regulations are implemented to promote the public policy of ensuring the delivery of affordable financial services to low-income households -- to protect a consumer group which is viewed as relatively unsophisticated with little social or economic power. However, the evidence suggests that the state must devote resources to enforce compliance with the statute to ensure its effectiveness; passive regulation is ineffective. [J. Caskey, Check-Cashing Outlets in the U.S. Financial System, Fed. Res. Bank of K. C. Econ. Rev. (November/December 1991)].

The current base of available information regarding the accessibility of services offered to low-income groups and their cost is insufficient to warrant a conclusion that sectors of the financial industry, such as check cashers, should be state regulated. Moreover, check cashers who charge excessive fees for post-dated checks, which are considered loans, are currently subjected to the jurisdiction of the Attorney General's Uniform Consumer Credit Code office. However, the balance of check casher transactions are wholly unregulated. When the DCRA and Division of Civil Rights survey results are viewed with the needs and habits of Denver's unbanked low-income population and the abuses which some alternative financial servicers have committed against this group, it is clear that the public interest demands further inquiry into this area.

III. Additional Loan Production Offices

As an adjunct to the needs of the economically disadvantaged and/or unbanked public, the Division believes that there may exist a growing interest among bankers to allow state-chartered banks to operate more than one loan production office. Currently, Section 11-6-101(1), C.R.S. provides that a bank can only have one loan production office. However, should this provision be amended to permit bankers to operate additional loan production offices, the Division believes that additional minority lending opportunities may result. The feasibility of this approach should likewise be considered as a means of serving the public interest.

(Administrative)
Recommendation 13: **The General Assembly should direct the Executive Director of the Department of Regulatory Agencies to appoint members to a task force that should be commissioned for the purposes of: (1) evaluating reports of lending discrimination against minorities and crafting possible solutions thereto; and (2) identifying whether the banking needs of low-income and other disadvantaged consumers requires further state regulation or legislation.**

Trust Company Fees Should be Fully Disclosed

The Division of Banking reports that most complaints it fields deal with fees charged for trust account services. The Division of Securities also reports having received complaints about trust company fees from consumers. This Division also reports that it receives a quarterly print-out from the Securities and Exchange Commission which reflects the volume of complaints that are lodged against Colorado entities by people outside of Colorado. The Commissioner of Securities represents that, in a recent print-out, the one Colorado entity against which people from outside Colorado lodged the most complaints is a state-chartered trust company. Although the subject matter and legitimacy of the complaints are not disclosed by the SEC on its printout, the Commissioner of Securities suspects that the complaints may deal primarily with trust company fees imposed against customers who hold self-directed accounts. Some complaints regarding trust companies are resolved informally by the Division of Banking's intervention as an intermediary.

Typically, trust companies charge: (1) an annual administration fee which is flat, based on assets or income, or a combination; (2) a transaction fee for each purchase, sale, or distribution; (3) a termination fee for closing an account; (4) an origination fee of opening an account; and (5) fees for special or unusual services, such as an asset charge for holding mortgages.

The Division reports that most complainants are disgruntled because they are either hit with high termination fees after neglecting to read the account agreement which sets out fee schedules, or they do not wish to pay for charges accruing on account transfers which are slow. Another common complaint relates to increased fee schedules. The Commissioner of Securities believes that many fee complaints arise when trust companies act in their custodial capacity. In other words, when consumers request broker-dealers to purchase self-directed accounts, such as IRA's, consumers may or may not be furnished with the trust company's fee schedule. Once the trust company starts maintaining the account, however, various fees are imposed upon the customer's account as a matter of course.

Although the issue of regulating trust company fees has been presented to the Banking Board for discussion as recently as August 1992, the Banking Board has refused to regulate or to cap trust company fees since it has no statutory authority to do so. However, the issue of the Banking Board's jurisdiction over trust company fee regulation should be revisited in light of consumer complaints and trust company fee abuses which were illustrated in a recent lawsuit.

In the recent case of **Upp v. Mellon Bank, N.A.**, 799 F. Supp. 540 (E.D. Pa. 1992), the District Court of Pennsylvania awarded plaintiffs a judgment in excess of $55 million, plus punitive damages, against a trust company for charging clients excessive "sweep" fees while performing a fiduciary investment function. The court reasoned that the fees which Mellon charged its clients violated the state statute permitting fiduciaries to make "reasonable" charges for its temporary investment of fiduciary funds. The court based its decision on the rationale that the trust company was "double-dipping" by charging its customers a standard management fee and then topping it off with an unreasonable sweep fee for its services. The unreasonableness of this charge was heightened by Mellon's failure to inform its trust customers, in meaningful terms, of the application of sweep fees. The court stated: "In short, by charging excessive sweep fees, Mellon is simply feathering its own nest at the expense of funds it holds in trust." Id. at 542. Accordingly, it held that Mellon breached its fiduciary duties. The Third Circuit reversed this decision on the grounds that disclosure of sweep fees charged by trust companies should be decided by state courts. Nevertheless, the substance of the Mellon Bank case demonstrates that the potential for abuse which exists in the trust company fee area.

The Division reports that, over the past year, it has received approximately fifty complaints relating to trust company fees. Although these complaints must be viewed in context of the 627,717 customer accounts held in Colorado trust companies, this figure does not take into account the number of complaints received by the Division of Securities or by the SEC. Many of these customers are out-of-state consumers who do not possess easy access to their institutions, relying instead upon the intermediation of the Division. The numbers point up the fact that trust companies typically operate to their customers' satisfaction; nevertheless, the potential for abuse exists in areas of fee reasonableness and disclosure.

Under these circumstances, consumer protection measures should be enacted in our state. Illinois and Pennsylvania have enacted legislation which permits fiduciaries to receive "reasonable" compensation for their services. [See Ill. Ann. Stat. ch. 17 Section 1552-3 (Smith-Hurd 1992)]. However, this language requires legal construction to shield consumers from incurring "unreasonable" fees.

Colorado's trust company industry reports that most Colorado trust companies routinely provide disclosure to their customers about their fees in contract documents. They also reportedly extend a grace period after a fee increase within which consumers may terminate or transfer their accounts without penalty. It is apparent that if trust companies already engage in the business practice of disclosing their fees and extending penalty-free grace periods to consumers, then a statute vesting the Banking Board with the authority to require trust companies to comport with these good business practices shouldn't impose an undue or unnecessary burden upon the industry. Such a statute will, however, guarantee consumers the information upon which they can make informed choices.

(Statutory)
Recommendation 14: **The General Assembly should amend Section 11-23-101, et seq. to authorize the Banking Board to require trust companies, through rulemaking, to provide their customers with written disclosure regarding trust company account fees and a penalty-free grace period within which to terminate their trust accounts upon a fee increase.**

Adopt the "Prudent Investor" Rule

Section 11-23-111, C.R.S. provides that "[a] trust company in the exercise of its fiduciary powers shall be subject to the same duties, liabilities, and penalties as an individual fiduciary acting in like capacity." Therefore, trust companies performing fiduciary duties are subject to the "prudent man rule" codified in Section 15-1-509, C.R.S., which provides:

> In the exercise of any of the powers granted in this part 5, a fiduciary has a duty to act reasonably and equitably with due regard for his obligations and responsibilities toward the interests of beneficiaries and creditors and the estate or trust involved and the purposes thereof and with due regard for the manner in which men of prudence, discretion, and intelligence would act in the management of property of another.

This standard of care is adopted from the prudent man rule as set out in the Restatement (Second) of Trusts section 227. However, this rule has been recently revised in Restatement (Third) of Trusts section 227 (1992) as the "prudent investor" rule. This rule seeks to eliminate some of the "arbitrary restrictions" which courts have imposed on trust investment activity and which the Restatement characterizes as unwarranted and counterproductive. Also inherent in the standard is the realization that trust companies or professional fiduciaries possess higher standards of skill to which they must adhere. As Illustration 10 in the Restatement discussion notes:

> [A trust company] has a duty to make use of facilities and to exercise a degree of skill consistent with the facilities and skill possessed, or those actually or impliedly represented to be possessed, by the trust company. This would include both professional sensitivity to the duty of caution and professional sophistication in establishing and implementing an appropriate investment strategy for the trust for the benefit of [the beneficiary].

Thus, the Restatement has generated an updated standard of care which is aligned with current knowledge, practice and experience in the modern investment world:

> [T]he prudent investor rule of this Restatement seeks to modernize trust investment law and to restore the generality and flexibility of the original doctrine. The language of the prudent investor rule and the accompanying Comments in section 227 are thus intended to preserve the law's adaptability by confining its mandates to those that seem essential to prudence (based on traditional duties of care, skill, and caution), to the protection of fiduciary goals, and to supplying helpful guidance to courts and trustees. The rule's mandates are limited to principles that are supported by general consensus among various theories and that are adaptable to the differences among various trusts, trustees and their needs and objectives.

Essentially, the revised Restatement sets out principles of prudence which reflect that sound diversification is fundamental to risk management and is therefore normally required of trustees; that risk and return are directly related, requiring analysis and decisions; that trustees have a duty to avoid unjustified fees, transaction costs and expenses; that the fiduciary duty of impartiality requires a balancing of certain elements; and that trustees may have a duty to delegate.
The new rule is expressed as follows:

Section 227. **General Standard of Prudent Investment**

The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

(1) conform to fundamental fiduciary duties of loyalty and impartiality;

(2) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and

(3) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.

(d) The trustee's duties under this Section are subject to the rule of section 228, dealing primarily with contrary investment provisions of a trust or statute.

Adoption of this revised standard of care will protect consumers who rely upon fiduciaries for investment advice and decisions while protecting fiduciaries from unreasonably restrictive standards which are counterproductive in today's market. This rule fundamentally requires fiduciaries who hold themselves out as experienced and qualified professionals to adhere to a higher standard of care than their less-experienced counterparts. It should be noted that adoption of this new standard will affect institutions other than trust companies and banks, including, for instance, estate planners.

(Statutory)
Recommendation 15: **The General Assembly should amend Section 15-1-509, C.R.S. to replace the prudent man standard of care with the prudent investor standard of care as established in Section 227 of the Restatement (Third) of Trusts.**

IV. The Need to Promote Organizational Competence and to Preserve Resources

The limited state of the Division's automation has been discussed at length elsewhere in this report and requires no further elaboration. Likewise, the need to preserve and promote organizational competence is self-explanatory in a Division which assumes the role of primary regulator for a complex and technical field. The following recommendations are intended to preserve and promote the Division's goals to increase its competence and resources.

Fully Automate Division Functions

When compared with its abject lack of automation five years ago, the Division's automation capabilities have improved 100%. Having said that, however, perhaps the most pervasive problem day-to-day problem which the Division encounters is its lack of an integrated database owing to the Division's lack of uniform computer equipment and software. Since some Division staff operate with a Wang system and others with personal computers, the Division has no central automated base of information. This deficiency interrupts the productivity and efficiency of each and every Division employee.

The Division will soon receive new equipment which will permit it to be linked up to DORA's LAN RS-6000 system. The LAN system is composed of PC's with uniform software which will be hooked up to all Division equipment. Therefore, the Division's automation problem will be resolved to the extent that it will be operating with one data base from which information can be accessed.

However, in order to capitalize on this new tool, the Division will have to devote resources toward developing, rewriting or purchasing applicable software programs. For example, computerized examination templates for safety and soundness need to be improved and refined, and specialty examination templates need to be developed. The Division will also have to devote resources toward the consistent input of information into an automated data base so that it can be accessed uniformly. If this is done, supervising examiners will be able to access automated financial information, and field examiners will be able to download this information onto hard disks and utilize it while conducting on-site examinations. These tools will help improve the Division's information resources while an historical data base is being developed.

The Division's receipt of new computer equipment which is linked to the LAN system will permit it to automate many aspects of its operations. It should aggressively integrate all systems to the extent possible so that it can more effectively regulate an automated industry.

(Administrative)
Recommendation 16: **The Division should automate all possible functions once it receives new computer equipment.**

Automate Recordkeeping

The strides which the Division has made in fundamental areas of operation are exhibited by its incorporation and implementation of a recordkeeping system and associated policies and procedures. This development is crucial, particularly since the Division is inundated with paper on a daily basis.

However, staff continues to report inefficiencies which are inherent in a system which depends on automated list processing and individuals routing paper and files to the proper place. Sometimes paper ends up on a desk in a logjam; other staffmembers hold onto files to ensure their ability to locate important material which otherwise might not be found in its proper place in a timely manner.

These problems can be eliminated by the implementation of an automated imaging system. This system operates by feeding a document into a machine which scans, prints, and indexes it into the computer system. All documents which are scanned are on-line and accessible on computer to all staff, who can conduct computer searches for documents, bring them up on screen for review, and annotate them if they wish. The Division will be able, under this system, to scan each piece of paper which it receives or generates for immediate computer access by Division employees and then to file the hard copy as appropriate.

Imaging is an option which other divisions in DORA are currently thinking about incorporating. Although the Division of Banking will be able to incorporate imaging once it receives its new equipment this summer, it is an expense which the Division will not be able to shoulder immediately given other priorities. Nevertheless, its implementation should be given serious consideration, particularly since automation of this function will increase the accessibility of information, enhancing the Division's off-site monitoring function.

(Administrative)
Recommendation 17: **The Division should consider improving its recordkeeping function by using a computerized imaging system.**

Increase Training for All Division Employees

Much staff training is conducted on the job. In addition, the Division has implemented a training program which is predicated upon individual training plans established in conjunction with most employee PACE plans and upon in-house training which the Division conducts quarterly. In FY 1992-1993, the Division expended approximately $20,850 on 1,188 hours of training.

In addition to these positive efforts, CSBS continues to recommend that the Division increase its training budget and incorporate or emphasize training in certain areas, including holding company examinations, a recommendation with which some Division staff and industry members agree. The Division does not agree that its training budget should be increased since it can secure free expert training. Nevertheless, in a field in which new developments are constantly evolving, the Division must continue to provide its employees with timely information and training.

(Administrative)
<u>Recommendation 18:</u> **The Division should increase its training budget and continue to emphasize staff training, particularly in the areas of compliance and holding company examinations.**

<u>Promulgate Uniform Evaluation Procedures</u>

The Division employs an evaluation technique with respect to safety and soundness examiners on a frequent basis which should be formalized.

Safety and soundness field examination teams usually consist of one "loan" and one "detail" person who are charged by the OSM with certain responsibilities. After each examination, the detail person receives a "special" written evaluation by the OSM. The "loan" person is not evaluated after every examination. However, because examiners are rotated between detail and loan duties, examiners are evaluated on a regular basis in addition to their annual performance rating and interim progress review.

The Division defends its detail person evaluation policy on the ground that the performance of this position is critical to the proper functioning of an exam. However, because the duties for which the detail person is evaluated are difficult and complex, many examiners perceive that the evaluation policy relative to detail assignments may be used unfairly against the employee. The special evaluation of the detail person should continue so long as they are conducted pursuant to Division policy and procedures which alleviate any perception of arbitrariness.

(Administrative)
<u>Recommendation 19:</u> **The Commissioner should promulgate policies and procedures requiring uniform evaluations of detail persons assigned to an on-site examination.**

V. Statutory Revisions

The following statutory change proposals have been prepared by the Division of Banking in cooperation with the Executive Director of the Department of Regulatory Agencies. Each proposed amendment includes a discussion of the need for the changes and suggested language, or a recommendation concerning the needed legislative action.

Permit Written Certification of the Authenticity of Division Records

Division employees are required on occasion to appear in court to testify that Division records which are being offered into evidence are authentic. This procedure has cost the Division time and money and is unnecessary. The provision which exempts the Division of Securities from performing this function should be adopted by the Division of Banking.

Recommendation 20: **The General Assembly should amend Section 11-2-111(3) to provide:**

"Upon request and at such reasonable charges as she prescribes, the Commissioner of Banking shall furnish to any person photostatic or other copies of any document which is a matter of public record. Such a certified copy may be introduced in evidence as if it were the original. In any proceeding or prosecution under this article, and any copy so certified is prima facie evidence of the contents of the entry or document certified."

Modify Banking Board Congressional District Requirement

Section 11-2-102(2)(c) states: "Not more than one banker member of the banking board appointed pursuant to paragraph (a) of subsection (2) shall be from any one congressional district, and of the four state bank members and the one industrial bank member and one trust company member of the banking board, not more than three shall be of the same major political party." Subsection (2)(a) refers to the four state bank board members, while subsections (2)(a.1) and (a.2) refer to the industrial bank and trust company board members. Nevertheless, the statutory congressional district limitation provision is ambiguous since it may also apply to the industrial bank representative listed in subsection (2).

Clarification of this provision's application to "state bank" members only will alleviate the confusion which has apparently resulted whenever the industrial bank member's seat has become vacant. Moreover, the clarification as requested will not jeopardize the intent of the General Assembly, as provided in section 11-2-102(d), that "of the eight members appointed under this subsection (2), at least one shall be appointed from each congressional district of the state."

<u>Recommendation 21:</u> **The General Assembly should amend Section 11-2-102(2)(c) to provide that: "Not more than one state bank member of the banking board appointed pursuant to paragraph (a) of this subsection (2) shall be from any one congressional district, ..."**

<u>Modify Banking Board Political Representation Requirement</u>

The Commissioner and most of the Banking Board also share the opinion that the political affiliation requirement in section 11-2-102(2)(c) should apply only to the four state bank members. State (commercial) banks constitute a large constituency which is represented by the largest voting block on the Banking Board. Hence, unlike the other board members who represent small numbers of institutions, there is a danger that this group could form an homogenous political block which would destroy the balance of representation.

However, the amount of remaining institutions are not numerous enough to warrant concern over the inequality of political representation. In fact, neither the Commissioner nor various Banking Board members can recall instances in which the political affiliation of Board members motivated or influenced Board votes. The Division would like to simplify the process of replacing board members by eliminating the political representation requirement for the trust company and industrial bank representatives.

<u>Recommendation 22:</u> **The General Assembly should consider amending Section 11-2-102(c) to provide that the political affiliation requirements of board members should apply only to state bank members.**

Revise Obsolete Bank Holding Statute

Section 11-6.4-103(7), C.R.S. addresses interstate bank acquisitions and requires out-of-state bank holding companies to satisfy a federal minimum ratio of total capital to total assets requirement before acquiring control of a Colorado bank or bank holding company. However, this ratio, which used to be required and employed by the Federal Bank Holding Act and the Federal Reserve Board, is now obsolete. This statutory provision should be amended so that the present requirement is replaced with the standard now employed by federal legislation or the Federal Reserve Board.

Recommendation 23: **The General Assembly should amend Section 11-6.4-103(7) to replace the obsolete federal minimum ratio requirement with the proper federal capital standard.**

Amend the Division's Annual Report Requirement

The Division of Banking is currently required to publish an annual report pursuant to Section 11-2-110, C.R.S. This statute requires the Division to disclose a considerable amount of information in the annual report, including a tabular statement of condition for each bank, as well as the text of every rule issued by the Banking Board during the year. The Division reports that this requirement is one of the most burdensome in the nation, and that this information is already available to the public in a variety of formats. Further, publication of this report has become extremely burdensome on the Division since it requires the efforts of one staffperson, with the assistance of two or three other Division staff, a period of three to four months to prepare the report. Under these circumstances, Section 11-2-110 should be revised and patterned after Michigan's banking statute, which requires the Division of Banking to publish an annual report on the condition of state-chartered banks in such form as the Commissioner determines to be necessary and appropriate.

Recommendation 24: **The General Assembly should repeal and reenact Section 11-2-110, C.R.S. to provide:**

"For each calendar year the commissioner shall compile and publish an annual report in such form and containing such information as the commissioner may determine necessary to reasonably summarize the operations of the bureau during such year."

APPENDIX 1

SUNSET STATUTORY EVALUATION CRITERIA

(I) Whether regulation by the agency is necessary to protect the public health, safety and welfare; whether the conditions which led to the initial regulation have changed; and whether other conditions have arisen which would warrant more, less or the same degree of regulation;

(II) If regulation is necessary, whether the existing statutes and regulations establish the least restrictive form of regulation consistent with the public interest, considering other available regulatory mechanisms and whether agency rules enhance the public interest and are within the scope of legislative intent;

(III) Whether the agency operates in the public interest and whether its operation is impeded or enhanced by existing statutes, rules, procedures and practices of the Department of Regulatory Agencies and any other circumstances, including budgetary, resource and personnel matters;

(IV) Whether an analysis of agency operations indicates that the agency performs its statutory duties efficiently and effectively;

(V) Whether the composition of the agency's board or commission adequately represents the public interest and whether the agency encourages public participation in its decisions rather than participation only by the people it regulates;

(VI) The economic impact of regulation and, if national economic information is available, whether the agency stimulates or restricts competition;

(VII) Whether complaint, investigation and disciplinary procedures adequately protect the public and whether final dispositions of complaints are in the public interest or self-serving to the profession;

(VIII) Whether the scope of practice of the regulated occupation contributes to the optimum utilization of personnel and whether entry requirements encourage affirmative action;

(IX) Whether administrative and statutory changes are necessary to improve agency operations to enhance public interest.

APPENDIX 2

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Table II.35.

BANK SECURITIES AUTHORITY-DECEMBER 31, 1992

	Brokerage		Underwriting			
				Municipal		
	Discount	Full	General Securities	General Obligation	Revenue	Notes
AL	Yes*	Yes*	No	No	No	* Through a Subsidiary.
AK	No	No	No	No	No	
AZ	Yes	No	Yes*	Yes*	Yes*	* Through a Subsidiary.
AR	Yes	Yes	No	No	No	
CA	Yes*	Yes**	Yes**	Yes*	Yes*	* State laws are Silent, but State Banking Authorities indicate approval would be granted. ** Possible through Equity Investment Authority. Banks may engage in percentage leasing of space.
CO	No	No	No	No	No	
CT	Yes*	Yes*	Yes*	Yes*	Yes*	* State Law is Silent Concerning Direct Exercise of Power Through Bank, But Power Can be Exercised Through a Subsidiary.
DE	Yes	Yes	Yes	Yes	Yes	
FL	Yes	No	Yes*	Yes**	Yes**	* Permitted Though State Banking Laws are Silent; Activity is Allowed Only by Nonmember Banks and Only Through a Subsidiary. ** Permitted Though State Banking Laws are Silent. With Permission of State Banking Authorities.
GA	Yes	Yes	No	Yes*	Yes*	* For Banks With Capital and Surplus of More Than $20 Million.
HI	Yes*	No	No	No	No	* State Laws Are Silent, But Regulatory Approval is Possible.
ID	Yes*	Yes*	No	No	No	* State Law is Silent, But Regulatory Approval is Possible.
IL	Yes	No*	No	No	No	* Full-Service Brokerage Permitted Through a Wholly-Owned Subsidiary.
IN	Yes	Yes	No	Yes	No	

Table II.35. Continued from preceding page.

BANK SECURITIES AUTHORITY-DECEMBER 31, 1992

	Brokerage		Underwriting			
				Municipal		
	Discount	Full	General Securities	General Obligation	Revenue	Notes
IA	Yes	Yes*	Yes*	Yes*	Yes*	* Through a Subsidiary.
KS	Yes	Yes*	No	Yes*	No	* Through a Subsidiary.
KY	Yes	No	No	No	No	
LA	Yes	No	No	No	No	
ME	Yes	Yes	Yes*	Yes*	Yes*	* Through a Subsidiary.
MD	Yes	Yes*	No	No	No	* Whatever a National Bank May do.
MA	Yes	Yes*	Yes*	Yes*	Yes*	* Possible Through Equity Investment Authority.
MI	Yes	Yes	*	Yes	No	* Only Obligations of U. S. Government and Political Subdivisions.
MN	Yes	Yes*	No	Yes	No	* Through a Subsidiary.
MS	No	No	*	Yes	Yes	* Only Federal, State and Local Government Issuers.
MO	Yes	Yes*	No	Yes**	Yes**	* Through a Subsidiary. ** Through a Subsidiary and Only to the Extent of Bank's Legal Loan Limit.
MT	No	No	Yes*	Yes*	Yes*	* Limited to Banks With at Least $5 Million in Capital.
NE	Yes	Yes	*	Yes	No	* Only U. S., State and Local Government General Obligations.
NV	Yes	*	*	*	*	* State Banking Law is Silent.
NH	Yes*	*	*	*	*	* State Banking Laws are Silent.
NJ	Yes	Yes*	Yes**	Yes	Yes**	* Possible Through Leeway Authority. ** Possible Through Leeway Authority, But Only On Specific Application and Approval.
NM	Yes	No	No	Yes	No	

Table II.35. Continued from preceding page.

BANK SECURITIES AUTHORITY-DECEMBER 31, 1992

	Brokerage		Underwriting			
				Municipal		
	Discount	Full	General Securities	General Obligation	Revenue	Notes
NY	Yes	Yes	Yes*	Yes	Yes*	* State-chartered Banks are Permitted Through Affiliates or Subsidiaries to Underwrite and Deal in Certain Securities Provided That Such Dealing and Underwriting Does Not Constitute More Than 25 Per Cent of the Affiliate's or Subsidiary's Total Dealing and Underwriting Business.
NC	Yes	Yes**	Yes**	Yes*	Yes*	* Possible Through Equity Investment Authority. ** State Law is Silent, but Activity Would be Allowed Only Through Equity Investment Authority.
ND	Yes	Yes	No	No	No	
OH	Yes	Yes*	No	Yes	No	* Through a Subsidiary.
OK	Yes*	Yes*	No	Yes	Yes	* On Customer Order.
OR	No	No	No	No	No	
PA	Yes	No	Yes*	Yes	No	* Mortgage-Backed Securities, Only.
PR	No	No	No	Yes*	Yes*	* Governments, Agencies and Their Instrumentalities.
RI	*	*	*	*	*	* Unclear whether Activity is Possible, Banking Laws are Silent.
SC*	No	No	No	No	No	* Based on December 31, 1991 data.
SD	No*	No*	No*	No*	No*	* State Banking Laws Are Silent, But State Banking Authorities Indicate Approval Unlikely.
TN	Yes	Yes*	Yes*	Yes*	Yes*	* Regulations Allowing These Activities are Effective 09/26/90.
TX	Yes*	Yes*	Yes*	Yes*	Yes*	* Through a Subsidiary.

Table II.35. Continued from preceding page.

BANK SECURITIES AUTHORITY-DECEMBER 31, 1992

	Brokerage		Underwriting			
				Municipal		
	Discount	Full	General Securities	General Obligation	Revenue	Notes
UT	Yes*	No	No	Yes	Yes	* Through a Subsidiary.
VT	Yes	Yes	*	Yes	Yes	* Only for Federal, State and Local Government Entities.
VA	Yes*	No	No	No	No	* Through a Subsidiary.
WA	Yes*	Yes*	No	Yes	Yes	* Through a Subsidiary.
WV	Yes*	Yes	Yes	Yes	Yes	* Possible Through Equity Investment Authority.
WI	Yes	No	No	No	No	
WY	*	*	*	*	*	* State Laws are Silent. State Authority's Practice is to Prohibit These Activities.

Table II.33.

SELECTED STATE-CHARTERED BANK* EXPANDED ACTIVITIES: STATE AUTHORIZATION
DECEMBER 31, 1991

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* Expanded activities above those permitted national banks and bank holding companies under the bank holding company act. Extent of practice unknown.

1 Through a subsidiary.
2 Laws are silent, but regulatory approval is possible.
3 Possible through equity investment authority.
4 Possible through leeway authority.
5 Only in towns with less than 200,000 population.
6 Permitted in towns with a population of less than 5,000.

Table II.34.

BANK REAL ESTATE AUTHORITY-DECEMBER 31, 1992

State	Real Estate Brokerage	Equity Participation[1]	Real Estate Development[2]	Notes
AL	Yes*	No	No	* Through a Subsidiary.
AK	No	No	No	
AZ	Yes*	Yes*	Yes*	* Through a Subsidiary.
AR	No	Yes*	Yes*	* Investment Limited to 20 Per Cent of Capital, Unimpaired Surplus and Undivided Profits.
CA	Yes*	Yes**	Yes**	* Possible Through Equity Investment Authority. ** May be Conducted Either in Bank or in Subsidiary. Bank Limit is 100 Per Cent of Equity; Subsidiary Limit is Ten Per Cent of Assets.
CO	No	Yes*	Yes*	* Aggregate Investment Limited to 10 Per Cent of Assets.
CT	Yes*	Yes*	Yes*	* Leeway Authority is Available or Other Applicable Statutory Authority.
DE	No	No	Yes*	* If Established Prior to 1933.
FL	Yes*	Yes*	Yes*	* Through a Subsidiary. Limited to 10% of Total Bank Assets (5 Percent for Banks Less Than Three Years Old).
GA	Yes	Yes*	Yes*	* Investment Limited to Lesser of Borrowers' Equity Interest or 25 Per Cent of Appraised Value of Real Estate. Investments and Loans Aggregated May Not Exceed Lending Limits. Aggregate Bank Investment in Real Estate Equity Participation May Not Exceed Bank's Statutory Capital Base.
HI	No	No	No	
ID	Yes*	No	No	* State Law is Silent, But Regulatory Approval is Possible.
IL	No*	No	No*	* Corporate Fiduciary Department May Develop and Broker Real Estate Held in Trusts.
IN	No	No*	No	* Equity Limited to 2% of Capital and Surplus in Individual Projects and 5% of Capital and Surplus in the Aggregate.
IA	Yes	Yes*	No	* Limited to 20 Per Cent of Capital and Must be for Economic or Community Development Purpose.
KS	No	No	No	
KY	No	Yes*	Yes*	* Aggregate Investment Limited to 10 Per Cent of Capital and Surplus.
LA	No	No	No	

Table II.34. Continued from preceding page.

BANK REAL ESTATE AUTHORITY-DECEMBER 31, 1992

State	Real Estate Brokerage	Equity Participation[1]	Real Estate Development[2]	Notes
ME	*	Yes	Yes	* Bank-Owned Property, Only.
MD	No	No	No	
MA	Yes*	Yes*	Yes*	* Possible Through Equity Investment Authority.
MI	No	No	Yes*	* Limited to Ten Per Cent of Total Assets.
MN	Yes*	No	Yes**	* Through a Subsidiary. ** Limited to Two Per Cent of Capital and Surplus for Projects Designed to Promote Community Welfare.
MS	No	No	No	
MO	No	Yes*	Yes*	* Through a Subsidiary. Cumulative Investment Limited to Five Per Cent of Total Assets; No More Than 20 Per Cent of Unimpaired Capital May be Invested in One Project.
MT	No	No	No	
NE	Yes*	No	No	* Through a Person Licensed as a Real Estate Broker.
NV	No	Yes*	Yes*	* Investment Limited to Lesser of Ten Per Cent of Assets or 100 Per Cent of Capital.
NH	*	Yes**	Yes**	* Bank-Owned Property, Only. ** Through a Subsidiary.
NJ	Yes*	Yes**	Yes**	* Only Through Leeway Investment. ** To the Same Extent as Federal Thrifts or Through Leeway Authority.
NM	No	No	No	
NY	No	No	No	
NC	Yes*	Yes	Yes*	* Possible Through Equity Investment Authority .
ND	No	No	No	
OH	No	Yes*	Yes*	* Aggregate Investment Limited to Ten Per Cent of Assets or 100 Per Cent of Capital and Unimpaired Surplus, Whichever is Greater.
OK	No	No	No	
OR	No	Yes*	Yes*	* Investment Limited to 15 Per Cent of Capital and 49 Per Cent of Subsidiary's Equity.

Table II.34. Continued from preceding page.

BANK REAL ESTATE AUTHORITY-DECEMBER 31, 1992

State	Real Estate Brokerage	Equity Participation[1]	Real Estate Development[2]	Notes
PA	No	Yes*	Yes*	* Investment Limited to One Per Cent of Assets.
PR	No	No	No	
RI	**	Yes*	Yes*	* Aggregate Investment Limited to Two Per Cent of Savings Deposits. ** State banking laws are silent.
SC	No*	No*	No*	* Based on December 31, 1991 data.
SD	*	Yes	No	* Uncertain, State Banking Laws Are Silent.
TN	No	Yes*	Yes*	* Aggregate Investment Limited to 100 Per Cent of Capital and Surplus.
TX	No	No	No	
UT	Yes**	Yes*	Yes*	* Investment Limited to Ten Per Cent of Capital. Bank Capital Ratio Must be at Least Eight Per Cent. ** Authorized to Local National Banks. If These Banks Exercise These Powers, State Banks Will be Authorized to Exercise the Same Powers.
VT	No*	No**	No	* State Banking Laws Are Silent, but State Banking Authorities Indicate That Approval Is Unlikely. ** Except Housing.
VA	No	Yes*	No	* Aggregate Investment Limited to Five Per Cent of Assets .
WA	No	Yes*	Yes*	* Investment Limited to One Per Cent of Capital and Surplus.
WV	No	Yes	No	
WI	Yes	No	No	
WY	*	No	No	* State Laws Are Silent.

1. Equity Participations Involve a Passive Investment Role.

2. Development Involves an Active Role in the Development of Real Properties Other Than Foreclosed Properties.

Table II.36.

BANK INSURANCE AUTHORITY--DECEMBER 31, 1992

State	Credit Life Brokerage	General Insurance Brokerage	Insurance Underwriting[1]	Notes
AL	Yes	Yes*	No	* Through a Subsidiary.
AK	Yes	No	No	
AZ	Yes*	Yes	Yes	* State Law is Silent, But Regulatory Approval is Possible. State law permits a bank to engage in any activity which is closely related or incidental to banking.
AR	Yes	*	No	* Only in Towns With a Population of Less Than 5,000.
CA	Yes	Yes	No	
CO	Yes	*	No	* Only in Towns With a Population of Less Than 5,000.
CT	Yes	No*	No	* Insurance Statutes Forbid Licensing of Banks for Sale of Insurance Products Other Than Credit Life, or Group Life and Disability Sold in Connection With Mortgage Loans.
DE	Yes	Yes	Yes	
FL	Yes**	Yes*	Yes*	* Only in Towns With a Population Less Than 5,000 and Only if Bank is Not a Bank Holding Company Affiliate. ** Also Includes Credit Disability.
GA	Yes	No	No	
HI	Yes	No	No	
ID	Yes	Yes	No	
IL	Yes	No	No	
IN	Yes	Yes*	No	* Except for Life Insurance.
IA	Yes	Yes	No	
KS	Yes	*	No	* Only in Towns With Population of Less Than 5,000.
KY	Yes	No	No	

Table II.36. Continued from preceding page.

BANK INSURANCE ACTIVITY–DECEMBER 31, 1992

State	Credit Life Brokerage	General Insurance Brokerage	Insurance Underwriting[1]	Notes
LA	Yes	No*	No	* Unless grandfathered Prior to January 01, 1984.
ME	Yes	No	No	
MD	Yes	Yes*	No	* Only in Towns With a Population of Less Than 5,000.
MA	Yes	Yes*	Yes**	* Possible Through Equity Investment Authority, Except in Massachusetts and in Any Other States That Prohibit Banks From Engaging in Insurance Brokerage Activities. ** Possible Through Equity Investment Authority.
MI	Yes	No	No	
MN	Yes	Yes	No	
MS	Yes	No	No	
MO	Yes	*	No	* Only in Towns With a Population of Less Than 5,000.
MT	Yes	No	No	
NE	Yes*	Yes*	No	* Only in Towns With a Population of Less Than 200,000.
NV	Yes	No	No	
NH	Yes	No	No	
NJ	Yes	Yes*	Yes**	* Possible Through Leeway Authority. ** Possible Through Leeway Authority, But Only On Specific Application and Approval.
NM	Yes*	No	No	* Only in Towns With a Population of Less Than 5,000.
NY	Yes	No*	No	* Thrifts and Savings and Loans May Invest in Bank Service Corporations Which Provide Such Services; However, Commercial Banks Cannot.
NC	Yes	Yes	Yes*	* Possible Through Equity Investment Authority.
ND	Yes	Yes*	No	* Only in Towns With Population Less Than 5,000.
OH	Yes	Yes	No	
OK	Yes	Yes*	No	* Only in Towns With a Population of Less Than 5,000.
OR	Yes	Yes	No	
PA	Yes	No	No	

Table II.36. Continued from preceding page.

BANK INSURANCE ACTIVITY–DECEMBER 31, 1992

State	Credit Life Brokerage	General Insurance Brokerage	Insurance Underwriting[1]	Notes
PR	No	No	No	
RI	Yes	*	*	* State Banking Laws are Silent.
SC*	Yes	No	No	* Based on December 31, 1991 data.
SD	Yes	Yes	Yes	
TN	Yes	*	No	* Only in Towns With a Population of Less Than 5,000.
TX	Yes*	No	No	* Through a Subsidiary.
UT	Yes	*	*	* Parity With National Banks Has Been Granted; However, Two Local Banks Have Grandfathered Rights to Underwrite and Broker Insurance. If These Banks Exercise These Powers, State Banks Might be Authorized the Same Powers.
VT	Yes	No	No	
VA	Yes	Yes	No	
WA	Yes	Yes*	No	* In Towns With a Population of Less Than 5,000.
WV	Yes	No	No	
WI	Yes	Yes*	No	* Banks Must be Licensed by Insurance Commission.
WY	Yes	Yes	*	* State Laws Are Silent. State Regulator's Practice is to Prohibit Activity.

[1] Underwriting Authority Beyond Credit Life Insurance.

COLORADO DIVISION OF BANKING

POLICY NO. 80-1

Date Issued: 6/02/89
Date Revised: 6/30/93

TITLE: RISK-BASED EXAMINATION SCHEDULING

1. PURPOSE: To establish the types and frequencies of examinations to be conducted by the Division of Banking based upon the condition of the institution, commencing June 30, 1993.

2. REFERENCE: C.R.S. 11-2-108(1) and (1.1)
C.R.S. 11-6.5-106(1)
C.R.S. 11-10.5-109(3)
C.R.S. 11-22-109(1)(and (1.1)
C.R.S. 11-23-117(2) and (3)
C.R.S. 12-20-109
C.R.S. 12-52-110
C.R.S. 5-3-506(1) and 5-6-105

3. TERMS DEFINED:

A. Financial Institution

For the purposes of this policy, the term financial institution refers to commercial banks, industrial banks, trust companies, money order companies, debt adjustors, or EDP servicers.

B. Area of Examination

The term area of examination refers to safety and soundness, EDP, PDPA, escrow bank, UCCC, trust department, money order, or debt adjustor examinations.

C. Rating

The composite rating derived from the rating systems commonly used by the state and federal regulators for various areas of examination. Composite ratings range from 1 to 5, with 1 being the best and 5 being the worst.

D. Scope of Examination

1. Full Examination. An on-site examination that covers all aspects of the area being examined in sufficient depth to assign a new rating. A full examination includes participation in a joint examination. In extraordinary circumstances, and with the approval of the Commissioner, a recent federal regulator full examination can be substituted for a state mandatory full examination.

2. Target Examination. An on-site or off-site examination that covers less than the full examination. A rating will not be assigned at a target examination. The

scope of a target examination can vary widely from examination to examination. It may cover almost everything in a full examination or be limited to a single item that requires only a few hours to review.

The scope for a safety and soundness examination will be predetermined via discussions between the examiner in charge of the examination and the Group Leader responsible for the institution being examined. The scope of all other examinations will be predetermined via discussions between the examiner in charge of the examination and that examiners direct supervisor.

E. Type of Examination

1. Mandatory Examination. An examination that this policy requires be completed at specified intervals.

2. Discretionary Examination. An examination, either full or target, that in the opinion of the Division of Banking Staff, needs to be completed to enhance regulatory oversight.

4. POLICY: A. Mandatory Examinations

Examinations of specific areas will be conducted based upon the rating of that area existing in the financial institution at the most recent (state or federal) examination.

Generally, when different areas of examination of the same institution are mandated for completion in the same fiscal year, these examinations will be conducted concurrently. The mandate date of the safety and soundness examination will be the key factor in determining the actual date of these concurrent examinations.

1. Safety and Soundness Examinations

Mandatory safety and soundness examinations at commercial banks, industrial banks, and depository trust companies will be based on the following criteria

CONDITION	EXAMINATION TYPE
New Charter/ Conversion	Target examination within the first 60 days of operation as a state charter. This examination should focus on seeing that the new institution gets off to a good start and

on establishing a working relationship between the institution and the Division of Banking.

A target or full examination by a federal regulator may be substituted for this target examination if the federal regulator's examination is conducted, or scheduled for the near future, within the first 60 days of as a state charter. If a federal regulator's examination is substituted for this target examination, the Group Leader responsible for the institution shall visit the institution within the first 90 days of operation.

Full examination within the first 12 months of operation as a state charter.

Change of Control — Full examination within the first 90 days of the change unless the Division of Banking's knowledge of the new ownership reflects satisfactory management and financial performance.

Most Recent CAMEL Rating

1 or 2 — Full examination no less than every 3 years.

Target examination any time during the three-year period. A full examination completed by a federal regulator may be substituted for this target examination.

3 — Full examination no less than every 2 years.

Target examination any time during the two-year period. A full examination completed by a federal regulator may be substituted for this target examination.

4 or 5 — Full examination no less than every 12 months.

2. Safety and Soundness Examinations of Non-Depository Trust Companies.

Mandatory safety and soundness examinations at non-depository trust companies will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Charter	Target examination within the first 60 days of operation. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working relationship between the institution and the Division of Banking. Full examination within the first 12 months of operation.
Change of Control	Full Examination within the first 90 days of the change unless the Division of Banking's knowledge of the new ownership reflects satisfactory management and financial performance.
Most Recent CAMEL Rating	
1 or 2	Full examination no less than every 2 years. Target examination any time during the two-year period.
3	Full examination no less than every 12 months.
4 or 5	Full examination no less than every 12 months. Target examination any time during the 12 month period.

3. EDP Examinations of Independent EDP Servicers.

   Mandatory EDP examinations at independent EDP Servicers (no common ownership of servicer and serviced banks) will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Servicer	Target examination within the first 60 days that services are provided to a regulated institution. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working

relationship between the institution and the Division of Banking.

A target or full examination by a federal regulator may be substituted for this target examination if the federal regulator's examination is conducted, or scheduled for the near future, within the first 60 days that services are provided to a regulated institution. If a federal regulator's examination is substituted for this target examination, the Group Leader responsible for the institution shall visit the institution within the first 90 days of operation.

Full examination within the first 12 months that services are provided to a regulated.

Control Change	Full examination within the first 90 days of the change unless the Division of Banking's knowledge of the new ownership reflects satisfactory management and financial performance.
Most Recent EDP Rating	
1 or 2	Full examination no less than every 24 months.
3	Full examination no less than every 18 months.
4 or 5	Full examination no less than every 12 months. Target examination any time during the 12 month period. A full examination completed by a federal regulator may be substituted for this target examination.

4. EDP Examinations of Non-Independent Centers.

Mandatory EDP examinations at commercial banks, industrial banks, and trust companies which are not independent servicers will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New EDP Center	Target examination within the first 60 days of operation. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working relationship between the institution and the Division of Banking. A target or full examination by a federal regulator may be substituted for this target examination if the federal regulator's examination is conducted, or scheduled for the near future, within the first 60 days of operation of the center. If a federal regulator's examination is substituted for this target examination, the Group Leader responsible for the institution shall visit the institution within the first 90 days of operation. Full examination within the first 12 months of operation.
Change of Software or Management	Full examination within the first 90 days of the change unless the Division of Banking's knowledge of the new ownership reflects satisfactory management and financial performance.
Most Recent EDP Rating	
1 or 2	Full examination no less than every 3 years.
3	Full examination no less than every 2 years.
4 or 5	Full examination no less than every 12 months.

5. Out-of-State EDP Servicers

Mandatory examinations of out-of-state EDP servicers will be conducted off-site by reviewing examination reports from other regulators as such reports are received.

6. PDPA Examinations

Mandatory PDPA examinations at commercial banks and industrial banks will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Certificate	Target examination within the first 60 days of accepting public deposits. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working relationship between the institution and the Division of Banking.
Most Recent CAMEL Rating	
1, 2 or 3	Target examination no less than every 3 years.
4 or 5	Full examination no less than every 12 months.

7. Escrow PDPA Examinations

Mandatory escrow PDPA examinations at PDPA escrow banks will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Certificate	Target examination within the first 60 days of acting as a PDPA escrow bank. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working relationship between the institution and the Division of Banking.
Existing Escrow Bank	Full examination no less than every 3 years.

8. UCCC Examinations

Mandatory UCCC examinations at commercial banks and industrial banks will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Charter	Target examination within the first 60 days of operation as a state charter. This examination should focus on seeing that the new institution gets off to a good start and establishing a working relationship between the institution and the Division of Banking.
Most Recent UCCC Rating	
1 or 2	Full examination no less than every 3 years.
3	Full examination no less than every 2 years.
4 or 5	Full examination no less than every 12 months.

9. Trust Department Examinations.

   Mandatory trust department examinations at commercial banks will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Exercise of Powers	Target examination within the first 60 days of exercise of the new power by the institution. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working relationship between the institution and the Division of Banking. A target or full examination by a federal regulator may be substituted for this target examination if the federal regulator's examination is conducted, or scheduled for the near future, within the first 60 days of exercise of the new power by the institution. If a federal regulator's examination is substituted for this target examination, the Group Leader responsible for the institution shall visit the institution within the first 90 days of operation. Full examination within the first 12 months of exercise of the new power.

Most Recent Trust Rating	
1, 2 or 3	Full examination no less than every 3 years.
4 or 5	Full examination no less than every 12 months.

10. Money Order Company Examinations

    Mandatory money order company examinations will be alternating on-site full examinations, off-site review of other regulator's report(s), and off-site review of CPA audit reports on a 3 to 5 year cycle.

11. Debt Adjustor Examinations

    Mandatory debt adjustor examinations will be based on the following criteria:

CONDITION	EXAMINATION TYPE
New Charter	Target examination within the first 60 days of operation. This examination should focus on seeing that the new institution gets off to a good start and on establishing a working relationship between the institution and the Division of Banking. Full examination within the first 12 months of operation.
Change of Control	Full examination within the first 90 days of the change unless the Division of Banking's knowledge of the new ownership reflects satisfactory management and financial performance.
Existing Company	Full examination every year.

B. Discretionary Examinations

The scheduling and scope of a discretionary examination will be determined by the Commissioner or his/her designee with input from the Division of Banking staff and will be based on off-site monitoring or on any other information that indicates a problem or potential problem requiring a discretionary examination.

All financial institutions will be monitored continually on an off-site basis, to include review of the following:

- Call Reports,
- Other supervisory agency reports,
- Third-party examination and commentary reports, and
- Computer-based trend analysis.

Anything in the on-going off-site monitoring or examination programs may trigger a discretionary full or target examination.

Industry Distribution Yes X No ____

APPROVED: Sandra J. Herzog
Chairman,
State Banking Board

6/17/93
Date

READER RESPONSE FORM

TO: Colorado Department of Regulatory Agencies
Office of Policy and Research
1560 Broadway, Suite 1550
Denver, CO 80202

RE: Sunrise/Sunset Report on ______________________________
(Report Title and Date)

FROM: ______________________________
____
Your Name and Address

DATE: ______________________

I have read your report and found it:

Excellent ____ Good ____ Fair ____ Poor ____

Here are my suggestions for improving the report:

____
____
____

The report was thorough in its coverage of the subject:

Yes ____ No ____

Comments:

____
____
____

The report was fair in its treatment of the issues:

Yes ____ No ____

Comments:

____
____
____

Thank you for your response. We hope you found our report useful.

Revised June, 1993.