4 Important Events In Bank Regulation: A Midyear Review

By **Christina Grigorian** (June 28, 2024)

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The first half of 2024 has been a study of contrasts with respect to bank regulation.

On the one hand, regulators have had a respite from the economic and political fallout that marked the first half of 2023 resulting from the failures of a number of insured depository institutions and related significant losses to the Deposit Insurance Fund.

On the other hand, the courts continue to play a very active role in determining the scope of permissible activities in which insured depository institutions can engage.

Moreover, new leadership is likely to be installed at the Federal Deposit Insurance Corp. in the coming months, capping a tumultuous period of internal reflection and review.

And, of course, a presidential election looms in the fall, which, as of the date of this filing, is incapable of confident prediction.

Set forth below are four events that occurred in the first six months of 2024 that have significantly affected the regulatory standards applicable to insured depository institutions.

From a regulatory perspective, the flood of recent regulatory adoptions, particularly with respect to consumer credit, is likely to soon cool given the potential for a change in presidential administrations in the fall and the possibility that the adoption of any final rules could be subject to reversal with Congress' exercise of its powers under the Congressional Review Act.[1]

1. The Supreme Court validates a CFPB funding mechanism.

In a 7-2 decision that was widely expected after oral argument, the U.S. Supreme Court issued its decision in Consumer Financial Protection Bureau v. Community Financial Services Association of America Ltd. on May 16, holding that the CFPB's funding mechanism, as set forth in Title X of the Dodd-Frank Wall Street Reform Consumer Protection Act, is constitutional.

The case arose from a challenge by the Community Financial Services Association of America, a nonbank consumer lender trade association, related to certain provisions in final rules adopted by the CFPB related to consumer payment authorizations on higher interest, short-term consumer lending products.[2]

In its challenge to the CFPB's adoption of the payday rule, the CFSA raised a number of arguments, including one that challenged the CFPB's funding mechanism as violative of the appropriations clause.

Specifically, the CFSA posited that the CFPB's funding mechanism "usurp[ed] Congress's role in the appropriation of federal funds," arguing further that such funding was too open-ended and inconsistent with other federal agencies that require annual funding authorization from Congress.

The U.S. District Court for the Western District of Texas initially held that the CFPB's funding mechanism did not create an "Appropriation Clause issue."[3] The U.S. Court of Appeals for the Fifth Circuit agreed with the CFSA, however, finding the CFPB's funding mechanism violated the appropriations clause.[4]

Authored by Justice Clarence Thomas, the decision finds that the Dodd-Frank Act's funding scheme for the CFPA complies with the U.S. Constitution's appropriations clause, which states that "[n]o Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law."

In evaluating the CFPB's funding structure against the Constitution's requirements, the court found that the agency's appropriation mechanism is constitutionally permissible given that it includes an identifiable source of public money and a designated purpose.

To that end, the opinion holds that "[b]ased on the Constitution's text, the history against which that text was enacted, and congressional practice immediately following ratification, ... appropriations need only identify a source of public funds and authorize the expenditure of those funds for designated purposes to satisfy the Appropriations Clause."

While this case is especially significant for banks with more than $10 billion in assets that are directly regulated by the CFPB, the case is also significant to the banking industry because it deflects similar arguments that could have been raised, had this case been successful, in connection with the funding mechanisms for other banking regulators like the Office of the Comptroller of the Currency and the FDIC.

There now is further discussion related to the CFPB's funding as it relates to the following provision in the Dodd-Frank Act: "Each year (or quarter of such year) ... the Board of Governors shall transfer to the [Consumer Financial Protection] Bureau from the combined earnings of the Federal Reserve System, the amount determined by the Director to be reasonably necessary."[5]

Notably, the Federal Reserve System has no earnings at this time, and has not for years. How this issue resolves itself will likely play out in the next six months as those seemingly aggrieved by the CFPB's actions make this point in various court and enforcement cases.

2. Federal regulators release proposed rules related to incentive compensation.

On May 6, the FDIC, the OCC, the Federal Housing Administration and the National Credit Union Administration released proposed rules related to incentive compensation arrangements.[6] Final regulations are required by Section 956 of the Dodd-Frank Act.

This issuance is essentially a reproposal of regulatory requirements first published in 2016 but includes certain alternatives and questions the banking regulators have posited to the public. Notably, the regulators stated that they have had the opportunity to consider compensation practices in connection with recent bank failures where excessive compensation and tying financial incentives to volume-based metrics — like loan production — were implicated in such failures.

The proposal seeks comments on a variety of incentive-based issues including: the effective date of final regulations; the asset thresholds for determining eligibility requirements; the definitional components of incentive-based compensation; and the parameters for forfeiture, downward adjustments and clawbacks.

This proposal will not be published in the Federal Register for official comment until all affected agencies — including the U.S. Securities and Exchange Commission and the Federal Reserve — join in issuing the same proposal.

3. Two regulators release proposals related to bank mergers.

Both the OCC and the FDIC issued separate proposals in connection with bank combinations and mergers.

OCC

On Feb. 14, the OCC published in the Federal Register materials related to business combinations involving national banks and federal savings associations.

First, the OCC proposed to amend Title 12 of the Code of Federal Regulations, Section 5.33, to delete the ability to submit streamlined applications, eliminating OCC-expedited bank merger review.

Second, the OCC published a proposed policy statement as an appendix to Part 5, Subchapter C. The proposed statement describes the general factors in connection with applications that are generally approved, and includes examples of indicators that raise supervisory and regulatory concerns.

The comment period closed on June 15.

FDIC

On March 21, the FDIC issued for comment in the Federal Register a proposed statement of policy on bank merger transactions. If adopted, the proposal will replace the FDIC's existing policy on bank merger transactions.

The proposal includes a separate discussion of each statutory factor the FDIC is required to consider, including: competitive effects, financial and managerial resources, future prospects, convenience and needs of the community to be served, risk to the stability of the U.S. banking or financial system, and effectiveness in combating money laundering.

Of particular note is the proposal's emphasis on the point that the scope of merger transactions subject to approval encompasses transactions that take other forms, including purchase and assumption transactions that are mergers in substance.

As noted by the FDIC, the proposal reflects a broadened review of the financial stability risks that could arise from a merger given that the size of an insured depository institution may limit the FDIC's failure resolution options, thereby increasing risks to the Deposit Insurance Fund.

The comment period closed on June 18.

Considered collectively, these proposals reflect interest by the federal banking regulators to utilize lessons learned from recent financial crises to evaluate proposed transactions that expand an insured depository institution's existing business lines and associated risks.

4. The Supreme Court vacates a banking case related to preemption.

On May 30, the Supreme Court unanimously remanded a case involving the accrual of interest on escrow deposits to the U.S. Court of Appeals for the Second Circuit.

In Cantero v. Bank of America NA,[7] the justices held that the Second Circuit had failed to follow the preemption standard set forth in the Dodd-Frank Act — incorporating the standards in the court's 1996 decision in Barnett Bank of Marion County NA v. Nelson — in a case related to claims that national banks are subject to a New York state law that requires that consumers be paid a rate of interest on funds held in residential mortgage escrow accounts.

Known as the Barnett standard, this analytical framework requires consideration of whether a state law "prevents or significantly interferes" with the exercise of a national bank's powers. The court provided in its opinion examples as to where that standard had been satisfied, as well as examples of cases where it had not.

In light of the Supreme Court's ruling, the Second Circuit will thus have to reconsider the case and reissue an opinion that satisfies the Barnett standard.

The result of this opinion presents significant operational questions for national banks with respect to reviews of existing state laws to determine their applicability to national banks' operations.

While it is clear that a law that requires any type of licensing or registration should be preempted under the Barnett standard, the Second Circuit will need to fully assess the operational and related challenges that would arise with respect to monitoring state laws related to escrow interest requirements, and the related calculations and distributions that would be required if applicable to a national bank's business.

Conclusion

While the first six months of 2024 have been fairly stable — for example, the CFPB funding decision was widely anticipated, and the incentive compensation proposal involves concepts first proposed nearly a decade ago — it is the last six months of 2024 that need to be closely watched. From likely new leadership at the FDIC to a presidential election that could result in significant changes to banking and U.S. economic policy, the next six months possess potential variables that are impossible to predict at the year's halfway point.

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[1] In short, the Congressional Review Act permits Congress to pass a resolution to rescind a rule promulgated by an administrative agency "if the Congress enacts a joint resolution of disapproval." Congress generally has 60 days of continuous session from the date a rule is submitted to use the disapproval procedure.

[2] 12 CFR Part 1041 (Subpart C- Payments) (Payday Rule). The CFSA was joined in the action by the Consumer Service Alliance of Texas.

[3] Cmty. Fin. Servs. Ass'n of Am., Ltd. v. CFPB, No. 1:18-cv-00295 (W.D. Tex. Aug. 31, 2021).

[4] 51 F. 4th 616 (5th Cir. 2022) (en banc).

[5] 12 USC § 5497.

[6] https://www.occ.gov/news-issuances/news-releases/2024/nr-ia-2024-47a.pdf The Dodd-Frank Act requires the Banking Regulators as well as the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System (Federal Reserve) to also adopt rules related to executive compensation. The SEC has included executive compensation issues on its rulemaking agenda. The Federal Reserve has not yet indicated its position on this matter and did not join the Banking Regulators in its promulgation.

[7] No. 22-529 (U.S. May 30, 2024).