Charles G. Cooper
Commissioner

TEXAS DEPARTMENT OF BANKING

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To: The Honorable John Corona
Chairman of the Senate Committee on Business and Commerce

From: Charles G. Cooper, Banking Commissioner

Date: January 8, 2014

Subject: Quarterly Update on Texas Department of Banking

I. Texas state-chartered bank information.

	June 30, 2012	June 30, 2013	September 30, 2013
Number of Insured Depository Institutions	300	288	283
Assets *(billions)**	$196.3	$203.3	$208.8
Net Loan Volume *(billions)**	$109.5	$115.3	$115.6
Problem Banks**	46	27	23

**FDIC financial data for insured institutions.*
***The Department defines problem banks as any financial institution with a composite rating of "3", "4" or "5".*

Conversion Activity – In the last three years, the agency has experienced an increase in conversions from national charters to state charters. Since 2010, there have been thirteen financial institutions convert from a national charter to a Texas state-chartered bank. As of December 31, 2013, no conversion applications were pending. Additional mergers and consolidations of smaller banks are expected to continue.

II. Debit Card Surcharge Legislation

The 83rd Texas Legislature passed HB 3068 which became effective on September 1, 2013. The legislation added §59.402 to the Texas Finance Code which prohibits a merchant from imposing a surcharge on a buyer for using a debit or stored value card as payment. Since September 1, 2013, the Department of Banking has received four consumer complaints regarding this practice. The Department developed a letter that can be sent to the offending merchant which (1) advises the merchant of the new law, (2) requests the merchant to refund the surcharge to the buyer, (3) requires confirmation that the practice has ceased, and (4) requests that the merchant provide information on the steps taken to ensure the fee is not imposed in the future. The statute does not authorize the Department to take enforcement actions for noncompliance.

III. Community Banking in the 21st Century: Opportunities, Challenges and Perspectives

The concern of regulatory overburden on the banking industry brought together academicians, regulators, and financial institutions to discuss community banking in today's environment on October 3 – 4, 2013 at the CSBS-Federal Reserve Community Banking Research Conference at the St. Louis Federal Reserve. Banking departments across the country were asked to provide insight into their respective state community banking industries. To aid in the research, the Texas Department of Banking met with bankers in four town hall meetings across the state to gather first-hand accounts of the challenges and opportunities that are impacting the way community banks operate today. The Conference of State Bank Supervisors (CSBS) and the Federal Reserve Bank of St. Louis released *Community Banking in the 21st Century: Opportunities, Challenges and Perspective*, a first-of-its-kind report on the challenges and opportunities facing community banks.

IV. Federal Implementation of Dodd-Frank.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] significantly changed the financial landscape and the regulation of domestic and foreign financial institutions, but Dodd-Frank relies heavily on rulemaking and interpretation by federal regulatory agencies for implementing many of its provisions regarding regulatory improvements.

The Davis Polk law firm tracks and reports monthly progress in these rulemaking requirements, and recently released its January Dodd-Frank Progress Report.[2] As of January 2, 2014, 201 (50.5%) of the 398 total rulemaking requirements of Dodd-Frank had been met with finalized rules, and rules have been proposed that would meet an additional 87 (21.9%) more. Rules have not yet been proposed to meet 110 (27.6 %) of the rulemaking requirements. However, the Dodd-Frank reform rules that most affect community banks have largely been completed.

The Department of Banking described the "Volcker Rule"[3] in its last quarterly update and indicated that a final rule was expected by year-end. On December 10, 2013, the five federal agencies with rulemaking responsibility for the Volcker Rule jointly promulgated the 71-page final rule, supported by an 882-page preamble.[4] One unexpected provision in the final rule threatened to force community banks to take millions of dollars in write-offs in 2013, despite repeated assurances from the federal agencies that the Volcker Rule would not significantly affect smaller institutions. The banker anger that erupted appears to have caught the federal agencies by surprise. While the situation is fluid and the exact form of relief could change, the federal agencies appear to be considering an exemption for all existing collateralized debt obligations (CDOs) backed by trust-preferred securities from compliance with the Volcker Rule, perhaps within the next week or so. Although a solution of this nature will fully address the concerns of community bankers, the controversy should be explained.

The statutory Volcker Rule contains two prohibitions on "banking entities." First, it restricts banking entities from engaging in "proprietary trading." 12 U.S.C. § 1851(a)(1)(A). Second, and

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[1] Pub. L. No. 111-203.

[2] The monthly Dodd-Frank Progress Report can be found at: http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

[3] Quarterly Update Memorandum of the Texas Department of Banking dated October 15, 2013. Briefly, Congress enacted the Volcker Rule as § 619 of the Dodd-Frank Act, now codified as 12 U.S.C. § 1851. In general, the Volcker Rule is intended to prevent financial institutions from undertaking risky investments with their own funds, exposing taxpayers to the possibility of future bailouts in the event of catastrophic losses.

[4] Not yet published in the *Federal Register*. *See* the Joint Press Release dated December 10, 2013: http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

the issue in controversy here, it provides that banks may not "acquire or retain any equity, partnership, or other ownership interest" in a "covered fund." 12 U.S.C. § 1851(a)(1)(B). At issue is whether banks are required to shed CDOs made up of trust-preferred securities and how quickly. Under the final rule issued in early December, certain CDOs backed by trust-preferred securities would be covered.

The problem is one of accounting. If these CDOs are covered by the Volcker Rule, banks can no longer treat them as held-to-maturity securities and must instead mark them as available-for-sale, either selling them or taking significant write-downs in the process. Importantly, banks would have to change the accounting treatment for their fourth-quarter filings, which are due at the end of January.

By every appearance, the federal agencies overlooked and never recognized what would happen by including these CDOs under the Volcker Rule, including the potential losses that would have to be recognized immediately. As a result, the agencies were unprepared for the backlash from small banks and their trade group representatives, as well as the intense, bipartisan interest from members of Congress in the issue. The agencies have been frantically working to fix the issue ever since. The agencies' first effort at addressing the issue came December 19th, when regulators released a Frequently Asked Questions designed to clarify which CDOs were covered by Volcker.[5] The release specified that banks might be able to restructure their investments so that they were exempt from the ban. But instead of clarifying the issue, it just confused matters further.

The American Bankers Association filed a lawsuit on December 24th seeking an emergency court ruling by the end of the year stopping the Volcker Rule from going into effect.[6] The regulators issued another release on December 27th saying that they were considering whether to exempt these specific CDOs from the Volcker Rule, with a final decision due by Jan. 15.[7] The release included a specific mention of the accounting issues, suggesting banks should wait to decide treatment for the fourth quarter until regulators clarify the situation. This second regulatory statement allowed the ABA to drop the demand for an immediate court ruling because it relieved pressure from bank auditors to have a decision by year-end. But the lawsuit is still pending. The agencies clearly want to solve this problem and may act before their self-imposed deadline of January 15th.

V. Issues of Interest to the Committee Members.

- **Certain Regulatory Fee Increases** The Department is charged with responsibility for all direct and indirect costs of its existence and operation, and may not directly or indirectly cause the general revenue fund to incur any of such costs (Finance Code §16.003). The Finance Code authorizes the Finance Commission to adopt necessary or reasonable rules regarding recovery of the cost of maintaining and operating the Department and the cost of enforcing the Finance Code, by imposing and collecting ratable and equitable fees for notices, applications, and examinations.

  The recent evaluation of the Department's fee structure revealed two regulatory functions for which the cost of operations was found to exceed related revenue. They were:

[5] Joint Press Release dated December 19, 2013: http://www.federalreserve.gov/newsevents/press/bcreg/20131219d.htm.
[6] *American Bankers Association, et al. v. Federal Deposit Insurance Corporation, et al.*, Case 1:13-cv-02050-RJL, pending in the United States District Court for the District of Columbia.
[7] Joint Press Release dated December 27, 2013: http://www.federalreserve.gov/newsevents/press/bcreg/20131227a.htm.

- the examination of state trust companies, state bank fiduciary activities, and other special examinations and investigations, including examinations of banks, bank holding companies, interstate branches of out-of-state, state banks in Texas as host state, state bank affiliates, and third-party contractors performing activities on behalf of state banks; and
- application processing for banks, trust companies, and money services businesses.

On December 13, 2013, the Finance Commission adopted rule amendments that adjusted application, license, examination, and investigation fees to better enable the department to be self-supporting and each regulatory program to be self-sustaining. The following sections of Title 7 of the Texas Administrative Code were amended:

- §17.22 and §17.23 — revise examination fees and call reports for trust companies;
- §15.2 and §15.3 — revise application fees for state banks and foreign banks;
- §21.2 — revise application fees for trust companies;
- §33.21 and §33.27 — repeal annual renewal and revise license fees for money services businesses;
- §3.36 — revise special examination and investigation fees for state banks, foreign banks, bank holding companies, and bank service providers.

The new revised fees became effective on January 1, 2014.

➢ **Patent Troll Problem** - An area of growing concern for financial institutions is patent infringement litigation, first described by the Department of Banking in its last quarterly update.[8] In brief, "patent trolls" (more polite terms are patent assertion entities (PAEs) or non-practicing entities (NPEs)) are companies that buy broadly worded patents, sometimes from firms that go bankrupt, with the intent of suing other companies for illegally infringing on these patents — and they have nothing to lose when they sue others for infringement.

Intellectual property is highly valuable to large companies and they will spend significant resources to defend their own patents or defend against the asserted patent rights of others. Patent trolls therefore tend to avoid targeting large enterprises and instead move downstream to prey on small businesses. The cost of postage fuels the most common troll business model, sending vague and deceptive demand letters asserting infringement of one or more patents identified only by number. They know that an early settlement is much, much cheaper for a defendant than fighting. Intellectual property protection is largely a matter of federal law, based on Congressional power under Article I, Section 8, "To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries..." Congress is slowly inching its way to a legislative solution, but affected businesses still believe there is a role for the states to play, primarily based on attacking the deceptive and misleading nature of demand letters. As previously reported, several attorneys general are aggressively pursuing their state law remedies, including Vermont, Nebraska, Minnesota, and Pennsylvania.

Attorney General Greg Abbot has signed a joint letter dated December 17, 2013, with 42 other attorneys general in support of the Federal Trade Commission (FTC) investigation of the patent troll problem. The letter describes the issue as follows:

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[8] Quarterly Update Memorandum of the Texas Department of Banking dated October 15, 2013.

> [T]hrough the issuance of numerous demand letters to their targets (often consumers, non-profits, and small businesses having little, if anything, to do with the underlying patent), [patent trolls] commonly demand license fees or settlements accompanied by the threat of costly litigation if the target does not 'pay up.' These [victims] usually possess little knowledge of patent law and are intimidated by demand letters."[9]

Recent developments:

- In September, the FTC announced its plan to conduct a wide-ranging investigation of known patent trolls, or PAEs, and solicited public comment.[10]
- On November 14, 2013, Lieutenant Governor David Dewhurst announced that he would make "patent trolling" the subject of an interim charge. In a speech at the Texas Taxpayer and Research Association's annual meeting, he said he would charge the State Affairs Committee with examining the negative economic impact on Texas businesses from legal issues involving patent litigation by PAEs, or "patent trolls," and would instruct the committee to make recommendations on how the State of Texas can address problems related to frivolous tort action and unsubstantiated patent claims against legitimate businesses and Texas job creators.[11]
- On December 5, 2013, the U.S. House of Representatives approved H.R.3309, the Innovation Act, spearheaded by House Judiciary Chairman Bob Goodlatte (R.-Va.), by a vote of 325-91. The bill would call for more specificity in patent lawsuits, make patent ownership more transparent, add a fee-shifting provision, delay discovery, and work to protect downstream users.
- On December 9, 2013, H.R.3309 was received in the Senate and referred to the Committee on the Judiciary, where several Senate bills on this issue are pending.
- On December 17, 2013, the National Association of Attorneys General (NAAG) issued a press release announcing that 43 attorneys general had signed a letter to the FTC to express support for the FTC's proposed project to collect a significant amount of data and information about PAEs, or patent trolls. The NAAG comments suggested that the FTC share, to the extent permitted by law, the entirety of the response to the information request with state attorneys general. The attorneys general also suggested two specific additions to the federal information-gathering effort. First, the FTC should inquire about the role of legal counsel, who may play a central role in patent assertion schemes. Second, the FTC should increase the number of PAEs, manufacturing firms, and other firms to which the information request will be submitted.[12]
- On December 19, 2013, the Senate Judiciary Committee held a hearing on the issue entitled "Protecting Small Businesses and Promoting Innovation by Limiting Patent Troll Abuse."[13]

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[9] The letter may be viewed at http://www.naag.org/ags-support-federal-information-gathering-project-on-patent-trolls.php.
[10] The notice was published in the October 3, 2013, edition of the *Federal Register* (78 FR 61352).
[11] Press release at http://www.ltgov.state.tx.us/prview.php?id=493.
[12] http://www.naag.org/ags-support-federal-information-gathering-project-on-patent-trolls1.php.
[13] Information and submitted testimony can be found at http://www.judiciary.senate.gov/hearings/hearing.cfm?id=32caee8082f9297f0e7df6280b03ff1f.