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MEMORANDUM

DATE: January 6, 2021

TO: Senate Industry, Business and Labor Committee

FROM: Lise Kruse, Commissioner

SUBJECT: Testimony in Support of Senate Bill No. 2102

Chairman Klein and members of the Senate Industry, Business and Labor Committee, thank you for the opportunity to testify in support of Senate Bill No. 2102.

Mr. Chairman and members of the Committee, Senate Bill No. 2102 creates 6-07.2 of the North Dakota Century Code, replacing 6-07, which is repealed relating to the dissolution, insolvency, suspension, emergency receivership, and liquidation of institutions under the department of financial institutions' supervision. This bill also includes amendments to Chapters 6-01, 6-02, 6-03, 6-05, 6-06 of the North Dakota Century Code relating to financial institutions cross references, cease and desist orders, and prompt corrective action. Prior to filing this bill, the department met with various staff

and committee members of the North Dakota Bankers Association, Independent Community Banks of North Dakota, and the Dakota Credit Union Association, and had discussions with several bankers and credit union officials to review our proposed legislation.

Before I go into the specifics of the Bill, I would like to give you an overview and reasoning behind it. This has to do with bank failures. When necessary, the department needs to take possession of a bank, turn it over to the Federal Deposit Insurance Corporation (FDIC), in as smooth of a way as possible, with minimal, if any, impact to the customer. The last bank failure in North Dakota was in 1991 – 30 years ago. Since then, a lot has changed with the process. Our current statute, 6-07 was written in 1887, updated in the 1930s and again with some tweaks in 1991. If we would have a bank failure today, it would be painful for all parties involved. The process has changed at the federal level, which is why we need to change our statute so we can accommodate a seamless transition. Let me walk through a basic scenario: A failure is rarely a surprise unless fraud is involved. Under most circumstances, the failure can be years in the making. As a bank begins to deteriorate, we will institute measures with the goal of restoring the bank to a healthy institution. At some point, capital may be critically low, or the bank may not be able to meet its obligations to customers, and we need to take

possession of the bank to save the customers' deposits. This whole process is done jointly with our federal counterpart with equal say in how we approach the situation. When failure is becoming more and more likely, the FDIC will shop around for potential purchasers of the failing institution. At a particular Friday, the state examiners will enter the institution and all its branches and take possession, turning the charter over to FDIC, the receiver. FDIC will work over the weekend, and the doors will open Monday morning under a new bank name. The customers will not be affected and will hardly notice – other than the new name. However, this is not to minimize that there is always a shock to the community, which is why the process has to be as seamless as possible to minimize any impact – where the community continue to receive banking services without interruption.

I conferred with the FDIC resolutions division, as well as other commissioners throughout the country who have experienced more recent failures, to come up with what is today considered best practice. The new statute is taken from several other states, and with some carryover from the current statute, although with modernized language. Also, when looking at this statute, we also wanted to make sure it covers credit unions. In 2017, the National Credit Union Association (NCUA) took one of our credit unions under conservatorship. Although the state was involved up to that point, due

to our antiquated law, the department was not party to the conservatorship, rather NCUA laws were used. If the state is unable or unwilling to take action, both the FDIC for banks, and the NCUA for credit unions can take possession of the institution. Based upon the experience in 2017, it is in the best interest of North Dakota institutions and customers (or members for the credit unions) that the state has a seat at the table and is involved as much as possible.

The biggest concern with the current law is whether the department would have the authority to intervene if there was a liquidity event (bank run), cyber event, or a ransomware attack. The new law is written to ensure that these scenarios are covered. It includes a provision for the department to take temporary possession where we do not close the institution permanently, rather we hold it for a short time to turn it over to the same management. A ransomware situation is where this can be important. The institution would not need to close permanently (fail), rather it would just need some time to recover.

I want to make clear that I am not anticipating any failures in the foreseeable future; however, there have been a couple of failures in the nation due to fraud in the last few years, and I do not want to assume that

we are immune from fraud – people can become desperate and make poor decisions, especially under economic pressure.

There are three areas that are changed that I want to bring to your attention: First, the procedure is administrative rather than judicial. At least 40 states have an administrative procedure. It can be a hurdle to find a judge at the specific Friday the closure is scheduled. I have found no record of a judge not signing an order, and it would also be strange for a judge to overrule the department's execution of its responsibility. If there was a hindrance of any kind due to a judicial procedure, the FDIC and NCUA may take action, effectively removing state influence in the process.

Second, the authority is with the commissioner rather than the State Banking Board or State Credit Union Board. However, the boards are informed of the institutions conditions and are involved up to the time of taking possession. Most states act without a board making such decisions. Only 7 other states (14%) have boards make the factual finding on the bank side. For credit unions, only 9 other states (20% of other chartering states) have boards that make the decision. Closing an institution is a safety and soundness issue, which is the commissioner's number one objective, concern, and responsibility. Closure is guided by the condition of the bank - it should not be at anyone's discretion or left to a vote. The new law has a

lengthy list of reasons when the department can take possession, so it is not an arbitrary decision. As mentioned earlier, the process should be as smooth as possible, with limited harm to consumers and institutions alike. We need to make sure the department can work this out with the FDIC or NCUA from a regulatory perspective. It is a high burden to ask a banker or credit union president to vote on closing a friend's, colleague's, and competitor's bank or credit union. In such a small state with few institutions (64 banks and 20 credit unions), it is difficult to put our board members in such a position and could make it difficult to find members. A former board member from the 80s once told me it was the most difficult thing he ever had to do. If there is concern about the commissioner acting irresponsibly, please keep in mind that the commissioner can be removed by the governor, so if we have a corrupt commissioner, there is a safeguard. The commissioner is also confirmed by the senate, so the legislative body has a say as well.

There was some concern about the structure from a couple of credit union individuals. Hearing the credit unions' concerns, we are proposing an amendment to add a level of board appeal to an emergency conservatorship, which we will discuss more shortly. We believe the criteria listed for conservatorship action is specific enough to address any concerns. Additionally, the previously discussed controls over the commissioner

positions including oversight by the legislative body make it appropriate to structure the process as we have proposed, a similar process employed by the majority of state governments.

Third is the appeals process. There are several areas where an institution can appeal a decision, and we have added an amendment to add more controls over the process. The board is aware of the condition of our institutions and any appeals process leading up to the failure is in place. However, as soon as the institution is turned over to the FDIC or NCUA there is no going back. At that point there is nothing the department or boards can do, and we should remove any liability. Current law implies that this can somehow be reversed, but realistically once the final resolution process has commenced, it is not possible to unwind the transaction. Any appeals or grievances should be filed prior to the institution being in possession of the receiver. As mentioned earlier, under normal circumstances, there is a long period leading up to the failure, giving the institution's management and board many opportunities to object to any examination findings.

In listening to the concerns from the credit union industry, we did hear from them an opportunity to add an additional safeguard over emergency conservatorship actions. While the emergency provision is designed to be temporary which itself is a control, adding an appeal to the board in this

section of the law as well will serve to strengthen the controls over the process. We are proposing an amendment to add this additional appeal process to the emergency provision.

The first 8 sections of the Bill are either related administrative actions or cross reference corrections.

Section 1 of the Bill would amend Subsection 4 of 6-01-04.2 regarding emergency, temporary cease and desist orders changing the appeals process to the board. The reasoning is to be consistent with the new Chapter 6-07.2 since that is an administrative procedure.

Section 2 of the Bill provides for an amendment to 6-01-04.4, allows the commissioner to enter an order if a bank is undercapitalized. The thresholds for undercapitalized, significantly undercapitalized, and critically undercapitalized are defined in federal law and the FDIC has the authority to take action as well. The amendment gives the commissioner the same ability for the same reasoning as earlier discussed. This would especially be necessary if the affected institution has a member on the banking board, or when the action must be taken quickly. There is an appeals process with the state banking board as a safeguard, and the procedure is again administrative.

Sections 3, 4, 5, 6, and 7 of the Bill are to update cross references.

Section 8 of the Bill is to amend 6-06-08.4 prompt corrective action for credit unions. The capital thresholds are defined in this section and the commissioner or the board have the authority to take prompt corrective action. The commissioner is able to take possession, consistent with the new Chapter 6-07.2. An appeals process with the state credit union board is included and the process is administrative.

Section 9 of the Bill will create and enact section 6-07.2. I will briefly go through it. The section explains the procedure, giving a lengthy list of reasons which clarifies situations when possession can take place and to remove arbitrary or vague language. It covers termination of possession and notice procedures and details the appointment of the receiver and transfer to the receiver, as well as the powers of the receiver, which includes sale of assets and authority for the receiver to borrow. The receiver would most likely be the FDIC or NCUA; however, the department can appoint a different receiver if circumstances so warrant. Almost identical to our prior statute (6-07-52), the presentation and payment order of claims are detailed.

The emergency temporary suspension or conservatorship was briefly mentioned earlier. One of the primary reasons this is commissioner-initiated action is due to the nature of the emergency. The most likely scenario we foresee is a ransomware attack where an institution is unable to operate and

needs immediate assistance. We would not have the time to notice a meeting of the state boards or ensure a quorum for the board to make the decision. This section is intended to be temporary, which is a safeguard; however, as discussed, an amendment has been proposed to address industry concern and add additional safeguards. Some other tweaks were also discovered in the legislative version, therefore, attached to this testimony, we are including proposed amendments to this Bill.

Finally, this statute (6-07.2-18) includes clear guidelines for when an institution decides to voluntarily liquidate, turning itself over to the department. This is a scenario that has been discussed in recent years, when bankers are nearing retirement and may have a challenge finding a merging or purchasing partner, giving this as an option.

Section 10 of this Bill repeals Chapter 6-07.

To conclude, I want to make clear that the department is committed to our oversight of the safety and soundness of our financial institutions. A bank or credit union's failure always has an impact on the local community, and no one wants to see that happen, and we will do our best to prevent it.

Mr. Chairman, thank you for the opportunity to provide this testimony. I would be happy to answer any questions the Committee may have.