To: The Honorable Michael Schwab, Incoming Chair, Sunshine Committee
Sunshine Committee Members
Mary Tennyson, Sunshine Committee Staff

From: The Department of Financial Institutions (DFI)

Date: May 3, 2011

Re: Background and History of DFI's Exemptions from Public Disclosure

Because you will be joining the Public Records Exemption Accountability Committee (Sunshine Committee) in the middle of its review of the Department of Financial Institution's (DFI) exemptions from the Public Records Act (PRA), DFI wanted to provide you a brief history of its interaction with the Sunshine Committee and basis for its recommendations on its exemptions from the PRA.

I. DFI's Form and Function

DFI is Washington's state financial services regulator. Between its four substantive divisions (Banks, Credit Unions, Consumer Services, and Securities), it regulates a variety of entities ranging from state-chartered banks and credit unions to mortgage brokers and payday lenders to investment advisors and securities brokers. Many of these entities are regulated at both the state and federal level, so DFI has complicated relationships and interactions with our federal counterparts. These counterparts have included the Office of the Comptroller of the Currency (OCC, regulator of national banks), the-now defunct Office of Thrift Supervision (OTS, former regulator of federal thrifts), the Federal Deposit Insurance Corporation (FDIC, insurer of all national and state-chartered banks), the National Credit Union Administration (NCUA, regulator of federal credit unions and insurer of state-chartered credit unions) and the newly created Consumer Finance Protection Bureau (CFPB, with some

authorities over a variety of consumer finance companies and potentially some banks and credit unions).

II. DFI's History with the Sunshine Committee

Prior to DFI's direct involvement with the Sunshine Committee, it offered two bills in 2010 that sought to update DFI's existing banking and credit union Acts to provide new regulatory tools to address weaknesses in the financial system. The amendments also sought to clarify bank and credit union confidentiality provisions to bring them into line with federal law and existing DFI practice. After objections were raised in the Legislature, and because the amendments were merely clarifying and didn't change DFI's practices, DFI agreed to withdraw the confidentiality portions of the amendments to preserve the broader bills. Both bills passed without the clarifying language.

DFI has appeared before the Sunshine Committee twice—once on October 19, 2010, and once on March 22, 2011. At the October meeting, the Division Directors for Banks (Brad Williamson) and Credit Unions (Linda Jekel) testified, along with representatives of the banking and credit union industries. They provided general testimony on DFI's recommendations for leaving DFI's existing exemptions intact (as discussed below). At the March meeting, DFI's General Counsel and the Acting Division Director for Banks testified before the Committee.[1] This testimony was much more in-depth, and included a discussion of a Basel Committee report offered by Committee member Ramsey Ramerman as well as general federal preemption issues. In addition, DFI provided a variety of public documents as examples of the wealth of information

[1] Brad Williamson, DFI's former Division Director of Banks left the agency between the October and May meetings. His deputy, Gloria McVey, assumed the duties of the Acting Division Director when he left.

already available to the public. At the conclusion of that meeting, Committee Member Frank Garred asked for time to prepare proposals for amendments to be discussed at the Sunshine Committee meeting in May. Those proposals were received by DFI on April 15, 2011.

III. Why DFI's Exemptions from Disclosure Should be Left Intact

Each of DFI's exemptions from public disclosure exists for very specific policy reasons. DFI provided members of the Sunshine Committee with a chart of the exemptions under review, recommendations for retaining or eliminating the exemptions, and explanations of DFI's recommendations. A copy has been provided in the information packet you should receive from Sunshine Committee staff. The majority of DFI's "retain" recommendations are based on four fundamental policy purposes : 1) compliance with federal laws and agreements with federal regulators; 2) protecting the competitiveness of Washington businesses; 3) maintaining public confidence in the financial sector; and 4) increasing the candor of DFI licensees and charters during examinations. Each is addressed below.

1) Compliance with Federal Laws and Agreements

For banks and credit unions, DFI operates in a dual-regulatory system. For example, state-chartered banks are subject to examination by DFI (as their primary regulator) and the Federal Deposit Insurance Corporation (FDIC) (as the insurer of most deposits). To promote regulatory efficiency and cost savings for the agencies, and to minimize disruption of and expense to examined banks, DFI has historically conducted either joint or alternating examinations with the FDIC. This means that in years in which only one regulator examines a bank, DFI accepts FDIC examination reports and vice

versa. This subjects DFI to the FDIC's federal confidentiality rules. The FDIC's rules prohibit disclosure of "exempt records" by anyone except under narrow circumstances.[2] "Exempt records" include

> Records that are contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the FDIC or any agency responsible for the regulation or supervision of financial institutions . . .[3]

Similar rules apply to credit unions and the National Credit Union Administration. The NCUA's rules provide that:

> All reports, documents, and papers made available pursuant to [12 C.F.R. 792.31, authorizing release to government agencies and insured financial institutions] shall remain the property of NCUA. *No person, agency, or employee shall disclose the reports or exempt records without NCUA's express written permission.*

[emphasis added] Like for banks, exempt records include information "contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for the use of NCUA or any agency responsible for the regulation or supervision of financial institutions."[4]

Exemptions from the Washington Public Records Act (PRA) that protect bank examination reports and related information simply codify the federal laws that DFI must comply with. Even if these provisions were removed from the PRA, DFI would still be unable to release bank examination reports. In fact, in some cases a bank examiner at DFI could be committing a federal crime if he or she were to disclose a bank examination report that contained certain kinds of information.[5]

[2] 12 C.F.R. 309.6.
[3] 12 C.F.R. 309.5.
[4] 12 CFR 792.1.
[5] 12 U.S.C. 1906.

While federal confidentiality obligations are less for investment advisors, securities brokers, and check cashers and sellers, all operate in cooperation with DFI's federal counterparts and some parts of exams may be independently protected. For example, check casher and seller examiners have access to a Department of the Treasury database that records suspicious financial transactions. Our examiners occasionally use data obtained from this database in examination reports. This data is highly confidential and privileged under both federal law and DFI's agreement with Treasury that grants DFI access to the database. Eliminating the examination report confidentiality privilege may reduce DFI's ability to use such data in conducting thorough compliance examinations, which would ultimately undermine the security and safety of the financial system and could harm Washington consumers.

2) Protecting Competitiveness

Financial services are highly competitive industries. State-chartered banks and credit unions compete against each other, federally-chartered institutions, and a variety of non-depository businesses. Federally-chartered institutions are often significantly larger than state-chartered ones, and have a greater degree of influence over national regulatory policy. They often benefit from federal programs and protections that are not available to state charters, leaving state-charters in some ways at a natural disadvantage.

Examination reports contain detailed information about the operations, status, and assets of the examined entity. It may also include personal information about borrowers, depositors, investors, lenders, and other affiliated persons and entities. Reports may provide operational details about emerging products or services, in addition to contemplated changes to the long-term strategic plan. Some of this information may

constitute trade secrets, but much of it would not. If the examination report confidentiality provisions were removed for our licensees and charters, this information would be made public, likely significantly disadvantaging Washington-licensed and –chartered companies. A competitor would be able to obtain a copy of a report and use the data contained in it to obtain a competitive advantage, particularly where the obtaining entity is not itself subject to disclosure of its exam reports. Eliminating these exemptions would weaken Washington licenses and charters.

Banks and credit unions can choose which charter they operate under—federal or state—and can change if they feel it is necessary. Removing the disclosure exemptions for banks and credit unions may encourage them to switch to federal charters. Bank and credit union examination reports in particular contain detailed information about the operations and health of an institution, and provide a great deal of information that could be used by a savvy competitor. Removing these exemptions would widen the already-existing competitiveness gap between state- and federally-chartered financial institutions.

Particularly on the banking and credit union side, state charters are important to Washington. They provide direct benefits to their communities--their CEOs, CFOs, and employees mostly live and work in local communities, and are more connected to those communities than most national bankers. Because they're local, they can be more responsive to local business needs, and have historically been good corporate citizens in Washington. In general, the deposits collected in Washington are used to make local loans to Washington businesses and consumers. They're also regulated by DFI rather than federal regulators, so the state has direct oversight on their operations and can reign in any bad practices. If the state charter becomes too disadvantageous, state institutions

may flip charters and Washington may lose the benefits of having local financial institutions with a stake in Washington communities.

3) Maintain Public Confidence

Part of DFI's role as a banking regulator is to prevent runs on banks or credit unions. It does so in part by maintaining confidence in financial industries. This confidence could be undermined by release of currently confidential banking information. By their nature, bank and credit union examination reports are critical. They only specifically identify problems or potential problems and don't mention any of the good things a bank does. They are therefore subject to misinterpretation. As we saw with IndyMac Bank in California, when public confidence is shaken (appropriately or not), even banks that are not on the problem bank list are subject to collapse under a large enough deposit run. The kind of information that DFI includes in examination reports of even healthy institutions may be misinterpreted in a way that could harm those institutions and undermine public confidence.

While there is little risk of a run on a check casher and seller, an investment advisor, or a securities broker, there are other risks to public confidence from over-disclosure. Like bank and credit union reports, examination reports of these kinds of licensees are by nature critical. They only identify problems. Release of a bad examination report may kill a business that could easily have corrected any identified problems.

4) Increasing Candor

DFI, like any regulator, cannot always be in every institution and cannot review every business decision or transaction. DFI relies on the cooperation and candor of its

licensees and charters in conducting regulatory activities. Institutions and entities can be self-critical in their dealings with DFI in part because they know that any information they provide to or the conclusions they reach internally will not be subject to public disclosure. The legislature has realized the importance of candor over the last few years with regards to "paperwork violations." They have passed three laws in three sessions[6] to reduce the penalties assessed against Washington businesses for minor violations, in part to encourage self-reporting of minor errors.

Making examination reports public would almost certainly undermine the candor that DFI relies on, and would weaken DFI's ability to effectively regulate its institutions.

DFI has provided some additional information for each of the public records exemptions that are being reviewed by the Sunshine Committee, but the four listed above are the overarching reasons behind its recommendations and apply to the majority of DFI's exemptions.

[6] 2009 SL 358, 2010 SL 194, HB 2603, and 2011 SL 18.