

***Innovation in State Banking –
Washington State Business Development Company Act of 2006***

By Joseph M. Vincent*

The current preemption battle between the Office of the Comptroller of the Currency (OCC) and the states has again directed a spotlight on the state banking charter and the function of state banking regulation. This scrutiny has prompted many states to perform the kind of self-examination that has historically led to many improvements in banking. Indeed, throughout the history of the dual banking charter, the function of the states in financial institutions regulation has shown a great capacity and affinity for innovation. Examples of such innovation by the states, which were only later adopted by Congress, include checking accounts, bank branches, real estate loans, trust services, NOW accounts, reserve requirements, deposit insurance, adjustable-rate mortgages, automated teller machines, bank sales of insurance products, interstate electronic funds transfer systems, and interstate bank holding companies.

In this same spirit self-improvement and innovation, Washington State this year enacted the Business Development Company Act (SSB 6168, 2006 Session Laws, Ch. 87), which thoroughly overhauled and modernized an obscure and seldom-used industrial development corporation act (Ch. 31.24 RCW).

The Act facilitates an innovative type of *financial institutions charter*, which encourages banks, thrifts and/or credit unions, the investment community, private entrepreneurs, and even government-sponsored entities (GSEs) to form business development companies that will lend to or invest in small business, agriculture, community development and/or historical preservation. Of the minimum of five initial incorporators of a business development company, three (3) of them must be federally insured depository institutions. Federal- and state-chartered institutions may participate *with* each other.

The legislation is in keeping with four important functions of state banking regulation. First, it promotes the financial integrity of state institutions by making it easier for state-chartered banks and thrifts to be in compliance with their Community Reinvestment Act obligations. Second, the Act will help assure banks and thrifts that the business development companies in which they invest abide by safe and sound practices. Third, it helps eliminate unfair barriers to entry for small business, agriculture and community development projects by improving access to credit and choice of financial products. And finally, by encouraging all of the above, the Act helps enhance the economic vitality of the state.

In drafting the Act, the Washington State Department of Financial Institutions had four main goals in mind. First, the Act had to be *user friendly*, in the sense that business development companies ought to be easier to charter, govern, raise capital, attract

stakeholder participation, and manage. If this was so, the Department felt that creative business plans might emerge that were market (need) driven. Second, the Department saw the need for *open source* stakeholder participation, rather than the previous law's "closed system" of 10 or more banks with rigid rules for "membership" and "assessment." In the ideal business development company, there would be a cross-fertilization of ideas through joint participation by depository institutions, the investment community, entrepreneurs, and GSEs. Third, the Department wanted a *cafeteria plan* approach to permissible company activity, which would permit flexibility and choice in how a stakeholder participated, thereby fostering sustained interest. And fourth, the Department sought to encourage *stakeholder trust* in participation by assuring banks and other participants that there would be proper regulatory oversight and safety and soundness in an atmosphere of confidential examination.

The creation and maintenance of a viable business development company charter will be subject to straightforward, flexible, and functional regulation. A business plan, management and appropriate core capitalization must be approved in advance before the Department will grant a business development company charter (doing business as either a corporation or limited liability company). The business development company will be subject to a state safety and soundness examination every 24 months. The company must maintain a minimum capital-to-asset ratio of 8%. In harmony with the principle underlying Regulation O and other similar laws, the aggregate amount of qualified loans *and* investments of the company to any single borrower or business entity may not exceed 25%. Insider transactions must be ratified by the company's board of directors and are nonetheless subject to review upon examination by the Department. In keeping with statutes for state-chartered banks and thrifts, examinations reports will be confidential and exempt from Washington's expansive public disclosure law.

For any inquiries and copies of the Act, you may contact Joe Vincent at 360.902.0516 or jvincent@dfi.wa.gov.

* Joe Vincent is General Counsel at the Washington State Department of Financial Institutions and is presently Vice Chair of the State Banking Developments Subcommittee of the ABA Banking Law Committee. He was the principal drafter of the Washington Business Development Company Act of 2006, which is the subject of this article.