CONSIDERATION OF REGULATORY REFORM PROPOSALS

S. HRG. 108–885

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HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

ON

REGULATORY REFORM PROPOSALS

JUNE 22, 2004

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

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U.S. GOVERNMENT PRINTING OFFICE

25–856 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
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Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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CONSIDERATION OF REGULATORY REFORM PROPOSALS

TUESDAY, JUNE 22, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:08 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I want to thank everyone for being here today, and judging by the length of the witness list, that means a lot of thank you's. I will offer a blanket expression of gratitude.

But it should come as no surprise that so many witnesses are required for consideration of regulatory reform. The reality in today's marketplace is that technological development and shifts in consumer demand cause constant change in the financial services sector. This constant change, however, occurs in an environment where laws and regulations remain relatively static.

I believe that the tension caused by this situation makes it incumbent upon this Committee to undertake periodic reviews of the impact that the legal framework has on the operation of the marketplace. This entails reviewing the objectives behind the laws to determine whether they still remain relevant. It also requires, in the many instances where regulation is necessary, ensuring that compliance with such regulation can be achieved in a straightforward manner.

The bottom line is this: Most financial service firms compete to meet consumer demand and maximize profits. They are also tasked to meet certain safety and soundness and consumer protection requirements. I believe it is our responsibility here to ensure that the legal environment is such that firms can effectively meet their responsibilities to both the marketplace and to the regulatory system.

I would like to take a moment to thank Senator Crapo for his efforts and hard work with respect to regulatory reform. I know from past experience that developing a legislation product takes a great deal of time, patience, and effort. I want to commend him for the work he has done so far and the leadership he has shown. I look forward to working with him as this process continues.

Again, I want to thank all the witnesses for being here today, and I look forward to their testimony.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Mr. Chairman, and I want to thank Ranking Member Sarbanes as well for his interest and concern on this issue.

I appreciate your holding this hearing to begin our dialogue about reducing the regulatory burden faced by bankers and other financial service providers. I am confident that this hearing will be the beginning of a constructive period of collaboration to put together a bill that will maintain high standards for safety and soundness while at the same time reducing unnecessary red tape for financial institutions. And I want to welcome the excellent panels of witnesses that are here to join us this morning.

In South Dakota, we are extremely fortunate to benefit from a stable mix of large and small financial institutions. We have more than 100 small banks and credit unions scattered throughout our State, reaching into even the most remote communities. These small banks and credit unions provide critical financial services to these communities which might otherwise be underserved.

However, I frequently hear from my constituents that the regulatory burden on banks and other financial service providers has increased considerably over the past several decades. They report increasing amounts of time, energy, and dollars spent to comply with the numerous laws and regulations governing their operations. The 2003 nationwide survey of compliance offices by the American Bankers Association confirms these anecdotes.

Concern about regulatory burden and its impact is not a new topic for this body to address. In 1996, Congress, with my support, passed the Economic Growth and Regulatory Paperwork Reduction Act. That law requires the bank regulatory agencies to renew their regulations at least once every 10 years. I understand that process is underway, and I look forward to seeing progress from agencies in that review.

Reducing regulatory burden does not always mean eliminating laws and regulations. Proper reduction of regulatory burden does not sacrifice safety and soundness principles or reduce the level of consumer protection deemed adequate for the customers of banks and other financial service providers. Good public policy simply involves passing laws that allow businesses to operate without undue burden. One such example is legislation bringing uniformity to the rental-purchase industry, a bill I have cosponsored in the past few Congresses with one of our panelists, Senator Landrieu. I am pleased that Senator Landrieu will have this opportunity to speak about S. 884, which I believe is worthy of inclusion in any reg relief package.

I want to thank the panel members for joining us today, and I look forward to hearing their testimony, and I look forward to working with Chairman Shelby, Ranking Member Sarbanes, Senator Crapo, and other Members of this Committee to put together a reasonable and meaningful and doable regulatory relief package.

Mr. Chairman, I have some competing obligations that I am going to be dealing with and will not be able to stay for the entire duration of the hearing today. But, again, I thank you for calling this hearing. I think it will be a very valuable contribution to an urgent issue.

Thank you.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I, too, want to thank all of the witnesses for coming today and in advance will thank you for your cooperation, as we have not only a full, busy day here in the Committee but we also have a full, busy day on the floor. And we will, unfortunately, expect that there will be some interruptions, and we will try to make those as minimal as possible.

Eliminating outdated, ineffective, or unduly burdensome regulations that are not justified by either the need to ensure safety and soundness or to protect consumers is the focus of this legislation. We want to provide consumer protection on these critical and persistent issues within the banking purview of this Committee. When regulatory burdens are excessive and fail to add net value, they take a toll on the competitiveness of our financial system and squander scarce resources that could otherwise be devoted to productive activities, such as making loans or extending credit to small businesses and potential homeowners.

The sheer volume of regulatory requirements facing the financial services industry today presents a daunting task for any institution. Although there are no definitive studies of the total cost of regulation, it is estimated that the banking industry spends somewhere in the neighborhood of $26 to $40 billion annually simply to comply with regulatory requirements.

As we proceed, we need to make sure that we enact enough meaningful reforms so that the cost of change is not a burden in and of itself. The specific recommendations of the witnesses today will be of great use to me and to the other Members of this Committee as we create legislation to address the important issues of financial services regulatory reform.

While finding a consensus on these issues may be difficult, I look forward to working with you and the other Members of this Committee as we take up the regulatory relief issues in this Banking Committee.

I want to thank again all of you for appearing here today, and I look forward to your testimony and the questions and answers.

Chairman SHELBY. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman. I would ask that my full opening statement be placed in the record.

Chairman SHELBY. Without objection, it will be done.

Senator STABENOW. Thank you. In particular I want, though, to welcome our colleagues, Senator Lincoln and Senator Landrieu. We look forward to your testimony and appreciate your hard work.

I want to recognize Roger Little from the State of Michigan, our Deputy Commissioner of the Office of Financial and Insurance Services, and he also serves as Credit Union Director from Michigan. So we appreciate your testimony today.

I also welcome all of the other witnesses. We have a very broad array of views that we are going to hear that will help us as we

focus on regulatory reform. It is a very important topic, and it is important we begin this discussion on how we are able to proceed.

Thank you, Mr. Chairman, for your work and Senator Sarbanes, Senator Crapo, and everyone who is involved in this effort.

Chairman SHELBY. Thank you.

Our first panel is made up of Senator Mary Landrieu, a U.S. Senator from Louisiana, and Blanche Lambert Lincoln, a U.S. Senator from Arkansas.

We will start with Senator Landrieu.

STATEMENT OF MARY L. LANDRIEU
A U.S. SENATOR FROM THE STATE OF LOUISIANA

Senator LANDRIEU. Thank you, Mr. Chairman. And you all have a very full agenda, so I appreciate the opportunity, Mr. Chairman, to just share a few thoughts with you about S. 884, the Consumer Rental-Purchase Agreement Act, and ask that you would include this, consider including it in your package of regulatory relief.

Mr. Chairman, you are a cosponsor of the bill, along with many Members of the Committee, including Senator Johnson, who has provided a lot of leadership on this issue in the last few years.

Chairman SHELBY. Without objection, it is so ordered.

Senator LANDRIEU. Thank you. I will just make a few points this morning.

The rental-purchase industry makes household durable goods—appliances, furniture, electronics, computers, musical instruments, just to name a few—available to customers for rent on a weekly or monthly basis. Many people, Mr. Chairman, who rely on rent-to-own have no other means of acquiring household products. They are often families just starting out with no credit, or they are families who have had difficult times and have bad credit; military families who are transferred from location to location and find themselves only temporarily in a particular place; students who need to furnish an apartment or dorm room; and, yes, Mr. Chairman, even Members of Congress who have moved to Washington have used rent-to-own.

For these consumers, rent-to-own offers an opportunity to obtain the immediate use and eventual ownership, if they desire, of the things that many of us just take for granted—decent furniture, appliances like washers and dryers, et cetera—instead of using, as in many instances, laundromats, dropping coins into machines they will never own.

There is a store in a small town in North Louisiana, which is how this came to my attention, in Delhi called "The Easy Way." The President is Jimmy Strong. I have met with him many times and talked with him about his business. He rents a lot of air conditioners to people who cannot afford to buy them and would otherwise have to suffer through fairly unbearable summers, and they can do so through the hot months at very reasonable rates.

His customers, like other rent-to-own customers, are never obligated to rent beyond the initial term and can return the rental product at any time. So there are advantages to this system over the other system of credit currently only available under the law.

This bill attempts to do a couple of things. One, the purpose of this Federal legislation is to establish a floor of regulation, not a

ceiling, and our legislation does not prevent other States from enacting either stronger, different, or modified consumer protection laws as they see fit. States could also outlaw the practice if that is what they want to do.

It does set a Federal definition of rent-to-own transactions as rental-purchases and not as credit sales. This is the critical distinction. Under traditional credit transactions, the consumers must make all the payments over a predetermined period of time or risk default, repossession, deficiency judgments, and, at worst, could damage their credit or have to take personal bankruptcy.

By way of stark contrast, the rent-to-own customer enjoys control over his or her use of rental goods and the terms of the rental transaction itself.

So, Mr. Chairman, those are just a brief outline of what this legislation attempts to do. I know that you personally are familiar with this, as well as other Members. I appreciate the opportunity just to review again the benefits of this legislation and ask that you consider it in your regulatory package. Thank you.

Chairman SHELBY. Thank you.

Senator Lincoln.

STATEMENT OF BLANCHE LAMBERT LINCOLN
A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator LINCOLN. Thank you, Mr. Chairman and Senator Sarbanes, and all of our other colleagues here. I have been a little overzealous with my statement, so if I get too long, just cut me off.

This is an issue that really only deals with our State of Arkansas, and I am very proud to be here to testify in support of my bill, S. 904, allowing nonbank lenders in Arkansas who are currently subject to State usury restrictions to charge the same rates of interest that their out-of-State competitors are legally importing into Arkansas under Federal law. It is my hope that this bill will be included in your Regulatory Relief bill, and I am very proud and appreciative of the hard work that you have begun to put into this. The most important thing that I would like to ask the Members of this Committee to take from my testimony today is the question of whether a State usury law is good for consumers or bad for consumers is not the issue with what we are trying to do in our bill. With the passage of the Riegle-Neal Interstate Banking Act, the debate concerning the consumer benefits of State usury laws came to an end because lenders were then allowed to import their home State interest rates across State lines. The only issue now left to consider is whether in-State lenders who were placed at a competitive disadvantage because of this Federal law should be able to compete on a level playing field with out-of-State lenders. For my State, this is an issue of jobs, and I intend to fight very hard for the legislation that I have proposed, with the unified Arkansas delegation and our Governor. So we are very appreciative to be here today to state our case.

At this point, I would like to submit a copy of a letter from our Governor. I would also ask that a copy of an article by two professors of finance and one professor of economics from the University of Arkansas also be placed in the record.

Chairman SHELBY. Without objection, it will be included.

Senator LINCOLN. Thank you, Mr. Chairman.

Senator LINCOLN. The article is entitled "The History of Usury Law in Arkansas from 1836 to 1990," and I encourage all of my colleagues, particularly those who are critical of the current efforts of the entire Arkansas delegation, to free Arkansas' nonbank lenders from unfair out-of-State competition, to read the article. It is an excellent account of how Arkansas has struggled with this issue over the years before the passage of the Riegle-Neal Interstate Banking Act in 1994. I will go over some of the history of the issue in my testimony today, but I would like to highlight at this point two of the conclusions that were made by the scholars.

First, and I quote:

> To avoid the massive outflow of funds that the State has experienced in the past, any new constitutional usury provision must be structured so that both the business and financial communities are allowed a reasonable differential between their cost of funds and what they can charge for those funds.

The second quote comments that:

> Other costs in the form of a higher unemployment rate, higher prices, and the inability of borrowers to gain access to needed funds have occurred as a result of the restrictive nature of the State's usury law. If all these costs were converted into dollar amounts, there is no doubt that the price of having an artificially low interest rate at various times throughout the State's history would run into millions of dollars.

The Constitution of our State was rewritten in 1874 after Reconstruction was ended. Among the provisions written into the Arkansas Constitution at the time was a 10-percent cap on interest rates. From the very beginning, this cap on interest rates has been a limitation on capital that has hindered progress in our State. Caps on interest run counter to the economic realities of lending and have thus served not as a protection of consumers but a hindrance. The cap on the usury in Arkansas has limited the availability of capital for start-up businesses, high-risk loans, and low-income working families.

In 1982, Arkansas voters changes their Constitution by adopting Amendment 60 and created a two-tier interest rate cap. The opponents to the Amendment 60 were led by the Arkansas State AFL–CIO, the NAACP, and the Arkansas Community Organization for Reform Now, which is known as ACORN. Endorsing the amendment were over 70 organizations as well as our Governor, Frank White, Senator Pryor, Senator Bumpers, and former and future Governor Bill Clinton. The amendment which passed with 59 percent of the vote provided a cap of 5 percent over the Federal discount rate for general loans and a 17 percent above the discount rate for consumer loans. However, as is common with voter initiatives that do not move through an ordinary legislative process, the amendment was not properly designed. The Arkansas Supreme Court subsequently decided that the general loan provision overrode the consumer loan provision; thus, all loans in Arkansas were at that time capped at 5 percent over the discount rate. The clear intent of the people to lift the usury cap for consumer loans to something more in line with other States was struck down on a technicality by the courts. I have included a copy of the court's decision in my testimony. Arkansas has thus been left as one of the very few States that is still burdened by an antiquated and anticapitalistic usury restriction.

In his book on economic development in the State, "Laboratories of Democracy," David Osborne wrote of Arkansas that:

The usury law which limits interest on loans to 5 percentage points above the Federal Reserve Board's discount rate continues to inhibit both long-term fixed-rate loans and riskier short-term loans. He continues by saying that, "Governor Clinton's economic team recommended that it be abolished."

In the 1980's, the damaging impact of Arkansas's usury cap was limited to economic growth and capital availability in the State. In 1994, Congress got involved. That is when the viability of the Arkansas-based lenders was put at risk by the action of Congress. In 1994, Congress passed the Riegle-Neal Interstate Banking Act, many of you all will remember. This law gave interest lenders the authority to charge either their home State or their host State interest rates. The Federal law eliminated the practical effectiveness of Arkansas' cap on usury for out-of-State lenders and put Arkansas lenders, who remained subject to the law, at a competitive disadvantage.

At this point I would like to ask that a November 1998 article from *The Economist* magazine be placed in the record as well.

Chairman SHELBY. Without objection, it will be included.

Senator LINCOLN. Thank you, Mr. Chairman.

The article highlights the sad effects that the Riegle-Neal bill had upon Arkansas lenders and our jobs, unfortunately. The inequity of this Federal law created an immediate crisis for Arkansas banks competing with existing out-of-State bank branches in their communities. This prompted a unified Arkansas delegation to push to give Arkansas-chartered banks the authority to charge the same interest rate as the host State of interstate bank branches as part of the 1999 Gramm-Leach-Bliley Financial Modernization Act. This provision was specific to Arkansas.

In 1999, other lenders, nonbank lenders, with less established competitors did not feel the pressure as acutely as the Arkansas bankers did at the time. However, competition from out-of-State nonbank lenders has begun to take its toll on Arkansas lenders and its jobs just as it did on State banks in past years.

In 2000, with the support of former Senator Hutchinson, I introduced legislation to allow nonbank lenders the ability to import the rates of their competitors. The bill was modeled after the provision that passed in the 1999 bill for banks. Democratic Congressman Mike Ross, along with the entire House delegation, introduced identical language. The bill was reintroduced in the 108th Congress with Senator Pryor. The bill enjoys the support of the Democratic legislature, the Republican Governor, and countless groups in Arkansas who are truly concerned about job losses resulting from the current State law. The House Banking Committee has approved the legislation twice since introduction, and recently the full House approved the measure as a part of their regulatory relief bill.

I would like to close, Mr. Chairman, by addressing the three main criticisms I have heard about the legislation that I and the Arkansas delegation have proposed, and I will try to be brief.

Number one, doesn't the Arkansas usury provision protect consumers? Some argue that the usury cap in Arkansas serves a useful purpose for consumers and prevents discriminatory action by

lenders. However, because the Arkansas usury law only applies to Arkansas-based lenders, consumers are not protected by this cap at all. An out-of-State lender is contacted anytime a person's credit rating is too low to justify a capped rate. And as a result of the Federal law, out-of-State lenders are allowed to give credit that Arkansas lenders cannot give.

And, in fact, the Arkansas usury cap, combined with the power of out-of-State lenders to import their rates, actually leads to discriminatory actions by unscrupulous merchants. In order to prevent sales from leaving the State and their stores, sellers in Arkansas have begun charging higher prices for products in order to compensate for their inability to change interest. The high-risk credit consumer can be lured into these schemes because he or she has no other access to credit in Arkansas.

Second, shouldn't Arkansas fix the problem at home? And I know others think that we should, and that is why I want to make sure this Committee understands why we cannot. The problem at hand was created by Congress with the passage of the Riegle-Neal Interstate Banking Act. It is unlikely this Committee or the Senate would recommend repealing the Riegle-Neal or imposing a usury cap on all States. It was Congress that created a comparative disadvantage for Arkansas lenders by allowing the out-of-State lenders to import their rates. Congress has chosen to occupy the field of interest rate restrictions and should act responsibly to negate the inequities.

Further, in an environment where Federal laws and regulations have substantively occupied the field, the organizing document of a State is not flexible enough to keep up with the fluid changes of the Federal law. For example, the current Arkansas constitutional provision concerning usury ties interest rates in Arkansas to the Federal Reserve Bank's discount rate. The calculation of the discount rate was discontinued by the Federal Reserve Bank, and the term "discount rate" is no longer used. So the inflexibility of the Arkansas Constitution is left subject to interpretation.

And the last question, the lenders to whom we would extend the usury override are not regulated by banks, and so we cannot trust them with the power to charge a higher price for borrowed capital. Out-of-State nonbank lenders are importing rates into Arkansas in acts of interstate commerce. If critics of these lenders believe that Congress should regulate nonbank lenders operating in interstate commerce, they should propose that legislation, and that is something that we could certainly consider. However, there is nothing righteous in giving nonregulated lenders a competitive advantage over other nonregulated lenders because regulation does not exist.

Mr. Chairman, I thank you so much, you and your staff and the other staff and the Members of the Committee, for indulging me. This is an issue I have worked on since 1992, and it is one that has a tremendous effect on our ability as a State to grow, to provide the jobs that working families need, but, more importantly, to be a competitive State within this Union. And it is so important for us to be able to right the wrongs that we have seen and the disadvantages that we have found ourselves in. So, I would certainly ask you and the Members of this Committee to give every consideration to including our bill in your reg relief reform pack-

age. And if there are any questions, I will be more than happy to work with you all to answer any of those questions that exist.

I did cut my testimony short. I know it is hard to believe.

[Laughter.]

I did not give you the full history of Arkansas banking law.

[Laughter.]

Chairman SHELBY. We will make your full testimony a part of the record.

Senator LINCOLN. Thank you, Mr. Chairman, and thanks to all of you for indulging me.

Chairman SHELBY. Senator Lincoln, let me ask you one quick question. Did you say that the entire Arkansas Congressional delegation—you, Senator Pryor, and the Congressmen—the Governor and everybody is for what you are proposing?

Senator LINCOLN. Yes, sir, the entire delegation as well as the Governor are in full support of our legislation, and I have included a letter from the Governor, and all of the other delegation members are cosponsors.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, I know we have a lot of other people coming. We have these panels. I have a number of questions, but I am not going to pursue them.

Let me just ask one question. Arkansas could take care of this problem by changing its constitution, could it not?

Senator LINCOLN. And we tried. As I mentioned in my testimony, the first attempt there was poorly written. Changing the constitution is not an easy thing through the voters, and what we intended to do was to change it, first of all, and being poorly written, I think it was struck down by the courts.

Senator SARBANES. Well, it presumably could be well written and an effort could be made again to change your own constitution in order to take care of the problem, correct?

Senator LINCOLN. Some of our problems, however, do exist because of the Federal laws that we have passed, particularly the Riegle-Neal Banking——

Senator SARBANES. Well, except we passed Gramm-Leach-Bliley to even the playing field for the banks.

Senator LINCOLN. Yes, sir, but the nonbank lenders, and that is who we address in this bill. But I would be glad to visit with Senator Sarbanes on any other questions he may have. I promise.

Chairman SHELBY. Senator Crapo.

Senator CRAPO. I have no questions.

Chairman SHELBY. Senator Stabenow, would you like to ask any questions?

Senator STABENOW. No, Mr. Chairman.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Senator Lincoln, how are you?

Senator LINCOLN. I am fine, Senator Carper. How are you?

Senator CARPER. Good to see you. I am fine, thanks.

I just came from another hearing, and I missed most of what you said. I came in right at the end. Just give me a 30-second takeaway, what you would have us take away from what you said, so that when the other Members of our panel who are not here say, "Well, what did Senator Lincoln have to say?" I will be able to capture this in a few words.

Senator LINCOLN. In a nutshell—and I have given them a long history already—our usury laws in Arkansas have become quite antiquated, and we have tried to address those through several fixes in order to make sure that the caps that are on our lenders in Arkansas, the interest rate caps, are brought into a competitive level with out-of-State lenders who can transport their interest rates into our State to make our State lenders. Our problem is that nonbank lenders now are out of that competitive edge, and we want to just bring them in to full competitive nature with others who can import their rates into our State because it is causing really quite an economic disadvantage for our State, particularly on the parameters of the State where we have other States bordering us and we are seeing all of our jobs going out of our State. And much of our lending and capital as well is not staying in the State because they can import rates that are much lower from other places, not to mention the fact the disadvantage it puts many of our low-income, working families who cannot access those other lower rates, and they are only stuck with the in-State rates that tend to be higher. We would like to be able to make availability to them, too.

Senator CARPER. Thanks very much.

Senator LINCOLN. Thank you.

Chairman SHELBY. Thank you, Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo, do you want to take over?

Senator CRAPO. [Presiding.] We will now call up our second panel, and while they are changing the names, I will announce the panel. This panel is Donald Kohn, a Member of the Board of Governors of the Federal Reserve System; John M. Reich, Vice Chairman of the Federal Deposit Insurance Corporation; JoAnn Johnson, Chair of the National Credit Union Administration; Ms. Julie Williams, the First Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency; Mr. John Bowman, Chief Counsel of the Office of Thrift Supervision; Mr. John Allison, Commissioner of Banking and Consumer Finance for the State of Mississippi, who will be testifying on behalf of the Conference of State Bank Supervisors; and Mr. Roger W. Little, the Deputy Commissioner of the Credit Union Division for the Division of Financial Institutions of the State of Michigan, who will be testifying on behalf of the National Association of State Credit Union Supervisors.

Ladies and gentlemen, we welcome you here with us today. Before we get started, let me just say several people have mentioned the fact that we have a very full hearing today. You can see that by the fact that we have to scoot the chairs close together and fit everybody into this table. And we have another even larger panel following the first panel. In fact, between this panel and the next panel, we will actually take a break to add another table.

Senator CARPER. Mr. Chairman, is it true you are going to stack the tables on top of each other, a double decker?

[Laughter.]

Senator CRAPO. We are going to keep everybody in suspense as to just how we are going to fit that table in here, Senator Carper. But that is a possibility under consideration.

I do not know this for a fact, but this hearing may set a record for the number of witnesses that we have before us today. And that is going to require that we all cooperate together. You should have all been asked in the letter inviting you to testify—and this is for the witnesses in the next panel as well. You should have received a letter asking you to keep your testimony to 5 minutes, and we have these little clocks in front of you that it is incredibly hard for people to remember to look at when they are testifying. And so I just remind you to pay attention to the clock, and if your 5 minutes are up, I am going to just rap the gavel a little bit to remind you to look at that. And I can assure you that very few of you will finish your testimony before the clock runs out.

I will also assure you that your testimony is going to be very carefully read. Many of us have read a lot of it already, but your written testimony will be made a part of the record. And we want you to try to pay attention to the time limits that we have set here so that we will have some time for questions and answers and dialogue as we get into some of the issues.

So please forgive me if I have to rap the gavel a little bit to remind you to look down. I am one of those people who, once I get going, I do not look around at anything. So sometimes we need a little reminder.

With that, we will go ahead and start up in the order that I indicated. Mr. Kohn, you are first.

STATEMENT OF DONALD L. KOHN, MEMBER BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KOHN. Thank you, Senator, for the opportunity to testify on legislative initiatives related to regulatory relief.

Early this spring Chairman Greenspan, in a letter to you, highlighted three important proposals that the Board has supported for many years: Authorization for the Federal Reserve to pay interest on balances held by depository institutions in their accounts at Federal Reserve Banks, repeal of the prohibition against the payment of interest-on-demand deposits by depository institutions and increased flexibility for the Federal Reserve in setting reserve requirements.

Senator CRAPO. Mr. Kohn, you want to pull that mike just a little closer to you?

Mr. KOHN. Sure. Is that better?

Senator CRAPO. Thank you. Yes.

Mr. KOHN. For the purpose of implementing monetary policy, the Federal Reserve establishes reserve requirements on certain deposits of depository institutions. These requirements are met in part through balances held at the Reserve Banks. Because no interest is paid on these required reserve balances, depositories try to reduce their reserve requirements to a minimum through a variety

of reserve avoidance activities such as nightly sweeps of funds out of deposits that are subject to reserve requirements.

These activities absorb real resources and diminish the efficiency of our banking institutions. Payment of interest on required reserve balances would remove a substantial portion of the incentive for depositories to engage in such avoidance measures. Resulting improvements in efficiency should eventually be passed through to bank borrowers and depositors.

Even greater efficiencies in regulatory burden relief might be realized by substantially reducing or even eliminating the reserve requirements. Required reserve balances are useful for the implementation of monetary policy, in part because they provide a demand for balances at Federal Reserve Banks that is known in advance. When the Federal Reserve supplies balances through open market operations, it is able to achieve a given target level for the Federal Funds rate because of that predictable demand. Also reserve requirements must be met only on average over a 2-week period. The averaging allows banks to seek extra reserves when rates are low, and hold fewer reserves when they are high, and this behavior helps keep the funds rate stable.

However, if granted the authority, the Federal Reserve might be able to reduce substantially, or even eliminate, reserve requirements as long as it was authorized to pay interest on other types of balances held at the Reserve Banks. For instance, contractual clearing balances, which banks currently hold to ensure they can clear checks and make wire transfers without incurring overnight overdrafts, are also known in advance, and have an averaging feature like the balances used to satisfy reserve requirements. If explicit interest could be paid on such clearing balances, the demand for them potentially could be high and stable enough for monetary policy to be implemented effectively through existing procedures for open market operations, even in the absence of reserve requirements.

The efficiency of our financial sector also would be improved by eliminating the prohibition of interest-on-demand deposits. In order to compete for the liquid assets of businesses, banks now set up complicated procedures to pay implicit interest on compensating balance accounts. Banks also spend resources—and charges fees—for sweeping excess demand deposits of larger businesses into money market investments on a nightly basis. Such expenses waste the economy's resources, and they would be unnecessary if interest were allowed to be paid on both demand deposits and reserve balances that must be held against them.

Interest-on-demand deposits would clearly benefit small businesses that currently earn no interest on their checking accounts. But banks would likely incur higher costs, at least in the short-run. However, any cost increase for banks could have offsets through the repricing of other services, interest earned on balances held at the Federal Reserve, lower burdens of reserve requirements, the elimination of sweep programs and other reserve avoidance procedures. Over time these measures should help the banking sector, and especially small banks, to be more competitive in attracting liquid funds.

Although the Federal Reserve Board strongly supports repealing the prohibition of interest payments on demand deposits, the Board opposes the provisions in H.R. 1375 that would permit industrial loan companies to offer NOW accounts to businesses. ILC's are State-chartered, FDIC-insured banks, but their parent companies are not considered bank holding companies. Thus, commercial companies can own an ILC that is, an FDIC-insured bank, without complying with either the limitations on activities or the consolidated supervision requirements in the Bank Holding Company Act.

An amendment that would allow ILC's to offer NOW accounts to businesses would permit ILC's to become the functional equivalent of full service banks. H.R. 1375 also included ILC's in a provision removing limitations on de novo interstate branching. While the Federal Reserve supports expanding de novo branching authority for depository institutions, we believe that Congress should not grant this new branching to ILC's unless the corporate owners of these institutions are subject to the same type of consolidated supervision and activities restrictions as the owners of other insured banks.

Allowing a commercial or a financial firm to operate a full-service, nationwide insured bank outside the framework established by Congress for the other owners of insured banks, raises significant safety and soundness concerns, creates an unlevel competitive playing field, and poses important questions for the Congress concerning the Nation's policy of maintaining the separation of banking and commerce.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you very much, Mr. Kohn.

Mr. Reich.

STATEMENT OF JOHN M. REICH, VICE CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. REICH. Thank you very much, Senator Crapo, Senator Sarbanes, and Members of the Committee.

My name is John Reich. I am Vice Chairman of the FDIC. I am also here as head of the EGRPRA Task Force. As Senator Johnson mentioned earlier this morning, in 1996 Congress passed the Economic Growth and Paperwork Reduction Act, the EGRPRA, which required that all regulatory agencies work together over a 10-year period to review all regulations with an eye to eliminate those that are outdated, unduly burdensome, and no longer necessary.

By way of background, I am a former community banker. I was CEO of the National Bank of Sarasota in Sarasota, Florida for a number of years, a $450 million bank that had 19 offices along the West Coast of Florida. We were essentially a community bank.

In my capacity as Chairman of the EGRPRA Task Force, we have held a number of outreach meetings beginning in June of last year with the industry and with consumer groups. Last year, we had outreach meetings in St. Louis, Orlando, Denver, San Francisco, and New York City. We held meetings this year in Nashville and Seattle. We have one scheduled in Chicago. We had a consumer group meeting in February here in Washington, and will hold one later this week in San Francisco, followed by one in Chi-

cago slated for September. We are trying to consider the interests of all parties concerned.

My message to you this morning is, after speaking with many bankers over the past year, that regulatory burden is indeed an important issue for all banks, large and small. It is a particularly important issue for small community banks. Small community banks, in my opinion, face an uncertain future. Unless we take action soon to provide them with regulatory relief, and relief from the continuing avalanche of regulations which continues to be imposed upon community banks, they may indeed become an endangered species.

I would like to draw your attention to—I hope you have them at your seats—charts that are in front of you. Chart No. 1 is a chart of what has happened in community banking over the past 20 years. At the end of 1984, there were 11,780 community banks with assets under $100 million in the United States. At the end of last year, that number had declined dramatically to 4,390.

Chart No. 2 shows the market share of industry assets held by community banks. Adjusted for inflation, community banks held 9 percent of industry assets 20 years ago. The absolute number at that time was 13 percent. As of the end of last year, the market share of community banks with assets under $100 million, had declined to 2 percent.

Chart No. 3 shows the growth in assets of banks over $10 billion. There are 110 banks in the United States today with assets over $10 billion. Twenty years ago, those banks had a market share of 27 percent. At the end of last year, the market share of the megabanks over $10 billion in assets, had grown to 70 percent.

It has been widely reported that the industry as a whole earned a record $120.6 billion last year, surpassing the previous record of the year before of $105 billion. What is not often reported is the considerable disparity in earnings between large banks and small banks in the country. It is, indeed, as FDIC Chairman Powell has stated, a tale of two industries.

Last year, the 110 largest banks in the country earned $87.7 billion or 73 percent of total industry earnings. By contrast, the 4,390 community banks, representing 48 percent of the total number of institutions, earned only $2.1 billion, just 1.7 percent of total industry earnings. As Chart 4 shows, the community bank share of industry earnings has been on a downward slope since 1990, and I expect that this trend will continue.

I believe the disparity in profitability can be attributed, at least in part, to the disproportionate impact of the cost of compliance with accumulated regulation that has been placed on community banks.

To comply with the requirements of EGRPRA, as I mentioned, we are engaged in a joint effort to solicit comments from the public. The outreach meetings that I referred to have been attended by representatives of all of the Federal regulatory agencies: The OCC, the FDIC, the OTS, and the Federal Reserve. The State regulatory agencies are also participating at each of our outreach meetings. We divided all Federal regulations into 12 categories and are putting one or more categories out for public comment every 6 months until 2006. Through our outreach meetings and comment letters we

have received to date, we have identified a number of possible legislative proposals that I believe deserve our careful review and consideration by Congress.

In my written testimony are the following proposals: First, to eliminate unnecessary reporting requirements for bank officers and directors; second, to streamline the application process for certain bank mergers; third, to eliminate the annual privacy notice distribution requirement for banks that do not share personal information with third parties; fourth, to provide consumers the flexibility to weigh their right of rescission under certain circumstances and receive their money faster at real estate closings; fifth, to update certain provisions of the National Flood Insurance Act; and six, to repeal the CRA Sunshine Law. This is the first of what I expect will be a longer list of legislative proposals that we will be reviewing and recommending as a part of our EGRPRA regulatory review process.

Along with a number of issues pending on which we have not yet reached consensus, we will also have an opportunity to review the ideas and proposals that are suggested at this hearing today to develop a comprehensive list of regulatory relief initiatives that I hope all of the agencies can and will support. I intend to spend a substantial portion of my time over the next several months working toward this end.

Thank you, Mr. Chairman, for holding this hearing. I appreciate the opportunity to be here, and look forward to questions.

Senator CRAPO. Thank you.

Mrs. Johnson.

STATEMENT OF JOANN JOHNSON
CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Mrs. JOHNSON. Senator Crapo, Senator Sarbanes, and Members of the Committee, thank you for inviting me to appear on the panel today. On behalf of the National Credit Union Administration, I am pleased to provide our agency's views on regulatory efficiency recommendations. My written comments, previously provided to you, cover a number of issues, some of which I will highlight for you.

It is my strong belief that effective regulation, and not excessive regulation, should be the underlying principle supporting NCUA's critical mission of ensuring the safety and soundness of federally insured credit unions. In this regard, NCUA is carefully coordinating with the other four Federal financial institution regulation agencies in the review project mandated by the Economic Growth and Regulatory Paperwork Reduction Act of 1996, and we will soon be making our third request for public comment.

NCUA also scrutinizes one third of NCUA existing regulations annually to find ways to simplify or improve any rule that is outdated or in need of revision. To date, this internal process has brought about important regulatory reform for credit unions in many of NCUA's rules, including those on lending, share accounts, and incidental powers. We are on track to meet the EGRPRA deadline of 2006.

A time sensitive recommendation in my testimony today stems from the Financial Accounting Standards Board's proposed change in the accounting treatment of credit union mergers. This is a re-

cent development. Therefore, it has not previously been included in recommendations NCUA has submitted for your review. FASB's change will, in effect, prevent credit unions from moving forward with mergers which are clearly in the best interest of their members. Specifically, the change will provide that when two credit unions merge, the retained earnings of the discontinuing credit union would not be included in the post-merger net worth. FASB expects to implement this change as early as January 1, 2006. NCUA has suggested addition of statutory language to the Federal Credit Union Act, as well as report language, clarifying the limited purpose of this amendment to maintain net worth as it is. That language is attached to and made part of my written testimony for the Committee's consideration.

Another issue concerning net worth is the statutorily imposed requirements for prompt corrective action and NCUA's recommendation to move to a more equitable system where net worth requirements are more dependent on the risk in an individual credit union. Legislation introduced in November 2003, H.R. 3579, the Credit Union Regulatory Improvement Act of 2003, CURIA, has begun deliberations over how such a risk-based system could be applied to federally insured credit unions. NCUA strongly supports a risk-weighted system. A well-designed, risk-based system would alleviate regulatory concerns by not penalizing low risk activities and by providing credit union management with the ability to manage their compliance through adjustments to their assets and activities.

An important area where NCUA does not have jurisdiction comparable to the bank regulators, involves third party vendors. NCUA does not have direct authority to examine third party vendors that provide services to federally insured credit unions. Statutory authority previously existed for NCUA, but under a sunset provision, expired in 2001. We are currently required to work through credit unions to obtain vendor information or seek voluntary cooperation from vendors. We believe that in these times, privacy, money laundering, and financing of terrorism are issues of paramount national interest as well as general safety and soundness concerns. NCUA should have direct examination authority over those vendors providing services for federally insured credit unions.

A restoration of NCUA's examination authority would provide parity with other financial regulators. It would also eliminate the need for us to approach the matter indirectly through credit unions, thus providing some measure of regulatory relief. This is consistent with the October 2003 GAO report, which stated that Congress may wish to consider granting this authority to NCUA.

Other issues of which we are supportive: Authorizing Federal credit unions to provide check cashing and money transfer services to anyone eligible to become a member. This will greatly assist reaching unbanked individuals. Allowing the NCUA Board to set the investment limit for credit unions and credit union service organizations by establishing up to a new 3 percent investment limit. Seeking a provision to provide regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker/dealers when engaging in certain securities activities as banks are currently allowed.

NCUA has reviewed all of the additional credit union provisions included in the House passed bill, and the Agency has no safety and soundness concerns with these provisions.

For the record that NCUA is neither the regulator of nor the insurer of State-chartered credit unions whose deposits are not insured by the National Credit Union Share Insurance Fund. Accordingly, NCUA has no official position on the public policy issue related to privately insured, State-chartered credit unions being eligible to join the Federal Home Loan Bank System.

However, it is our belief that there is a problem with the language added to the basic provision to Section 301 or H.R. 1375. In our view, the language requiring private insurance providers to submit copies of their annual audit reports to NCUA should be removed to avoid potential consumer confusion and misunderstanding with respect to NCUA's jurisdiction, and with respect to the private nature of this insurance coverage. Also, we believe that the consultation language seeking to bring the NCUA into a role that appropriately rests with State credit union and insurance regulators should also be removed.

Thank you for allowing me to testify today and address these important regulatory reform issues. We hope to gain your support for these recommendations, and I would be pleased to assist you further on these in any way I can.

Thank you.

Senator CRAPO. Thank you, Mrs. Johnson.

Ms. Williams.

STATEMENT OF JULIE L. WILLIAMS
FIRST SENIOR DEPUTY COMPTROLLER
AND CHIEF COUNSEL
OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. WILLIAMS. Thank you. Senator Crapo and Members of the Committee, the Office of the Comptroller of the Currency welcomes the opportunity to contribute to the effort to address unnecessary regulatory burden on the banking industry. We very much appreciate your commitment and your dedication to this issue.

Unnecessary regulation imposes both direct and indirect costs. When unnecessary regulatory burdens drive up the cost of doing business for banks, bank customers feel the impact in the form of higher prices and in some cases, diminished product availability. Unnecessary regulatory burden can also become an issue of competitive viability, particularly for our Nation's community banks, where bankers face competitors that offer comparable products and services but are not subject to comparable regulatory requirements.

This is a challenge that we must confront on several levels. First, when regulators adopt regulations, and as we review the regulations that we already have on the books, we have a responsibility to ensure that regulations are effective to protect safety and soundness, foster the integrity of bank operations, and safeguard the interests of consumers. But we also have a responsibility to regulate efficiently so that we do not impose regulatory burdens that are unnecessary to achieve those goals.

Second, there are regulatory burden initiatives that must come from Congress in the form of Federal legislation, adding provisions

to law to provide new flexibilities, modifying requirements to be less burdensome, and, in some cases, perhaps eliminating certain requirements currently in the law altogether.

Finally, it is important to recognize that many of the areas that are often identified as prospects for regulatory burden reduction involve requirements put in place by Congress for the protection of consumers. Over the years, these requirements have accreted, and in the disclosure area, in particular, consumers today may receive disclosures that are so voluminous and so technical that many simply do not read them—or when they do—do not understand them.

As we continue our efforts to address regulatory burdens, we are going to run out of discrete fixes to make at some point and face some more fundamental questions about basic approaches that we pursue. If we are to undertake that task, and do that responsibly, we need much better data than we have now on the costs resulting from particular regulatory requirements and the benefits of those requirements—particularly data relative to the benefits of other approaches that could achieve Congress's goals with lesser burden. I would urge the Committee to consider what information and analysis would be needed as a foundation for that type of undertaking.

Congress took an important step to address the challenge of unnecessary regulatory burden in 1996 when it passed the Economic Growth and Regulatory Paperwork Reduction Act. As you know, that Act requires the regulatory agencies to conduct a review of all pertinent regulations every 10 years in order to identify outdated and unduly burdensome regulatory requirements. That review is now well underway, as you have heard from Vice Chairman Reich, under the Vice Chairman's very capable and dedicated leadership.

Ultimately, however, some important forms of regulatory relief require changes in Federal law. My written testimony describes a number of areas that we urge the Committee to consider at this time, and I will highlight just a few.

As both national and State banks seek to establish branch facilities to enhance their service to customers, a change that would reduce burden would be to repeal the State opt-in requirement that today blocks banks in many States from expanding interstate through de novo branching.

We also urge that directors of national banks that are organized as Subchapter S corporations be allowed to satisfy their directors' qualifying share requirements under the National Bank Act by purchasing subordinated debt instead of capital stock.

Another change that would provide some valuable simplification for national banks and for Federal thrifts would be a clarification, that for purposes of determining Federal court diversity jurisdiction, national banks and Federal thrifts are citizens only of the State in which these institutions have their main office.

One last change I would mention here is an amendment to the International Banking Act of 1978 which would allow the OCC to set the capital equivalency deposit for Federal branches and agencies to reflect the risk profile of the branch or agency. This would create a framework for capital adequacy standards for Federal branches and agencies that more closely resembles the risk-based capital framework now applicable to our domestic banks.

On behalf of the OCC, we very much appreciate your efforts today, and the Committee's efforts in prior years, to identify ways to reduce unnecessary burden on the banking industry while preserving safety and soundness and looking out for the interests of bank customers. We look forward to working with you, Senator Crapo, with other Members of the Committee, and with your staffs on these issues, and I would be very happy to answer your questions at the appropriate time.

Senator CRAPO. Thank you, Ms. Williams.

Mr. Bowman.

STATEMENT OF JOHN E. BOWMAN
CHIEF COUNSEL, OFFICE OF THRIFT SUPERVISION

Mr. BOWMAN. Good morning, Senator Crapo and Members of the Committee. Thank you for the opportunity to testify on the regulatory burden relief initiatives of the Office of Thrift Supervision.

It is always important to remove unnecessary regulatory obstacles that hinder profitability, innovation, and competition in our financial services industry. I particularly want to thank you, Senator Crapo, for your leadership in this area. We look forward to working with you and your staff on legislation to address the issues we discuss today.

In my written testimony, I discuss a number of proposals that we believe would significantly reduce burdens on thrift institutions. I ask that the full text of that statement be included in the record.

Senator CRAPO. Without objection, and the text of all statements today will be in the record.

Mr. BOWMAN. Today, I will highlight the two items in particular that would provide the most significant relief to thrifts. These are the proposed amendments that would treat thrifts and banks the same under the Federal securities laws.

Banks and thrifts may engage in the same type of activities covered by the investment adviser and broker/dealer requirements of the Federal securities laws, and these activities are subject to substantially similar supervision. The key point is that banks, but not thrifts, are exempt from registration under the Investment Advisers Act of 1940; and banks, but not thrifts, enjoy an exemption from broker/dealer registration under the 1934 Act for certain activities specified under the Gramm-Leach-Bliley Act.

For purposes of the broker/dealer requirements, until recently the SEC has treated thrifts the same as banks. however, the Commission has just issued two proposals, one in the broker area and the other dealing with the investment adviser issue, that fail to extend the same treatment to thrifts as banks enjoy in these two areas. Treating thrifts and banks the same under the Federal securities laws makes sense for a number of reasons.

Thrifts fill an important niche in the financial services arena by focusing their activities primarily on residential, community, small business, and consumer lending. The Homeowners Loan Act allows thrifts to provide trust and custody services on the same basis as national banks, and investment adviser and third party brokerage in the same manner as banks. Not only are the authorized activities the same, but OTS also examines those activities in the same manner as the other banking agencies.

While the bank and thrift charters are tailored to provide powers focused on different business strategies, in areas where powers are similar, the rules should be similar. No legitimate public policy rationale was served by imposing additional and superfluous administrative costs on thrifts to register as an investment adviser or as a broker/dealer when banks are exempt from similar registration. There should be similar treatment for regulated entities in similar circumstances.

The circumstances here are that, first, thrifts, like banks, have a regulator that specifically supervises the types of activities covered by the investment adviser and broker/dealer registration requirements. Second, thrifts, like banks, are subject to the same functional regulatory scheme endorsed by the Gramm-Leach-Bliley Act. Third, thrifts, like banks, are subject to substantially similar customer protections with respect to the activities covered by the registration requirements, which by the way, are based on the SEC's own customer protection rules.

The only difference is that thrifts, unlike banks, are subject to an additional and clearly burdensome administrative registration requirement. It is best stated in the SEC's own words from the preamble to their May 2001 interim final rule extending broker/dealer parity to thrifts: "Insured savings associations are subject to a similar regulatory structure and examination standards as banks. Extending the exemption for banks to savings associations and savings banks is necessary or appropriate in the public interest, and is consistent with the protection of investors."

OTS strongly supports legislation similar to that in Section 201 of H.R. 1375, the bill passed by the House in March of this year, to extend the bank registration exemptions to thrifts. Absent this treatment, thrifts are placed at a competitive disadvantage that is without merit and imposes significant regulatory cost and burdens.

As recently as the Gramm-Leach-Bliley Act, Congress affirmed the principles underlying the bank registration exemption. We believe the best way to absolve this matter for thrifts with certainty and finality is for Congress to extend, by statute, the same exemption to thrifts. OTS is committed to reducing burden whenever it has the ability to do so consistent with safety and soundness and compliance with the law.

We look forward to working with the Committee to address these and the other regulatory burden reduction items we discussed in our written statement. I especially thank you, Senator Crapo, and all who have shown leadership in this area.

I would be happy to answer any of your questions.

Thank you.

Senator CRAPO. Thank you very much, Mr. Bowman.

Mr. Allison.

STATEMENT OF JOHN S. ALLISON
COMMISSIONER OF BANKING AND CONSUMER FINANCE FOR THE STATE OF MISSISSIPPI
ON BEHALF OF
THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. ALLISON. Senator Crapo and Members of the Committee, I appreciate this opportunity to appear on behalf of the Conference

of State bank Supervisors to present the views of CSBS on the important issue of regulatory burden as it impacts the Nation's banking system.

As current Chairman of CSBS, I am pleased to represent my colleagues in all 50 States and the U.S. territories. As supervisor of over 74 percent of the Nation's bank charters, State banking regulators have the closest vantage point when it comes to supervisory issues as well as issues relating to our State and local economies.

Let me mention that CSBS is very concerned over regulatory actions that have resulted in a grave imbalance in the dual banking system. As of year end 2003, national banks had approximately 56 percent of the total assets in the banking system. Already since February, when the Office of the Comptroller of the Currency finalized its rule preempting national banks and their operating subsidiaries from State consumer protection laws, two large State-chartered banks have announced plans to convert their charters to national banks. With the announced and predicted conversions, the State system will have shrunk from 44 percent of the banking system's assets to under 33 percent in less than a year. Should many more of these banks with interstate operations switch charters, the State system as a whole will suffer. We believe that without a viable State chartering system there would not be community based banks.

Federal Reserve Chairman Greenspan has referred to the American dual banking system and its support of the community banks as jewels of our economy. The preservation of a State chartering and regulatory system sets the United States' financial system apart from every other developed Nation and has primarily contributed to our Nation's diverse, resilient, and responsive economy.

Centralization of authority or financial power in one agency or in a small group of narrowly regulated institutions would threaten the dynamic and responsive nature of our financial system. Therefore, the most important contribution toward reducing regulatory burden may be empowering the State banking system.

With this in mind, there are several provisions that we believe should be considered for any regulatory burden relief legislation that would be introduced in the Senate, and I will go over just a couple.

First, coordination of State examination authority. Through the CSBS Nationwide State-Federal Cooperative Agreements, State banking commissioners are working closely with either the FDIC or Federal Reserve and banking commissioners in host States where their bank operates branches, to provide quality risk-focused supervision. To further support these efforts, we strongly support including the provisions in the House regulatory relief bill that reinforces these principles and protocols. While the House language gives primacy of supervision, including the ability to charge supervisory fees to the chartering State, it requires both home and host State bank supervisors to abide by any written cooperative agreement relating to coordination and joint participation in exams.

Second, de novo interstate branching. CSBS supports the provision in the House regulatory relief bill allowing de novo interstate branching for banks and trust companies. Current Federal law takes an inconsistent approach toward how banks may branch

across State lines. Creative interpretations of this law have placed State-chartered institutions at a competitive disadvantage to those larger federally chartered institutions that can branch without restriction. We encourage you to revisit the Riegle-Neal Act to eliminate the disadvantage that has been created for State banks because of inconsistent application of Federal law.

Third, flexibility for the Federal Reserve. CSBS encourages you to grant the Federal Reserve the ability to permit State member banks to engage in expanded activities authorized by their chartering State and approved by the FDIC as posing no risk to the Deposit Insurance Fund. This amendment would remove a provision in the Federal Reserve Act that places unnecessary limitations on the powers of a State member bank. State-chartered, nonmember banks have always been allowed to exercise expanded powers within the confines of safety and soundness. It is an appropriate regulatory relief effort to eliminate this unnecessary distinction between State-chartered member banks and State nonmember banks.

Finally, CSBS would like to see a State banking regulator have a vote on the Federal Financial Institution Examination Council. I am currently Chairman of the State Liaison Committee, which consists of State bank, credit union, and savings bank regulators, and as such am able to provide input at the FFIEC Council meetings. However, neither I, nor any other State regulator, have any final say in Federal policy or examination procedures impacting the institutions that we charter and supervise.

Improved coordination and communication between regulators clearly benefit bankers and reduce regulatory burdens. In that spirit, we suggest that Congress should improve the FFIEC by changing the State position from one of observer to that of full voting member.

In conclusion, as you consider additional ways to reduce burden on our financial institutions, we urge you to remember that the strength of our banking system is its diversity. The fact that we have enough financial institutions of enough different sizes and specialties to meet the needs of the world's most diverse economy and society.

State bank supervisors appreciate the Committee's interest in eliminating barriers in the Federal law to allow more innovation from the State charter. We thank you for the opportunity to testify on this very important subject, and look forward to any questions that the Members might have.

Thank you.

Senator CRAPO. Thank you very much, Mr. Allison.

Mr. Little.

STATEMENT OF ROGER W. LITTLE
DEPUTY COMMISSIONER, CREDIT UNIONS
MICHIGAN OFFICE OF FINANCIAL AND
INSURANCE SERVICES, ON BEHALF OF THE NATIONAL
ASSOCIATION OF STATE CREDIT UNION SUPERVISORS

Mr. LITTLE. Senator Crapo, Members of the Committee, I serve the citizens of Michigan as Deputy Commissioner of Credit Unions for the Michigan Office of Financial and Insurance Services, and I

appear today on behalf of the National Association of State Credit Union Supervisors.

NASCUS' priorities for regulatory relief legislation focus on reforms that will strengthen the State system of credit union supervision, enhance the capabilities of State chartered credit unions to meet the financial needs of their members, and ensure the State credit union system continues to operate in a safe and sound manner. Some of our priorities are contained in H.R. 1375, but other NASCUS priorities are beyond the scope of that bill.

NASCUS supports Section 306 in H.R. 1375, revising member business lending restrictions in the Federal Credit Union Act to lift the restrictions on lending to nonprofit, religious organizations by federally insured, State-chartered credit unions. This is a win-win situation. Credit unions will be able to expand their member business lending offerings to members involved with nonprofit, religious organizations, thereby benefiting entire communities.

NASCUS supports Section 312 in H.R. 1375, giving all federally insured credit unions the same exemptions as banks and thrift institutions from premerger notification requirements and fees of the Federal Trade Commission. In fact, we believe it should be expanded to all State-chartered credit unions.

NASCUS supports Section 313 in H.R. 1375, providing federally insured credit unions and savings institutions parity with commercial banks regarding exemption from SEC registration requirements provided in the Gramm-Leach-Bliley Act. As depository institutions credit unions should be exempted from SEC registration requirements for the same reasons articulated by prior panel members. We urge that credit unions be accorded similar regulatory treatment in this manner.

NASCUS supports Section 301 in H.R. 1375, that permits nonfederally insured credit unions to join Federal Home Loan Banks. Federally insured credit unions now have access to these banks, while private-insured credit unions do not.

Today, there are approximately 375 privately insured credit unions. All of these credit unions are regulated and examined by State regulatory agencies to ensure they are operating in a safe and sound manner, and to assure consumers that their deposits are safe. We believe regulatory functions are a primary determinant of the safety and soundness of the credit union system. For these reasons and others detailed in my written testimony, it is clear that these credit unions are operated in a safe and sound manner. They should be granted the same access to the Federal Home Loan Bank System as federally insured credit unions. I also note that this is not a new precedent since 86 insurance companies, none of which are federally insured, now belong to the Federal Home Loan Bank System.

We also support regulatory relief proposals beyond those in H.R. 1375. The first addresses the prompt corrective action provisions, also known as PCA, of the Federal Credit Union Act. NASCUS strongly urges the Committee to amend the PCA provisions in the Act to allow federally insured credit unions to include all forms of capital when calculating the required net worth ratio. Under the current Federal statute credit union net worth is defined as "and limited to retained earnings." This exclusive reliance on re-

tained earnings limits credit unions' ability to grow, to implement new programs, or to expand services to meet the changing needs of their membership. Limiting statutory net worth to retained earnings has the unintended consequence of punishing credit unions for being successful.

NASCUS also supports Federal legislation that would add a risk-based capital component to the current net worth requirements for PCA. NASCUS has studied the risk-based capital reform proposal outlined in H.R. 3579, and supports a risk-weighted capital regime for credit unions. We believe that supplemental capital authority and a risk-based capital system are complementary reforms.

NASCUS also supports amending the definition of "net worth," as discussed by Chairman Johnson, to cure the unintended consequences for credit unions of business combination accounting rules that the Financial Accounting Standards Board intends to apply to business combinations of mutual enterprises. The new rules may cause significant dilution of net worth in credit union merger transactions if the definition of "net worth" continues to be solely limited to retained earnings.

As a regulator, it makes no business sense to deny credit unions access to capital that would improve their safety and soundness. We should take very financially feasible steps to strengthen the capital base of the Nation's credit union system.

H.R. 1375 expands business lending authority for Federal savings associations. NASCUS urges the Committee to include a similar expansion for credit union member business lending authority in the Senate bill. Raising the statutory limit for credit union business lending from 12.25 percent to 20 percent of total assets, as the House bill did for savings institutions, would provide equivalent regulatory relief for credit unions. This would enable credit unions to better meet the needs of their members and participate more fully in economic development within their communities.

Finally, preemptive actions of the Office of the Comptroller of the Currency have a potentially significant impact on the dual chartering system for commercial banks. We are concerned similar actions by the Federal credit union regulator may impact the States' chartering system as well, particularly in the area of consumer protection. Historically, States have established predatory lending and other consumer protection statutes that are applicable to both State and Federal depository institutions.

In general, national banks have been subject to such statutes to ensure protection of the same level to citizens of the State opting to use federally chartered financial institutions. There is widespread significant and expert opposition to these Federal rules. We hope Congress will intervene in this matter.

This concludes my remarks. NASCUS appreciates the opportunity to testify today. We welcome further participation and dialogue. We urge this Committee to protect and enhance the viability of the dual chartering system for credit unions. I will be happy to respond to any questions the Committee may have. Thank you.

Senator CRAPO. Thank you very much, Mr. Little, and I want to thank the entire panel.

As I indicated at the beginning, we are in a race today to get through the testimony and the material in this hearing. Many of

you may have noticed that a vote has been called. What I want to do is, I am going to be very brief in my questions. I am probably going to submit written questions to each member of the panel and have a dialogue, after we excuse this panel, with you.

I am just going to ask one question to Mr. Reich, then I am going to leave time for Senator Reed and if Senator Carper wants to ask some questions. We will then excuse this panel before we leave to vote. We will have a break at that time, and we will rearrange the tables. It is two votes, although if we leave at the end of the first vote, it should not take us too long to vote twice and get back. So, just to give you a little guideline there as to where we are headed.

The question I have for you, Mr. Reich, is this. Actually, I have a bunch of questions for all of you, and as I indicated, I will engage with you with regard to those questions after we excuse the panel. I just wanted to note I have read the written testimony of each of the witnesses who have been here before us today, and I have to say it is outstanding testimony. We asked you to come before us with recommendations to deal with the issue that we have here before us, and each of you did exactly that, specifically, in ways that will give us some very significant guidance. In terms of the old question, where is the beef? There is a lot of beef here. There is a lot of substance in this testimony.

As we go through this, Mr. Reich, in your capacity with EGRPRA, you indicated in your testimony that one of the things you were contemplating was looking at the proposals that have been made here today, to wind them into the EGRPRA process. I was wondering if you could, within a couple of weeks, review the proposals made by each of the regulators and get back to the Committee with just an analysis as to how the other regulators feel about the various proposals that have been put forward by this panel. Would that be something that you could achieve in that timeframe?

Mr. REICH. I will do my best, Mr. Chairman. I would be delighted to undertake that, prepare a matrix of all of the recommendations which have been made and come back to you within the next 2 weeks.

Senator CRAPO. Thank you. I appreciate that very much, and that certainly is a chore because there is a tremendous amount of substance here to go through, but I believe with your help and with the help of people in the private sector as well as the other regulators, we should be able to get a pretty thorough analysis or the recommendations that have been made by the members of the panel today.

With that, Senator Reed, I will turn the time over to you and maybe we will be able to get to the vote.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman.

Thank you for your excellent testimony. Mr. Kohn, can you give us an estimate based on your analysis, about the amount of resources are consumed in sweep accounts to avoid the interest on checking prohibition? Is that a significant number?

Mr. KOHN. I cannot give you a number, Senator. But I do think it is a significant number. We are really talking about two kinds

of sweep accounts here. One kind is to avoid the nonpayment of interest on reserve requirements, and many banks, including small and medium-size banks, as well as large banks, have instituted programs to sweep deposits out of reservable accounts every night into nonreservable accounts. Although the computer programs get cheaper and cheaper to make that happen, every time the computer system changes, every time there is a bank merger, things have to be done again, and I think that there is no benefit to the economy or to society from activities that try to get around the reserve requirement tax.

The other types of sweep programs are to get out of the prohibition of interest on demand deposits. Obviously, the two work in tandem to a certain extent, and banks do that in two ways. One is to sweep money, particularly for large businesses, out of the demand deposits into market accounts every night, into euro dollar accounts and RP's, and things like that, and it serves no purpose whatsoever but to get around this prohibition.

The other thing that banks do is pay implicit interest through compensating balance accounts. That is, a business will hold demand deposits at a bank. It does not earn explicit interest but it gets services in return for that. These can be complex kinds of calculations. They have cutoff points. Businesses are constrained in how flexible they can be in their banking. In terms of using the services, they tend to tie the business to the bank to use that particular service. So even those sorts of things, although they may not cost something explicitly, they do cost something in economic efficiency. They make markets less effective and less competitive.

Senator REED. This underscores your recommendation to repeal the interest on checking prohibitions?

Mr. KOHN. That is correct.

Senator REED. Thank you, Mr. Kohn.

I know we are getting close, so I will be as brief as possible. Let me quickly, Mr. Kohn, you indicate in your testimony about industrial loan companies, that you would see if they could offer NOW accounts that would give them advantage, and very briefly, could you just tick off the one or two advantages or whatever?

Mr. KOHN. Industrial loan companies already have advantages relative to other companies that own banks. They are exempt from the Bank Holding Company Act, and they were given this exemption because they were small specialized kind of institutions that have limited powers, and the exemption therefore did not have major public policy implications.

The exemption is important in two aspects. One is they are exempt from the consolidated supervision. Other depository institutions that are affiliated with nondepository institutions are subject to overall supervision and regulation of the whole company. The thinking is that you cannot separate a depository institution from its affiliates and its parents, that the health of the institution rises and falls together, and they are exempt from that concsolidated supervision.

The second thing they are exempt from is the banking and commerce separation that Congress has embodied in law. Many of the ILC's are owned by commercial firms and do not have to adhere to the separation of banking and banking and commerce. When this

exemption was granted, these were small institutions that were very specialized, but they have grown very rapidly, and to grant them additional powers would make them even more like banks, and make the disconnect between their activities and the public policy intent of the Congress to govern the relationship of a depository institution and its affiliates even more stark. So the Board has strongly opposed this expansion of the ILC powers.

Senator REED. Thank you.

Mr. Chairman, if I may just make one more comment.

Mrs. Johnson, I have read your testimony. Now let me emphasize your point about this ambiguity now, whether or not these privately insured credit unions may be somehow regulated by the NCUA. That ambiguity has to be cured very quickly. In Rhode Island, we suffered through a serious crisis when a private-insured system failed, and part of it was because of the confusion as to who was regulating it, was there any Federal backstop, et cetera, and I think your comments are right on point in terms of it has to be very clear. It should be strictly private. There should not be any illusion even to the Federal Government regulator. I just wanted to make that point.

Mrs. JOHNSON. That is correct. We advocate, as the language is currently in the other bill, that the regulation should be with the State regulators and insurers.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you.

Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I know there is a vote on. I will be very quick. I have two or three points I want to register.

First of all, Mr. Kohn, am I correct that the potential with respect to the ILC's for bridging the divide between banking and commerce is very serious and a very severe question? Would you agree with that?

Mr. KOHN. I do, Mr. Sarbanes.

Senator SARBANES. And, second, any effort that deals with the ILC's that fails to provide holding company supervision in the Federal Reserve, I mean, not even getting to the bigger question, which I think is a quite important one, but not even getting there, I do not quite see how you structure a system that does not provide the same kind of holding company supervision that exists in other banking activities. Would you agree with that as well?

Mr. KOHN. I agree, Senator Sarbanes. I think consolidated supervision is a very important aspect in protecting safety and soundness and protecting against systemic risks in the banking system.

Senator SARBANES. Now, Mrs. Johnson, are you all in touch with FASB to see if you can resolve your concerns from their proposed rules?

Mrs. JOHNSON. We have been working on this. We are hopeful.

Senator SARBANES. Most people seem to think that, you know, we set up this expert body to establish accounting standards and that they should be allowed to do their work. You are not asking for legislation, for the Congress to start legislating accounting standards, are you? I certainly hope not.

Mrs. JOHNSON. No, we are not. We believe that there is consequence to the current language being proposed by FASB, and we are preparing to adjust to it.

Senator SARBANES. Do you see your remedy as being an interaction with FASB?

Mrs. JOHNSON. No. We have suggested statutory language which would clarify the Federal Credit Union Act.

Senator SARBANES. Is the Congress to start legislating accounting standards in issue after issue that comes along?

Mrs. JOHNSON. We believe that this can be resolved with FASB's concurrence, Senator.

Senator SARBANES. Okay.

Thank you, Mr. Chairman.

Senator CRAPO. I have been notified that Chairman Shelby would like me to ask one question on his behalf before we wrap up here. Governor Kohn, you get that question.

His question is: Are there any safety and soundness implications associated with repealing the prohibition on the payment of interest on business checking accounts?

Mr. KOHN. I do not believe so, Mr. Chairman. I think it is true that small businesses will now be paid explicit interest on their demand deposits. Banks will have at least a small initial increase in expense. But I think that banks have proven very capable of pricing their deposits, pricing their services to make good profits. And I think, if anything, the ability to pay interest on business checking accounts will enable banks, particularly small banks, to increase their competitive presence in the community, as Mr. Reich was talking about, and, therefore, enhance their viability over long periods of time.

Senator CRAPO. Thank you. And at the risk of opening this up when I do not have time, is there anybody else on the panel who disagrees with Mr. Kohn's answer there?

[No response.]

Senator CRAPO. All right. Thank you very much. We will excuse this panel, and we will recess this Committee. The recess should probably not last longer than 10 or 15 minutes, long enough to go over and vote once, get that vote wrapped up, vote again, and get back here.

So this hearing will be recessed.

[Recess.]

The hearing will come to order.

We appreciate everyone's patience. We hope we will not have another interruption before 2 o'clock. We know we will have an interruption around 2:00 to 2:15. We will see where we are at that point.

First, before I begin with the third panel, Senator Chuck Hagel has asked that his opening statement be introduced into the record, and without objection, that will be done.

Senator CRAPO. With that, we will begin our third panel which consists of Mr. Mark Macomber, who is President and CEO of Litchfield Bancorp, testifying on behalf of America's Community Bankers; Mr. Edward J. Pinto, President and CEO of Lenders Residential Asset Company, who is testifying on behalf of the National Federation of Independent Business; Mr. Dale Leighty, who is the

Chairman and President of the First National Bank of Las Animas, Colorado, testifying on behalf of the Independent Community Bankers of America; Mr. Bradley Rock, President and CEO of the Bank of Smithtown, testifying on behalf of the American Bankers Association; Mr. Eugene Maloney, Executive Vice President of Federated Investors, Inc.; Ms. Marilyn F. James, CEO of NEPCO Federal Credit Union, testifying on behalf of the Credit Union National Association; Ms. Margot Saunders, Managing Attorney at the National Consumer Law Center, and Mr. Edmund Mierzwinski, Consumer Program Director of U.S. PIRG, both Ms. Saunders and Mr. Mierzwinski are testifying on behalf of Consumer Federation of America, Consumers Union, National Association of Consumer Advocates, and National Community Reinvestment Coalition; Mr. William Cheney, President and CEO of Xerox Federal Credit Union, testifying on behalf of the National Association of Federal Credit Unions; and, finally, Mr. William A. Longbrake, Vice Chair of Washington Mutual Incorporated, testifying on behalf of the Financial Services Roundtable.

Ladies and gentlemen, we welcome you here. I want to remind you of our hope that you will pay attention to the clock and not be offended if I remind you to look at it when your time has expired, and to try to summarize your testimony in 5 minutes so we can get engaged in some dialogue and some questions.

With that, we will start out in the order I indicated, the first being Mr. Macomber.

STATEMENT OF MARK E. MACOMBER
PRESIDENT AND CEO, LITCHFIELD BANCORP
ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. MACOMBER. Thank you. Chairman Shelby, Senator Sarbanes, Senator Crapo, and Members of the Committee, I am Mark Macomber, President and CEO of Litchfield Bancorp in Litchfield, Connecticut. Litchfield Bancorp is a $162 million, State-chartered, community bank, part of a two-bank mutual holding company.

Before I begin, I would like to recognize and thank Senator Dodd, a Member of this Committee, who so ably represents my home State of Connecticut.

I am here representing America's Community Bankers, ACB. I serve on ACB's Board of Directors and Executive Committee and am the Chair the Mutual Institutions Committee. I want to thank Chairman Shelby and Senator Crapo for their leadership in initiating the discussion today of the impact of outdated and unnecessary regulations on community banks and the communities we serve.

ACB is pleased to have this opportunity to discuss with the Committee our recommendations to reduce the regulatory burden and unnecessary costs on community banks. All we ask is that community banks be able to better serve consumers and small businesses in their local markets. This hearing and this topic are important and timely.

Ten years ago, there were 12,000 banks in the United States. Today, there are 9,000. ACB is concerned that community banks are significantly hindered in their ability to compete because of the cost and burden of unnecessary and outdated regulations. In our

written statement, ACB has endorsed 31 amendments to current law that will reduce unnecessary regulations on community banks. I would now like to discuss five of those recommendations.

A high priority for ACB is a modest increase in the business lending limit for savings associations. In recent years, community banks have experienced an increased demand for small business loans. To accommodate this demand, ACB wants to eliminate the lending limit restriction on small business loans. We would increase the aggregate lending limit on other commercial loans to 20 percent from 10. Expanded authority would enable savings associations to make more loans to small and medium-sized businesses. That would enhance their role as community-based lenders.

ACB vigorously believes that savings associations should have parity with banks under the Securities Exchange Act and the Investment Advisers Act. Statutory parity will ensure that savings associations and banks are under the same basic regulatory requirements when they are engaged in identical trust, brokerage, and other activities. As more savings associations engage in trust activities, there is no substantive reason to subject them to different requirements. They should be subject to the same regulatory conditions as banks engaged in the same services.

ACB strongly supports removing unnecessary restrictions on the ability of national and State banks to engage in interstate branching. Currently, national and State banks may only engage in de novo interstate branching if State law expressly permits. ACB recommends eliminating this restriction. The law should also clearly provide that State-chartered, Federal Reserve member banks may establish de novo interstate branches under the same terms and conditions applicable to national banks. ACB also recommends that Congress eliminate States' authority to prohibit an out-of-State bank or bank holding company from acquiring an in-State bank that has not existed for at least 5 years. These changes will extend the benefits of flexible branching authority to banks.

In the area of compliance reforms, ACB urges amending the Community Reinvestment Act to allow community banks with less than $1 billion in assets to participate in the CRA's small institution examination program. According to a report by the Congressional Research Service, a community bank participating in the streamlined CRA exam can save 40 percent—40 percent—in compliance costs. Expanding the small institution exam program will free up capital and other resources for almost 1,700 community banks across our Nation that are in the $250 million to $1 billion asset size range. That would allow them to invest even more in their local communities.

We believe that raising the threshold will reduce the regulatory burden for those institutions without diminishing the activities of community banks or their CRA obligation. The goals of CRA are laudable, and I take them very seriously. But as a community banker, I would not be in business if I did not meet the credit needs of my community. And I do not need costly recordkeeping or a lengthy examination to tell me if I am doing my job.

Prohibiting banks from paying interest on business checking accounts is long outdated, unnecessary, and anticompetitive. Restrictions on these accounts make community banks less competitive in

their ability to serve the financial needs of many business customers. Permitting banks and savings institutions to pay interest directly on demand accounts would be simpler. Institutions would no longer have to spend time and resources trying to get around the existing prohibition. This would benefit many community depository institutions that cannot currently afford to set up complex sweep operations for their—mostly small—business customers.

These five recommendations, along with those discussed in our written statement, will make doing business easier and less costly, further enabling community banks to help our communities prosper and create jobs. On behalf of ACB, I want to thank you for your invitation to testify on reducing regulatory burden. We look forward to working with you and your staff in crafting legislation to accomplish this goal. I will be happy to answer any questions you may have.

Thank you.

Senator CRAPO. Thank you, Mr. Macomber.

Mr. Pinto.

STATEMENT OF EDWARD J. PINTO
PRESIDENT AND CEO, LENDERS RESIDENTIAL ASSET COMPANY, LLC, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. PINTO. Good morning. I am Ed Pinto, President of Lenders Residential Asset Company in Bethesda, Maryland. Thank you, Chairman Shelby and Ranking Member Sarbanes, for the opportunity to testify on behalf of NFIB. I also would like to thank Senator Crapo. I just wish my wife could be here to hear that I have to finish my remarks in 5 minutes.

In preparing for this testimony, I was reminded of a story. Many years ago, a hallway was being painted in the Pentagon. After the fifth passerby could not resist touching the wet paint, the captain posted an MP to guard either end of the hallway. Years later, a professor of mine was teaching a class on management at the Pentagon. He asked each participant in the class to go out and find some area of efficiency that they could find for improvement. One lieutenant called the professor to say he could not find any. The professor asked him, "What is the closest thing to you?" And he said, "There is an MP standing right next to me." He said, "Well find out what he is doing." He did and got the response, "I am guarding the hall." Then he asked why, and the MP said, "I am guarding the hall to make sure no one touches the wet paint."

I ask you, does anyone in Congress remember why the law was passed over 70 years ago prohibiting the payment of interest on small business accounts. I think not.

I commend the Committee for conducting this hearing on regulatory reform. NFIB is particularly interested in this one issue. Eighty-six percent of our members support allowing business owners to earn interest on their business checking accounts. During this Congress, the House has already passed legislation overturning this archaic law, once by a voice vote and once by a vote of 418–0.

S. 1967, introduced by Senator Hagel and Senator Snowe, repeals this Depression-era law, but the bill continues to be stalled in the

Senate for reasons that I frankly do not understand. The big banks have consistently opposed repealing the ban on interest checking and have proposed compromise legislation that would delay the implementation for 3 years or more. Their efforts to insulate themselves from free market competition have hurt small businesses in this country. These businesses are the acknowledged job creation engines for the United States. This bill is necessary as consumer legislation, and every day it is delayed is an injustice to over 25 million taxpayers filing business income tax returns with the IRS. Let me repeat that number: 25 million taxpayers have business income that they file with the IRS each year. They are located in every community in America, every State, large and small. And the fact of the matter is that big businesses do not need to have this provision repealed. They already have cost-effective alternatives. Consumers do not need this provision because they already have had the right to earn interest on their accounts over 20 years ago.

Earlier today, we heard the regulators say there are no safety and soundness issues. The House-passed bill as currently written contains a 2-year delay, and it is already a compromise. NFIB strongly urges the Committee to resist efforts to lengthen the phase-in period and deny this much needed legislation to these millions of taxpayers.

Lenders Residential Asset Company, a company I founded in 1989, provides consulting services to the financial services industry. When the company was started, I can still recall my astonishment at being told that a business could not earn interest on a checking account. I was further astonished to find that my business account not only did not earn interest, but I had to pay a plethora of fees. My banker said not to worry and introduced me to the spellbinding concept of compensating balances. Boy, was I in for an education, and it had nothing to do with running my new business. I remember thinking that all of this seemed quite foreign and not exactly consumer friendly. I had been earning interest for years on my personal checking account, which had a much smaller balance. I asked my banker, "Why no interest?" I was simply told it was against the law.

Later, as my business prospered, my banker suggested I set up what she called a "sweep account," which, she told me, did not have the benefit of FDIC insurance but did pay interest. And so that is what we did. Boy, was it complicated.

First, we analyzed my account history to determine how much to keep in my regular account because I still needed those compensating balances. Then we had to project what I would earn in interest and compare that to the additional fees earned to administer my new account. And then I had to authorize the amount to be swept each night. Then I could decide whether I would do this automatically or by calling each night. Not being a glutton for punishment, I decided to do the automatic.

As any new business owner will tell you, there are better ways to spend your time than calling your banker every day.

What I did not know was that a sweep account is really designed for a larger company, one with an in-house accounting firm and financial staff to keep up with the flows and ebbs of this money, and also to deal with the over 250 pieces of paper that I receive over

the year because every day I receive a notice as to the movement of the money. I now knew why the fees were so high on the sweep account. Don't get me wrong. I am not arguing against sweep accounts, but they are a bookkeeping hassle.

While I have continued to work with traditional banking institutions, without a sweep account, I might add, it makes little sense about why it is continued. Repealing this provision will, in fact, give banks the opportunity to market these accounts on their merits. I do not recall ever seeing an ad extolling the virtues of compensating balances.

I support giving banks at least the choice to offer interest-bearing accounts. I urge the Committee to consider this bipartisan effort and resist efforts to lengthen the phase-in period. Now is the time to act. Thank you very much.

Senator CRAPO. Thank you very much, Mr. Pinto.

Mr. Leighty.

STATEMENT OF DALE L. LEIGHTY
CHAIRMAN AND PRESIDENT, FIRST NATIONAL BANK OF LAS ANIMAS (COLORADO), ON BEHALF OF INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. LEIGHTY. Thank you, Senator Crapo and Members of the Committee. My name is Dale Leighty. I am Chairman of the Independent Community Bankers of America and President of the First National Bank of Las Animas, Colorado, a $140 million bank in southeastern Colorado. I would like to thank you for examining the important issue of regulatory relief. This is one of ICBA's top priorities, and I am pleased today to testify on behalf of the 5,000 member community banks of our national association and to share with you our views and concerns.

ICBA supports a bank regulatory system that fosters safety and soundness. However, statutory and regulatory changes continually increase the cumulative regulatory burden for community banks. In the last few years alone, community banks have been saddled with the privacy rules of the Gramm-Leach-Bliley Act, the customer identification rules and other provisions of the USA PATRIOT Act, and the accounting, auditing, and corporate governance reforms of the Sarbanes-Oxley Act.

Yet relief from any regulatory or compliance obligation comes all too infrequently while new ones just keep being added. There is not any one regulation that community banks are unable to comply with. It is the cumulative effect that is so burdensome. As ICBA President and CEO Camden Fine recently stated, "Regulations are like snowflakes. Each one by itself may not be much but when you add them all up, it could crush the building."

Regulatory and paperwork requirements impose a disproportionate burden on community banks because of our small size and limited resources. We have had to devote so much of our resources and attention to regulatory compliance that our ability to serve our communities and support the credit needs of our customers is diminished.

Regulatory burden is a perennial problem for community banks. In 1992, Grant Thornton conducted a study on behalf of ICBA on the cost of complying with the 13 bank regulations that were

deemed the most burdensome for community bankers. At that time, over 10 years ago, the annual compliance cost for community banks for just 13 regulations was estimated to be $3.2 billion. In addition, the study found that 48 million staff hours were spent annually to comply with just those 13 regulations.

ICBA is pleased that, at the direction of Congress under the Economic Growth and Regulatory Paperwork Reduction Act of 1996, the Federal bank regulators are now reviewing all 129 Federal bank regulations, with an eye to eliminating rules that are outdated, unnecessary, or unduly burdensome. We wholly applaud this effort and fervently hope that it bears fruit.

However, Congress must recognize that there is only so much the regulators can do to provide relief since many regulatory requirements are hard-wired in Federal statutes. Therefore, effective reduction of regulatory burden will require Congressional action, and ICBA strongly urges the Congress to be bold and open-minded when considering recommendations offered by the regulators and the industry for regulatory relief.

The litany of burdensome regulations is long: Truth in Savings, Truth in Lending, RESPA, Fair Lending, HMDA, Currency Transaction Reports, Suspicious Activity Reports, Call Reports, Regulation O reports, the Bank Secrecy Act, and Community Reinvestment Act, just to name a few. These regulations are overwhelming to the 37 employees of my bank who must grapple with them daily.

CRA is a clear example of regulatory overkill. It deserves a special mention since there is a pending regulatory proposal to reduce the community bank regulatory and examination burden. Evaluating the CRA performance of large, complex banking organizations and small, locally owned and operated community banks using the same examination standards simply does not make sense.

ICBA strongly supports an increase in the asset size limit for eligibility for the small bank streamlined CRA examination process. While we would prefer that it be raised to $2 billion, we applaud the regulators' proposal to increase the limit to $500 million in assets and eliminate the separate holding company qualification.

Community banks pose different levels of risk to the banking system and have different abilities to absorb the costs of regulatory burden than large national or regional banks. Therefore, the ICBA strongly urges Congress and the regulators to continue to refine a tiered regulatory and supervisory system that recognizes the difference between community banks and larger, more complex institutions. Less burdensome rules and/or appropriate exemptions for community banks are the hallmark of the tiered regulatory system.

In conclusion, ICBA member banks are integral to our communities. However, regulatory burden and compliance requirements are consuming more and more of our resources to the detriment of our customers. And because the community banking industry is slowly being crushed under the cumulative weight of regulatory burden, many community bankers are giving serious consideration to selling or merging with larger institutions and taking the community bank out of the community.

The ICBA urges the Congress and the regulatory agencies to address these issues before it is too late. My written statement includes appendices with detailed discussion of the regulatory burden

of selected regulations. The ICBA strongly supports the current regulatory and legislative efforts to reduce this burden. We look forward to working with you toward enactment of statutory and regulatory changes to help ensure that the community banks remain vibrant and able to continue to serve our customers and our communities.

Mr. Chairman, thank you for the invitation to testify today, and I will be happy to answer your questions.

Senator CRAPO. Thank you very much, Mr. Leighty.

Mr. Rock.

STATEMENT OF BRADLEY E. ROCK

PRESIDENT AND CEO, BANK OF SMITHTOWN

ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. ROCK. Thank you, Mr. Chairman and Members of the Committee. My name is Brad Rock. I am Chairman, President, and CEO of Bank of Smithtown, a 95-year-old, $630 million community bank located on Long Island in Smithtown, New York. I am glad to present the views of the ABA. Reducing bank regulatory burden is an important issue for all businesses. This morning, I would like to make three key points.

First, bank regulatory burden is not just a minor nuisance for banks. It has a significant impact upon our customers and upon local economies. Over the past 25 years, it has steadily grown and now permeates all levels in the bank, from the front-line tellers to the CEO. Based on research in the 1990's, the total cost of compliance today for banks is between $26 and $40 billion per year.

Certainly, many of the regulatory costs are appropriate for safety and soundness reasons and for consumer protection. But if this burden could be reduced by 20 percent and directed to capital, it would support additional bank lending of between $52 to $78 billion. The impact on our economy would be huge.

Second, regulatory burden is significant for banks of all sizes, but pound for pound, small banks carry the heaviest regulatory load. Community banks are in great danger of being regulated right out of business. Eight thousand of the Nation's 9,000 banks have less than $500 million in assets, and 3,350 of those banks have fewer than 25 employees. They provide the banking services to people in small towns across America, yet these same community banks do not have the manpower to run the bank and to read, understand, and implement the thousands of pages of new and revised regulations they receive each year.

A few weeks ago, a fellow community banker told me that his bank, with only 20 employees, has had to add a full-time person for the sole purpose of completing reports related to the Bank Secrecy Act. Community banks in such circumstances will not be able to survive for long.

To illustrate the magnitude of this burden on small banks, consider this: Each year, the ABA publishes a reference guide that summarizes the requirements embodied in thousands of pages of regulations. The summary is 600 pages long and will be even longer next year to cover new responsibilities under the USA PATRIOT Act and the expanded HMDA reporting requirements.

Many of these regulatory efforts provide little or no meaningful benefit to bank consumers. As a banker and a lawyer, I can tell you that, for example, at real estate settlements, customers do not read the piles of documents that they are required to sign. In fact, the only people who read those voluminous forms are the bank staffers who are required to complete them and process them.

My third and final point is this: We are hopeful that the review of regulatory costs by Federal bank regulators will reduce the compliance burden. Many bankers are skeptical, however, as we have seen previous efforts at regulatory relief come and go without noticeable effect, while the overall level of regulatory burden has kept rising. It may take Congressional action to make a difference.

The bottom line is that too much time and too many resources are consumed by compliance paperwork of little or no benefit to customers or investors, leaving too little time and resources for providing actual banking services. The losers in this scenario are bank customers and the communities that banks serve.

Thank you for the opportunity to present our views.

Senator CRAPO. Thank you very much, Mr. Rock.

Mr. Maloney.

STATEMENT OF EUGENE F. MALONEY
EXECUTIVE VICE PRESIDENT, FEDERATED INVESTORS, INC.

Mr. MALONEY. Senator Crapo, Senator Santorum, my name is Eugene Maloney. I am Executive Vice President and Counsel to Federated Investors. Federated is a Pittsburgh-based financial services holding company. Our shares are listed on the New York Stock Exchange. Through a family of mutual funds used by or on behalf of financial intermediaries and other institutional investors, we manage approximately $200 billion. For the past 16 years, I have been a member of the faculty of Boston University Law School, where I teach a course in the master's program on the securities activities of banks. Our mutual funds are used by over 1,000 community banks either within their own portfolios or on behalf of their fiduciary customers.

In connection with the proposed removal of Regulation Q, thereby permitting banks and thrifts to pay interest on business checking, my firm's position is that we are strongly in favor of any rule, regulation, or legislation which results in our community bank friends becoming more competitive, more profitable, or being able to operate their businesses more efficiently. We are concerned that the current initiative to repeal Regulation Q will result in the exact opposite. This conclusion is based on my personal experience with the introduction of ceilingless deposit accounts in 1982 and the impact they had on our client base. Friends of long standing lost their jobs, their pensions, and their self-esteem because of the failure by governmental officials and Members of Congress to fully think through the economic impact of ceilingless deposit accounts to our banking system and its profitability. This failure cost every man, woman, and child in the United States $1,500.

In researching the history of ceilingless deposit accounts which were to be "competitive with and equivalent to money market mutual funds," we found some fascinating information. At the meeting chaired by the Secretary of the Treasury to consider the features

of the new account, the members were advised that if they set the minimum account size below $5,000, massive internal disintermediation would occur and it would result in pure cost to the banks. The account size was set at $2,500. We have been to the National Archives, Senator, and declassified the minutes of subsequent meetings. They make for astonishing reading. The members were fully briefed on the excesses committed by banks and thrifts and elected to do nothing to stop them. In my prepared remarks, which I have filed with the Committee, I brought some of my favorite ads with me.

One from First Bank in Atlanta, is particularly provocative and illustrates my point: "18.65 percent." This is an interview with the chief executive officer. How can you offer 18.65 percent when money market funds are paying 9 percent? "We are offering the 18.65 percent to attract new money from money market fund customers and to indicate our own commitment to offer customers the best possible product."

In this ad and other ads of similar content, there is only one piece of information that tells the story: the term "insured." "Insured." No one else in their right mind would ever sell a product for $8 that they are paying $21 to manufacture, but that is exactly what happened.

The legislative record to date indicates that only slight attention has been given to the cost to banks of paying interest on business checking accounts or the impact on bank earnings. We commissioned Treasury Strategies of Chicago, Illinois, to, in fact, look at the economic impact that it will have on banks, particularly community banks. I have not personally found any official of a community bank that is in favor of this initiative. These are some of the findings of Treasury Strategies.

One, small businesses will have to grow their deposits by 80 percent or raise service charges by 34 percent. Mid-sized company impact: Grow deposits by 35 percent or raise service charges by 16 percent.

The reason I am here today, Senator, is to make a fact-based attempt to prevent history from repeating itself.

Thank you.

Senator CRAPO. Thank you very much, Mr. Maloney.

Ms. James.

STATEMENT OF MARILYN F. JAMES
CEO, NEPCO FEDERAL CREDIT UNION
ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

Ms. JAMES. Thank you. Senator Crapo and Members of the Committee, on behalf of the Credit Union National Association, I greatly appreciate this opportunity to express the Association's views on legislation to help alleviate the regulatory burden under which all financial institutions operate today.

I am Marilyn James, President and CEO of NEPCO Federal Credit Union in Pueblo, Colorado. We are a $22 million institution. According to the U.S. Treasury, credit unions are clearly distinguishable from other depository institutions in their structure and operational characteristics. And despite their relative small size and restricted fields of membership, federally insured credit unions

operate under bank statutes and rules virtually identical to those applicable to banks and thrifts. However, Federal credit unions have more limited powers than national banks and Federal savings associations.

My written statement catalogues and describes the 137 laws and regulations that apply to credit unions, including many unique restrictions that are far more stringent and limiting than laws applicable to other depository institutions. Given the limited time available today, I will devote the rest of my statement to describing a few exceptionally important issues to credit unions.

As part of our mission, credit unions are devoted to providing affordable services to all of our members, including those of modest means. One provision pending in both the House and the Senate would better enable us to meet that goal. I am referring to legislation to permit credit unions to provide check-cashing and remittance services to those eligible for membership.

Many of the individuals who could benefit from this change live from paycheck to paycheck and do not have established accounts. We have had members join one day, deposit the necessary share balance, and come in the very next day and withdraw because they need the money. It is hard to believe, but sometimes a $5 withdrawal means the difference between eating or not.

Accomplishing our mission can also be greatly enhanced by revisiting two major components of the 1998-passed Credit Union Membership Access Act. With 6 years of experience, we have learned that what was thought to be good policy at the time has actually created new problems that need to be resolved to assure that credit unions can continue to meet their mission.

The first of these issues is the current cap on member business lending. There was no safety and soundness reason to impose these limits as the historical record is clear that such loans are not only safer than those in the banking industry but also safer than some other types of credit union loans. In fact, public policy argues strongly in favor of eliminating or increasing the limits from the current 12.25 percent to the 20 percent suggested in the House-introduced CURIA bill.

Small business is the backbone of our economy and responsible for the vast majority of new jobs in America. Yet, a February SBA study reveals that small businesses are having greater difficulty in getting loans in areas where bank consolidation has taken hold. CUMAA severely restricts small business access to credit and impedes economic growth in America.

Although few credit unions are currently bumping up against the cap, in a few years that might not be the case. Then take my small credit union. Investing in the expertise needed to involve yourself in business lending is a very costly proposition. With a 12.25 percent cap, we could not make up the costs needed to run such a program. If the cap were increased to 20 percent, we could seriously consider entering this line of lending.

Another critical issue needing correction pertains to the prompt corrective action regulations governing credit unions. Credit unions have higher statutory requirements than banks, but credit unions' cooperative structure creates a systemic incentive against excessive risk-taking, so they may actually require less capital to meet poten-

tial losses than do other depository institutions. And because of their conservative management style, credit unions generally seek to always be classified "well" capitalized as opposed to just "adequately" capitalized. To do that, they must maintain a significant cushion above the 7-percent level. PCA requirements incent credit unions to operate at overcapitalized levels.

CUNA believes that the best way to reform PCA would be to transform the system into one that is much more explicitly based on risk measurement. It would place much greater emphasis on ensuring that there is adequate net worth in relation to the risk a particular credit union undertakes. Reforming PCA along the lines of a risk-based approach would preserve and strengthen the National Credit Union Share Insurance Fund. It would more closely tie a credit union's net worth requirements to exposure to risk.

Just briefly, we would like to say that we agree with NCUA's position on FASB's proposed merger rule. We think it is important that it come to your attention.

In summary, Mr. Chairman, we strongly urge the Committee to act on this very important issue this year. Credit unions would benefit greatly from reducing unnecessary and costly regulatory burdens, and so would American consumers benefit from the savings that credit unions would pass on to their 85 million credit union members.

Thank you very much.

Senator CRAPO. Thank you very much, Ms. James.

Ms. Saunders.

STATEMENT OF MARGOT SAUNDERS
MANAGING ATTORNEY, NATIONAL CONSUMER LAW CENTER
ON BEHALF OF
CONSUMER FEDERATION OF AMERICA, CONSUMERS UNION, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES, AND NATIONAL COMMUNITY REINVESTMENT COALITION

Ms. SAUNDERS. Thank you, Senator Crapo. Mr. Chairman, Senator Sarbanes, and Members of the Committee, as our written testimony indicates, Mr. Mierzwinski and I have filed joint testimony in an attempt to represent all consumers regarding the huge number of proposals that are pending before you today. We want you to be sure to understand that if we have not specifically identified a proposal and said that we do not like it, it does not mean that we do like it. We just did not catch it.

[Laughter.]

Senator CRAPO. Understood. You are allowed to supplement your testimony, too.

Ms. SAUNDERS. I appreciate that, Senator.

Today, I will deal briefly with a number of proposals that we have concerns with and then also address some proposals that we are hoping you will adopt.

First, I would like to address Senator Lincoln's support for Senate bill 904, which would override the Arkansas Constitution and override the express sentiments and votes of the Arkansas voters. The people of Arkansas have determined that there should be a usury limit, and they have passed one in their State Constitution. There have been numerous attempts to amend the Constitution,

and on numerous occasions, the voters of Arkansas have resisted those changes.

I have been in touch with a variety of consumer representatives, including the unions in Arkansas, and have asked the question whether or not there is any perceived or actual lack of available credit in Arkansas. And I have been assured by Legal Services, by representatives of State offices, and by the unions, that there are no complaints from consumers that there is a lack of available credit. In fact, I am told that recent decreases in interest rates have led to an increased availability of financing, making more consumers able to afford credit than has been the case in previous years.

It is necessary for this Congress to understand that if Senate bill 904 passes, Arkansas would change from being in the forefront of consumer protection, because that is what Arkanas voters have mandated, to be in the absolute last place. Senate bill 904 would cut off all usury ceilings the State has altogether, and unlike every other State in the Union, the voters or the legislature would not be able to impose any protections for consumers on interest rate limits.

Second, I want to address the pending proposals to allow virtually unlimited diversity jurisdiction in the Federal courts for both national banks and Federal thrifts. This is a very bad idea. It would make the Federal courts essentially collection mills for the banks and the thrifts. It would also establish a legal procedural morass which would prevent consumers from defending against foreclosures in a variety of situations. While I do not have time in this verbal testimony today to explain the details of why this would be the case, but I am happy to answer any questions. My written remarks do provide these details.

The concept of diversity jurisdiction is based on the idea that people who are out of State may not get a fair hearing in the State courts. Yet, in fact, we are talking about creating a legal fiction where national banks or thrifts would have very active presences in the States, yet would be called "out of State" simply for the purpose of creating diversity jurisdiction in the Federal courts.

In my one and a half minutes left, I want to support a number of actions that you should consider which would actually protect consumers. The EGRPRA process has been mentioned several times. There is nothing in the law that tells the regulators that they should solely look at how to change regulations to benefit the industry. I have looked at it numerous times, yet to our great disappointment, the numerous papers that have come out of the agencies in the pursuit of the EGRPRA process have indicated that the agencies have yet to notice that, their job is not only to look after industry, but it is also to look after consumers. We ask you to tell the agencies that they should be cautious in their recommendations for change and, in fact, should include recommendations for change which would further protect consumers.

We also ask you to consider prohibiting the FDIC from allowing banks to rent their charters for payday loans. The FDIC is the only one of the Federal regulatory agencies that permits its regulated State banks to engage in payday lending. This is in derogation of State law. There have been a number of attempts by States to stop

payday lending in the States. And it is only because the FDIC permits its State-chartered banks to rent the charters and avoid State usury limits that this is permitted to go on.

Finally, I urge you to address a very mundane but very important change in the law. The Truth in Lending Act is the single most important consumer protection act that we have on the books, and it has a jurisdictional limit for nonreal estate, secured loans of $25,000. That means if you purchase a car with a loan of more than $25,000, you have no Federal law that covers your loan. That needs to be updated. The equivalent number from 1968, when TILA was passed, to 2004 would go from $25,000 to $132,000. We ask you to consider at least some update.

Thank you. I am happy to answer any questions.

Senator CRAPO. Thank you very much, Ms. Saunders.

Next is Mr. Mierzwinski.

STATEMENT OF EDMUND MIERZWINSKI
CONSUMER PROGRAM DIRECTOR, U.S. PIRG
ON BEHALF OF
CONSUMER FEDERATION OF AMERICA, CONSUMERS UNION, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES, AND NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. MIERZWINSKI. Thank you, Senator Crapo, Senator Sarbanes. I am Ed Mierzwinski of the U.S. Public Interest Research Group. I would like to highlight a couple more of the significant parts of our joint testimony.

First of all, the consumer groups and community groups strongly support the Federal Reserve's position that expansion of the authority of industrial loan companies to branch into other States de novo or to expand their checking account allowances under the law is a very bad idea, and we support the Fed in its proposal that you not take the industrial loan companies, which were intended to be small, limited-purpose institutions, and allow them to become full-blown banks with a full-blown banking system that is just like a bank except that the system does not have the same prudential regulatory structure above it that the bank holding companies have that the Federal Reserve regulates most other parts of the banking system. We think it would be extremely dangerous. We understand that the House passed an amendment that might prevent Wal-Mart from being part of this, but it does not prevent Wall Street nor does it prevent General Motors nor many other car companies nor other large companies from acquiring or expanding their industrial loan operations without the consolidated supervision, without the consolidated capital, without the extremely significant regulatory oversight that the Federal Reserve Board has that neither the FDIC nor the Utah Department of Banking or other State Departments of Banking have in order to examine or to oversee these institutions. So we support the Fed in its position against the expansion of industrial bank authority.

Second, the consumer groups feel very strongly that S. 884, Senator Landrieu's proposal to preempt stronger State laws regulating predatory rent-to-own stores, should not be considered by this Committee, particularly as any kind of a reduced regulatory burden. This is an industry that has enacted safe harbor legislation in

about 45 States that is virtually identical to the proposal before the Committee. The other 5 States choose to protect their consumers from unfair, overpriced, rent-to-own stores. Those States should not be preempted. The notion that this bill provides consumer protections is belied by the fact that there are virtually no protections in those States, nor in this bill, that are provided at any level comparable to those in the States that treat rent-to-own as a type of credit sale. We strongly urge you to oppose preempting New Jersey, preempting Wisconsin, preempting Minnesota, Vermont, and parts of some other State laws that treat rent-to-own as a credit sale provide their consumers with stronger protection. It is not just a Federalist position. It is a consumer protection position. I do not think that the Congress should be taking stronger State laws and throwing them out at the behest of an industry that is asking consumers to pay $10 a week for the privilege of buying a $200 television over a 78-week period and the industry does not even want to tell them the interest rate, which, by the way, is between 100 and 300 percent.

Our organizations also strongly oppose weakening the Community Reinvestment Act. The Community Reinvestment Act is an extremely important tool for stimulating bank lending and improving access to banking services for the Nation's underserved rural and urban communities. There are proposals before the regulators and before the Congress that would treat many mid-sized banks, in one case banks as large as $1 billion, under the streamlined small-bank exceptions that currently exist to the Community Reinvestment Act. If this were done, virtually thousands of banks would be exempt from the full coverage of the CRA. They would no longer have incentives to offer deposit services, lifeline banking, and branching into low-income and underserved communities. We strongly believe that this expansion of the small-bank exception to the CRA not be done by the Congress.

And, finally, I just want to add my concurrence with the credit union regulators and the credit union witnesses that the consumer groups strongly support Section 307 of the House bill, which would allow credit unions to offer check-cashing and remittance services to anyone in their field of membership, not only to their members. Many consumers, particularly the unbanked and underbanked, pay too much for remittance services. Billions of dollars is being transferred to large companies instead of back home. We think the credit unions could provide some needed competition. However, our testimony also points out that remittance services, no matter who is providing them, need greater regulation.

Thank you.

Senator CRAPO. Thank you very much, Mr. Mierzwinski.

Mr. Cheney and Mr. Longbrake, I do not know if you heard the bell a minute ago, but we are running up at the end of another vote, and so we are going to have to take a recess right here, run over and vote, and come back. So you two will have to stress a little bit longer over your testimony.

We will try to make that as quickly as we can, but I am guessing it takes about 10 minutes to get over and 10 minutes to get back. So we have at least a 20-minute break here, and we will be back as quickly as we can.

Thank you.

[Recess.]

Senator CRAPO. Okay. We will resume the hearing now, and, Mr. Cheney, you are next up. Please proceed.

STATEMENT OF BILL CHENEY
PRESIDENT AND CEO, XEROX FEDERAL CREDIT UNION
ON BEHALF OF
THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. CHENEY. Thank you. Good afternoon, Senator Crapo and Members of the Committee. My name is Bill Cheney. I am the President and CEO of Xerox Federal Credit Union, located in El Segundo, California. I am here today on behalf of the National Association of Federal Credit Unions to express our views on the need for regulatory relief and reform for credit unions. First, I want to thank you, Senator Crapo, for your leadership and for meeting with our staff on these issues.

As with all credit unions, Xerox Federal Credit Union is a not-for-profit financial cooperative governed by a volunteer board of directors who are elected by our member owners. America's credit unions have always remained true to their original mission of promoting thrift and providing a source of credit for provident or productive purposes. A 2004 Filene Research Institute study entitled "Who Uses Credit Unions?" found that the average household income of those who hold accounts solely at credit unions was $42,664, while the average household income for those who only hold accounts at a bank was $76,923.

NAFCU is pleased to report to the Committee that America's credit unions today are vibrant and healthy and that membership in credit unions continues to grow, with credit unions serving over 85 million Americans, more than at any time in history. At the same time, it is important to note that while credit union membership is growing, over the past 23 years credit unions have increased their market share only minimally and, as a consequence, provide little competitive threat to other financial institutions. In fact, according to data obtained from the Federal Reserve Board, during the 23-year period from 1980 to 2003, the percentage of total household financial assets held by credit unions increased from 1.4 percent to only 1.6 percent.

Mr. Chairman, as your Committee considers regulatory relief issues for credit unions, we hope that you will look at the provisions that have been under consideration in the House of Representatives. NAFCU believes that the credit union provisions in the House-passed Financial Services Regulatory Relief Act of 2004 are a positive step in addressing many of the regulatory burdens and restrictions on Federal credit unions.

NAFCU is pleased to see the growing support in the House for the Credit Union Regulatory Improvements Act, or CURIA. This legislation addresses additional key issues for credit unions. We hope that the Senate Banking Committee will consider provisions from both of these bills as it crafts its own regulatory relief bill.

As outlined in my written testimony, NAFCU supports the 12 credit union regulatory relief provisions that have been included in

both bills, and we would urge that they be included in any regulatory relief bill that comes out of the Committee.

There are also additional provisions included in CURIA that are not included in the regulatory relief bill as it has passed the House that are needed by the credit union community. NAFCU urges the Committee to modernize credit union capital requirements by redefining the net worth ratio to include risk assets. This would result in a new, more appropriate measurement to determine the relative risk of a credit union's balance sheet and improve the safety and soundness of credit unions and our Share Insurance Fund.

NAFCU also asks the Committee to refine the member business loan cap established as part of the Credit Union Membership Access Act in 1998, replacing the current formula with a flat rate of 20 percent of the total assets of a credit union. We support revising the definition of a member business loan by giving NCUA authority to exclude loans of $100,000 or less from counting against the cap. These provisions would facilitate member business lending without jeopardizing the safety and soundness of credit unions.

There is a lot of rhetoric out there on this issue, but I must note that a 2001 Treasury Department study entitled "Credit Union Member Business Lending" concluded that, "Credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions."

And finally, we urge the Committee to include language that would address the strain that could be placed on merging credit unions when the Financial Accounting Standards Board changes merger accounting rules from the pooling method of accounting for mergers to the purchase method. This can be done through a simple modification of the statutory definition of net worth in the Federal Credit Union Act to mean equity rather than the retained earnings balance of the credit union as determined under GAAP. FASB has reviewed this proposed change and stated in an April 27, 2004, letter to NAFCU that, "While our primary concerns are not regulatory issues, we do have an interest in supporting an expedited resolution of this matter. The attached proposed amendment proposes a way to resolve this matter."

I have a copy of this letter from FASB with me and would ask that a copy of this letter be included in the record with my testimony at this time.

Senator CRAPO. Without objection.

Mr. CHENEY. Thank you.

In conclusion, the state of the credit union community is strong and the safety and soundness of credit unions is unquestionable. Nevertheless, there is a clear need to ease the regulatory burden on credit unions as we move forward in the 21st century financial services marketplace. NAFCU urges the Committee to consider the important credit union provisions we have outlined in this testimony for inclusion in any Senate regulatory relief bill. We look forward to working with you and your staff on this important matter and would welcome your comments or questions.

Thank you.

Senator CRAPO. Thank you very much, Mr. Cheney.

And finally, Mr. Longbrake.

STATEMENT OF WILLIAM A. LONGBRAKE
VICE CHAIR, WASHINGTON MUTUAL INCORPORATED
ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. LONGBRAKE. Thank you very much, Chairman Crapo. My name is Bill Longbrake. I am Vice Chair of Washington Mutual, and today I am appearing on behalf of the Financial Services Roundtable. My career began as a regulator, serving in various capacities for the Comptroller of the Currency and the FDIC, thus giving me a perspective from both the regulator's viewpoint as well as from the banker's viewpoint.

The Roundtable strongly supports efforts to reduce the regulatory burden on financial services firms. The outdated laws and regulations increase the cost of financial products and services to consumers. It is important for Congress to periodically review the laws applicable to the financial services industry, and we applaud your efforts in doing so.

I would like to highlight for the Committee six provisions from the House-passed regulatory relief bill that we recommend be included in the bill you are drafting. I also urge you to use this opportunity to simplify the privacy notice required by the Gramm-Leach-Bliley Act.

It was exactly 10 years ago that Congress enacted the landmark Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Since then, the public benefits anticipated by that Act have been realized. The creation of new bank branches has helped to maintain the competitiveness of our financial services industry and has improved access to financial products in otherwise underserved markets. There is one remaining legal barrier to interstate branching which should be eliminated. Under the Riegle-Neal Act, a bank cannot establish a new so-called de novo interstate branch without the affirmative approval of a host State. The Roundtable urges the Committee to remove this barrier by incorporating Section 104 of H.R. 1375 in its version of the regulatory relief bill.

Another provision related to interstate banking that we would recommend to the Committee is Section 616 of H.R. 1375. This section clarifies the authority of State banking supervisors over interstate branches of State-chartered banks. This provision will also help to avoid needless confusion over the examination and supervision of interstate branches of State banks.

While the Roundtable supports all the thrift provisions of the House bill, I would highlight four of these provisions which are particularly important to our members.

First, Section 202 of H.R. 1375 would establish regulatory parity between the securities activities of banks and thrifts. Thrift institutions do not enjoy the same regulatory treatment as banks under the Exchange Act or the Investment Advisers Act, even though Congress has permitted thrifts to engage in the same brokerage and investment activities as commercial banks. The SEC has attempted to address this issue of regulatory disparity, but has not fully resolved the problem. Therefore, we urge the Committee to include Section 202 in its version of the regulatory relief bill and establish explicit exemptions for thrifts in the Exchange Act and the Investment Advisers Act that are comparable to the exemptions for commercial banks.

Second, we recommend including Section 213 of the House bill. This section would provide that a Federal savings association is a citizen of the State in which it has its home office. This change is needed to clarify when an interstate thrift can remove a case to Federal court based on diversity jurisdiction.

Third, the Roundtable supports Section 208 of the House bill. Current law limits the amount of automobile loans a thrift can make to no more than 35 percent of the institution's assets. Section 208 would remove this ceiling. This will allow thrifts to diversify their portfolios and will increase competition in the auto loan business.

Fourth, the Roundtable supports Section 204 of the House bill. This section would replace a mandatory dividend notice requirement for thrifts owned by savings and loan holding companies. The existing mandatory requirement is no longer necessary.

Finally, the Roundtable member companies have found that the privacy notice required by the Gramm-Leach-Bliley Act is overly confusing and largely ignored by many consumers. We recommend that the Committee use this opportunity to simplify the form of the notice required by the Gramm-Leach-Bliley Act. There is extensive research in support of simple notices. Consumer surveys indicate that approximately 58 percent of consumers would prefer a shorter notice than the lengthy privacy policy mandated by the Act.

The Federal banking agencies recently requested comment on alternative notices that would be more readable and useful to consumers. However, these Federal agencies lack the authority to make a simplified notice uniform in every State. We strongly recommend that the Committee direct the relevant Federal agencies to finalize a simplified Gramm-Leach-Bliley Act privacy notice that supercedes State privacy notices. Consumers will be better served if they are given a simple, uniform explanation of an institution's privacy policy and their privacy rights.

In conclusion, the Roundtable appreciates the efforts of the Committee to eliminate laws and regulations that impose significant and unnecessary burdens on financial services firms or impose unnecessary barriers in serving the marketplace. The cost savings that will result from this legislation will benefit the consumers of financial products and services.

We look forward to working with the Committee on this very important legislation. Thank you.

Senator CRAPO. Thank you very much, Mr. Longbrake. Before we proceed with questions, Senator Santorum was here and had to leave and asked that his statement be made a part of the record, which it will be, without objection.

Senator CRAPO. I would like to, first of all, thank all the witnesses, not only for your patience in a long hearing, but also for the very helpful materials that you have provided. I do not know if you can see the stacks of materials here, but they are about that thick, of written material that have been provided by the various witnesses and their groups today. I have read much of it. I will finish reading all of it soon, I promise.

As I have gone through this testimony it has become very evident to me that a tremendous amount of very thoughtful effort has gone into the testimony that was prepared today, because of the

importance of this issue. I believe that in context or another, there are very few Americans who are not touched in many different ways by the issues that will be before the Committee as we craft this legislation. Your help in identifying areas where we can improve the safety and soundness, and improve the consumer protection, and reduce the regulatory burden, thereby improving the services that are provided to the people of this Nation through our financial systems, is going to be very helpful.

One question that I wish I had had more time with the first panel to go into a little bit, but one question I want to start out with you on, and Mr. Leighty, it is probably one that you should jump in on first because you mentioned it in your testimony, is the question of the difference between large and small banks in the United States. After reviewing the testimony, and particularly the charts that have been shown by Mr. Reich earlier in his testimony and some of the information that you and others have provided, it is very clear that the number of community banks is dramatically dropping off and that their percentage of the market is dramatically dropping off.

The question that comes up is, should we consider the explicit creation of a two-tiered regulatory system for smaller institutions which are particularly vulnerable to the heavy regulation which we impose on larger institutions? And if so, what proposals would you suggest that we utilize in such a two-tiered approach? Do you want to start out, Mr. Leighty?

Mr. LEIGHTY. Sure. I think that the answer would be yes, and certainly there are some consumer protection laws that apply, whether it is a large institution or a small, so we would not advocate that there would be different consumer protection for a large versus a small institution.

However, there are some of the burdens that are harder on the smaller institutions relative to their resources. An example would be, I think something maybe as benign as call reports. The volumes of information that is required to be prepared quarterly for a small simple balance sheet institution, perhaps that could be something that could be streamlined for the smaller institutions at a threshold of size to be determined. Maybe all of the schedules that are be required to be sent in quarterly just do not make sense for a noncomplex institution.

Another which was mentioned earlier would clearly be the streamlined CRA examinations. I think it is important to point out that the streamlined CRA examination does not take away the requirements of CRA. It simply shifts the burden to the regulatory agencies when they are in examining the banks to determine if we in fact are meeting our obligations to our communities. So, I think it is a distinction that sometimes gets lost in these discussions, that with streamlined examinations we still are required to meet CRA requirements, but the examination process is not as onerous to the smaller institutions.

Senator CRAPO. Thank you. Anybody else want to jump in on this? Mr. Mierzwinski?

Mr. MIERZWINSKI. Just very briefly, I would refer you, Senator, to the consumer group testimony. It goes into detail about how we would have a difference of opinion with the other groups on the im-

portance of the full CRA examination being distinctly more important in evaluating whether a bank is serving the community. This is particularly important because the proposal to increase from $250 million to $500 million for the streamlining would exempt another 1,200 institutions. Some proposals would go to $1 billion. We are talking mid-size banks, not small banks. Under these proposals you would only have 600 banks getting the full benefit of the CRA examination.

Again, the streamlined test only looks at lending. It does not look at the service test as adequately. There is a lot more to it that we think is very important, particularly in small and medium-size communities where these banks have a very large presence.

Mr. LEIGHTY. If I might?

Senator CRAPO. Certainly.

Mr. LEIGHTY. I think the definition of small bank that the Fed uses is $1 billion, so we have a difference of terminology on what is a small institution.

Mr. LONGBRAKE. If I could just add a comment?

Senator CRAPO. Mr. Longbrake.

Mr. LONGBRAKE. Reducing burden is important, period, just for the benefit of consumers and businesses, so that applies to all institutions regardless of size and regardless of charter. So, I think it is important we not lose sight of that.

Having said that, in terms of the activities and the complexity of those activities, they do differ by type of organization and regulation should be suitable for the type of activities an institution performs. I would be careful about billing it as a two-tier system however.

Senator CRAPO. Good point. Mr. Rock.

Mr. ROCK. Thank you, Senator. Just with respect to the streamlined CRA test, I think that my bank is a pretty good example of some of the difficulties that exist. My last two CRA exams, one was under the streamlined test and then the most recent one was under the big bank test, so I have experienced both lately.

The problem for us, we are a 95-year-old community bank. We are 96 percent loaned up. We only loan money in our community. But our community is a suburban community on the north shore of Long Island. It is a fairly homogeneous community, and according to the Census Bureau we have no low- to moderate-income areas in our service area. Yet under the big bank test we are required to make loans in low to mod areas. So we have gone outside our area to comply with the big bank test, made loans in low to mod areas outside our service area. And in the most recent exam under the big bank test we were told by our regulator, the Federal Reserve Bank, that those loans do not qualify because they are outside our area, so they do not meet the standard. Yet, if we restrict our lending to our area under the big bank test, then we have not met our obligations.

It is quite a Catch-22. The only reason the Catch-22 exists is because the big bank test was designed for banks that are spread out over hundreds of branches—my bank has 10 branches, all along one strip of about 30 miles of a road called Middle Country Road in a suburban area. So when the big bank test is applied to com-

munity banks like mine there are anomalies and it just does not work.

Senator CRAPO. Mr. Macomber.

Mr. MACOMBER. We seem to have gotten into CRA as the point here, one thing to look at I think is the regulators. The FDIC in particular and the other regulators are recommending that a larger level be established. That is based, I think, on the performance of the small banks, the performance they have seen in banks between $250 and $500 million.

As far as two tiers, I think there are a number of regulations in place that do recognize the difference in size and so forth, but the level of risk, if it is safety and soundness, is certainly a lot less in a $166 million bank like mine than it is in Bill Longbrake's bank which is somewhat larger. I think there should be some recognition along those lines.

But on the CRA, the $250 million just seems like too low a threshold, given the complexity of the banks involved, the fact that those banks that are that size are restricted basically by their very size to serving the community they are in. There is not a banker here that does not want to make a loan that is a good loan, in any neighborhood.

Senator CRAPO. Anybody else want to get in on any of the aspects of this? Mr. Maloney.

Mr. MALONEY. Senator, my area of expertise with our clients is on the asset management side, small bank trust departments who service the investment and retirement needs of the communities where they reside. I testified before the House Financial Services Committee in August 2 years ago in a hearing chaired by Spencer Bachus from Alabama. I said, Mr. Bachus, if you did not get this functional regulation issue correct, what Congress has done is take 2,000 community banks off the board as competitors and get them out of serving the financial service needs of their communities.

Last Friday, I chaired a gathering here in Washington, coincidentally, of 200 bankers from all over the United States, the very largest and the very smallest, on the title to the brokerage provisions of Gramm-Leach-Bliley. The Securities and Exchange Commission at 2:53 Thursday afternoon issued a 228-page release interpreting the provisions of Title II. I have five $500-an-hour lawyers trying to figure out what they said. It will crush the life out of small bank trust departments in terms of the compliance burden.

Senator CRAPO. Thank you. Anybody else want to get in on this question?

I appreciate that perspective. One of the things that has become very evident to us as we have put this together—Senator Sarbanes and I were talking about it as we were walking to the vote—is that there are some areas where we are going to find ourselves in complete agreement, and there are some areas where we will understand the issue very well but we will find ourselves in disagreement. And there are a lot of other areas where we do not understand the implications of proposals or actions that might be under consideration, and we want to be sure that we narrow that down and make certain that we understand the complexities that we are dealing with and make certain that we deal with them properly.

Let me turn to the credit union issue for a minute. Ms. James and Mr. Cheney, you may be the two who want to jump in on this, but others are certainly welcome to do so. You have explained or stated that you believe it is important to amend the Federal Credit Union Act to create a risk-based capital structure for credit unions. Would you go into that a little further and explain why Congress should modify the statutory definition of net worth so that it would more focus on equity rather than on the retained earnings?

Mr. CHENEY. There are really two issues there. One is the statutory definition of net worth now is codified in the Federal Credit Union Act. It says that net worth means the retained earnings balance of the credit union. That was not a problem in 1998 when the Credit Union Membership Access Act was passed. But it is an issue today because the Financial Accounting Standards Board is about to change the method of accounting for mergers of not-for-profit entities from the pooling of interest method to the purchase method.

When that happens, when two credit unions merge, in the old method you would take the retained earnings balance of one credit union and add it to the retained earnings balance of another credit union, so everything was fine. The new entity got the benefit of all of the members' equity.

Under the purchase method, the retained earnings balance of the credit union that no longer exists, that is merged into the other entity, goes into an account that is called acquired equity, which is not recognized by the Federal Credit Union Act as net worth for the purposes of prompt corrective action. So our proposal was to change the definition in the Federal Credit Union Act to say equity instead of retained earnings balance, and the Financial Accounting Standards Board said as far as they were concerned, that would resolve the issue.

So it does not change their ruling at all. It just takes care of a statutory definition of retained earnings.

Senator CRAPO. Ms. James.

Ms. JAMES. Senator, my testimony concerned more prompt corrective action and relating that to the risk in an individual credit union, not necessarily to their retained earnings. I just think that there are ways to look at credit unions who are very simply operated, are not involved in anything risky, that they could have a different level of prompt corrective action applied to them. I am not saying that they should not have prompt corrective action, only that their capital levels be more in relationship to the actual activities that they are doing.

Senator CRAPO. Thank you very much. Anybody else want to get in on this issue?

Mr. CHENEY. Just to the build a little bit on risk-based capital. We agree absolutely with that issue. Right now prompt corrective action establishes capital levels, and you just take their net worth retained earnings divided by assets and that is how you determine the level. We would like to see the assets risk-weighted as they are in the banking industry, so that we are not providing the same level of capital for cash in vaults, for example, as we do for secured lending. Just one example.

Senator CRAPO. Thank you very much. Mr. Rock, were you——

Mr. ROCK. I understand Mr. Cheney's earlier remarks, the limited point he was making about pooling and purchase accounting and so on. But my understanding is they would like to see the leverage ratio eliminated and have only risk-based capital. And when he says like the banking industry, we have several capital ratios that we have to comply with, three to be certain, and that includes a leverage ratio. So if they want equality, that does not amount to eliminating the leverage ratio. They can have the risk-based capital ratio too, I suppose, and that might be wise, but we are not eliminating the other ratio.

Ms. JAMES. We are not asking for that.

Mr. CHENEY. I may have been misunderstood, but we are not asking to eliminate it.

Ms. JAMES. No, not at all.

Senator CRAPO. Good. Let me go to another issue. I am only going to have time to hit several issues here, and I apologize for that, but believe me, we have so much material here to work on that you can be assured that we will be getting back to you to discuss this even after the hearing to go through these things.

Mr. Longbrake, you raise the issue of privacy which we did not get to last year as we were moving forward, and I would like to ask you to just take a minute and make your case about what you would like us to do with regard to privacy, and then see if there are concerns or comments that anybody else on the panel would like to make in the context of that issue.

Mr. LONGBRAKE. Thank you, Senator. As I referred to in my testimony, many consumers when polled do not even realize that they received a privacy notice from their bank. What Washington Mutual has done is actually prepare a very nice brochure that highlights the key aspects of privacy. It is in an easy to read and understand form, and we put it in statements. So we get a much higher percentage than the one I quoted, of people saying, yes, we read the privacy notice.

Now here is the problem. When the Gramm-Leach-Bliley Act was passed it left open the creation of that privacy notice and it left to the States the opportunity to amplify in any way they saw fit. The result of that has been two-fold. First of all, the bank regulatory agencies and the others that have jurisdiction, there are about seven different agencies altogether, have different forms of the notice requirements, so that creates confusion just to begin with.

The second problem is that then when lawyers get going or our companies, they take no risks, so what ends up is being a very complex, convoluted, difficult to understand, not very user-friendly situation. So what we are encouraging here is that the regulatory relief bill include something in it that directs the Federal regulatory agencies to craft a standard notice that all can use. You can have behind that on kind of a stacked basis then, the more complex one that deals with all the different things, and you can add into that the State activity as well. But what we would like to recommend is that there be a standard Federal notice that supersedes the State ones that is done in a simple and easy to understand way for consumers.

Senator CRAPO. I can agree with your request for simplicity, because as a Member of the Committee I read all those privacy no-

tices that I get sent from the financial institutions that I deal with. I am a Member of the Committee, and I am also a lawyer, and those things are tough to read. And when you are done reading one and you get the next one, then you really do not what you have read. So, I have to agree. I think that we have to do something to make it very clear to the public what their rights are, and that is another piece of this issue. But I do believe we need to get to simplicity.

Mr. LEIGHTY. If I may?

Senator CRAPO. Sure, Mr. Leighty.

Mr. LEIGHTY. I think there would be some merit when the account is opened the customer would receive that institution's privacy policy, and then perhaps it can be streamlined where if there are no changes that the institution not have to reprovide privacy notices unless they change, and that could be done along with a statement stuffer to simplify the process.

Senator CRAPO. Thank you. Mr. Mierzwinski, you wanted to say something?

Mr. MIERZWINSKI. They are brief, Senator. The consumer groups, obviously, we would support improving the privacy notices. But to some extent, it is like rearranging deck chairs on the Titanic because in fact our view is that the Gramm-Leach-Bliley privacy protections are minimal at best. It is almost like a right without a remedy. Most of the activities can occur regardless of your privacy preference.

Now the FACT Act did add a new opt-out in certain circumstances when your information is used for marketing, but in general we believe that the Committee should reinstate the supremacy of the so-called Sarbanes Amendments to Gramm-Leach-Bliley and make it clear that the States do have authority to enact stronger privacy laws that give consumers real privacy protections. In fact, we would support a nutrition label type of privacy notice, but it must have room on it for stronger State privacy laws.

Senator CRAPO. Anybody else want to get in on the privacy issue? Yes, Mr. Macomber.

Mr. MACOMBER. Just to repeat, the repetitive nature of these, for banks that do not share their information with anybody, just does not make any sense at all. My bank does not share information with anyone, except just for third parties that actually process in the back room. To keep sending these out, I would have to compliment you, Senator Crapo, you are the only person I have ever heard say that he read every one of these he got.

Senator CRAPO. I am a little embarrassed that I admitted that.

Mr. MACOMBER. But these generally are very much like Truth in Savings disclosures, they go in the wastebasket before reading.

Senator CRAPO. I can understand that, because I will be honest with you, after about four or five of them I could not read the rest of them. It just got to the point where it was too complicated trying to figure out what everyone was saying, knowing they were all working supposedly on the same page.

Any other comments?

I apologize that I am going to have to just go into one more issue. There are a lot more that we could get into, but like I say, I assure you that the Committee is going to be working very promptly and

aggressively on this to see where we can bring together enough common support to move some significant reform legislation.

The last one I wanted to get into is, Mr. Maloney, I wanted to get back to you and ask you to just clarify your point with regard to interest on business checking, on that issue. Could you clarify your position there for me, or maybe explain it to me. I do not know if you remember Senator Carper earlier asking one of the witnesses to say—if you wanted me to just give the really short, concise version of what your point is, what is that?

Mr. MALONEY. As I mentioned in my opening remarks, our clients banks are our friends and we are opposed to any initiative, either regulatory or legislative, which creates a climate where our friends can be harmed. Looking at the history of interest rate deregulation as a result of the Garn-St. Germain Act, it is very easy to conclude that absent a reasonable phase-in period to allow an institution to adjust the asset liability mix, and absent a cap on the rate of return that can be paid on the deposit account, we all run the risk of repeating the excesses of the 1980's. That was my point.

Senator CRAPO. Any comments on this issue? Yes, Mr. Pinto.

Mr. PINTO. I would just like to say two things. One, during the 1980's I was actually Chief Credit Officer at Fannie Mae so I have a little familiarity with what went on during that period, and to my knowledge it had nothing really to do with the providing of interest on consumer accounts. It had more to do with a large expansion of the rights of thrifts in particular to get into areas that they really had no expertise in, particular commercial lending. That is where most of the losses arose from.

But two, the issue is that we live in a free-market economy and Professor Schumpeter said that capitalism is creative destruction, and I think it is time that sweep accounts were destroyed because they are really not providing a business purpose or an economic purpose, and I think the Federal regulator said that early today.

Mr. MALONEY. Maybe if we have a repeat of the 1980's, Mr. Pinto can clean up the mess. He goes on record as being in favor of it.

Senator CRAPO. Mr. Macomber, did you have something to say?

Mr. MACOMBER. This corner is in agreement, in the sense, particularly about reflecting back at the 1980's. That was a credit issue. Those were bad loans made by people who were not qualified to make them, and both in Texas and New England, where I come from, a real estate market that got way out of whack. But they were not related to what banks were paying on interest rates. There are very few banks that have ever had real issues as far as safety and soundness related to interest. They may have exacerbated credit problems, but it is credit problems that generally put banks out of business.

Senator CRAPO. Mr. Maloney, did you want the last word?

Mr. MALONEY. If you are paying 25 percent to induce people to put deposits in your bank, presumably you have to find an offsetting interest-earning asset that is going to pay you more than 25 percent. I was taking a tutorial at the Wharton School at the time and at least I absorbed that much from my professors. So to argue that it was a credit problem while ignoring what people were paying to attract deposits simply ignores history.

Senator CRAPO. I know that there could be some back and forth on that and I would actually like to hear it, but we are running out of time here, so let me again thank all of the witnesses. Like I said, I know that you did not get the time to go into all of what you would have liked to have said during your oral testimony, but believe me, your written testimony is going to be very carefully reviewed. We did not get the time to go into every question that we wanted today with regard to these important issues either in the give and take, but there will be a tremendous amount of that.

I encourage you to continue to do as you have been doing, and that is not only prepare such excellent materials but also to keep engaged with my office and the offices of the other Senators who are involved in putting this together. We intend to move expeditiously. You probably would like to know what that means. So would I. In the Senate these days, we have a short timeframe for the rest of this session and we find ourselves only moving ahead when we are able to build some solid common ground where we have bipartisan support for legislation. I am just thinking off the top of my head right here that at this point we are going to be trying to put together legislation that has the kind of common support that will allow us to move promptly.

At the same time, I am guessing that a number of these issues will take a little bit longer to iron out, and we will not lose sight of them. This does not need to be the only stab at this that we take, and we will be able to continue to work on these issues and move forward with a number of other efforts, if necessary. Frankly, we can probably move forward on different fronts as well. So, I do not want to confuse things, but I just want to make it clear that we want to be thorough in this job. We also are going to work our hardest to be sure that we are able to move legislation in this session, and that is going to require that we build some good, bipartisan support for legislation as we move forward.

Again, I want to thank everybody, particularly the witnesses and those of your support staff who worked with you to prepare these outstanding materials. Unless there is anything else, this hearing will be adjourned. Thank you.

[Whereupon, at 1:50 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. I appreciate that we are having this hearing today.

Let me begin by thanking all of our witnesses for taking time to come and testify today. I would like to say a special welcome to Senators Landrieu and Lincoln. I am glad that your busy schedules allow you to join us today in order to offer your insights.

And, I would also like to offer a special thank you to Roger Little, the State of Michigan's very own Deputy Commissioner at the Office of Financial and Insurance Services. He also serves as Credit Union Director for Michigan. I know the Committee will benefit from having his comments. I am glad that he can be with us to relay his firsthand experiences to the Committee.

Mr. Chairman, regulatory relief is not an easy task, but it is appropriate, I believe, to review our Government's regulations from time to time and make modifications if we find them to be overly burdensome, unrealistic, or outdated.

Regulations exist to protect the American people and make sure that markets do not fail the public interest. I would oppose efforts to weaken regulations that act as critical consumer protections, but I do support a review of our regulations and I suspect that there are a number of revisions upon which this Committee can agree need some corrections.

This will not be an easy or fast process. And, indeed, today's hearing is a chance to begin a discussion that I suspect will take us well into next year, but I think today will be a very useful discussion. And, I am also very grateful for the broad array of viewpoints we will hear today. It can only lead to a better, more balanced bill when you, Senator Crapo, and others are ready to introduce a reform proposal.

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Mr. Chairman, I want to thank you for holding today's hearing. I also want to thank Senator Crapo for his leadership in addressing regulatory reform. For four Congresses now, I have advocated and introduced legislation to repeal the ban on banks paying interest on business checking accounts. While this prohibition applies to all banks and businesses, it targets and discriminates against small banks and small businesses. That is why Senator Snowe, who chairs the Small Business and Entrepreneurship Committee, and I introduced the Interest On Business Checking Act last year.

Big banks can currently circumvent the prohibition and offer alternative accounts, called sweep accounts. These sweep accounts allow big banks to effectively provide their customers with interest-bearing checking accounts. Unfortunately, small banks find it hard to offer these accounts, because they are costly to provide. Additionally, small businesses find it hard to afford these accounts because large banks usually require businesses to maintain large balances in the accounts.

Complicating matters is the growing impact of nonbanking institutions that offer deposit-like money accounts to individuals and corporations alike. Large brokerage firms have long offered interest on deposit accounts they maintain for their customers. This places these firms at an advantage over community banks that cannot offer their corporate customers interest on their checking accounts. While I support business innovation, I do not believe it is fair when any business gains a competitive edge over another due to government interference through over-regulation.

Passage of this bill will remove one of the last vestiges of an obsolete interest rate control system. Abolishing the statutory requirement that prohibits businesses from owning interest bearing checking accounts will provide America's small business owners, farmers, and farm cooperatives with a funds management tool that is long overdue.

Passage of this bill will ensure America's entrepreneurs can compete effectively with larger businesses. My experience as a businessman has shown me, firsthand, that it is extremely important for anyone trying to maximize profits to be able to invest funds wisely for maximum efficiencies.

Repealing this ban has already passed the House this year and has passed the Senate Banking Committee in previous Congresses. Unfortunately, there has been some disagreement as to how to address this legislation with respect to Industrial Loan Corporations or ILC's. Mr. Chairman, the bill which I introduced last year, leaves the decision to be determined by the regulator.

I am pleased to say that repealing the ban has the strong support of America's Community Bankers, the National Federation of Independent Businesses, and the U.S. Chamber of Commerce. It also has the support of many of the banks, thrifts, and small businesses in my home State of Nebraska.

Mr. Chairman, this is a straightforward bill that will do away with an unnecessary regulation that burdens American business. It is an important tool to strengthen the Nation's engine of job growth—the small businesses that are important customers for small banks. This legislation also fits into the regulatory reform efforts being undertaken by this Committee. Thank you.

PREPARED STATEMENT OF SENATOR RICK SANTORUM

Mr. Chairman and Members of the Committee, I would like to thank the Chairman for holding this hearing regarding regulatory reform for our Nation's financial institutions. I am pleased that Mr. Gene Maloney, Director, Executive Vice President and Corporate Counsel of Federated Investors, Inc. in Pittsburgh, one of the Nation's largest investment management organizations, has been invited to testify at today's hearing. Mr. Maloney will talk about the proposed revision to Regulation Q, to allow banks to pay interest on business checking accounts. Gene has extensive industry experience and has previously testified before the Senate on matters of fiduciary compensation and the deregulation of the financial services industry.

Mr. Maloney has appeared as a speaker at American Bankers Association gatherings and is a frequent speaker at State Bankers Association meetings on the following subjects: The Gramm-Leach-Bliley Act, the deregulation of the financial services industry, the Uniform Prudent Investor Act, and the investment management process it contemplates, fiduciary compensation, and asset allocation as a means of optimizing return and minimizing risk.

Gene is a Director of the Foundation for Fiduciary Studies. He is an instructor in trust and securities law at Boston University School of Law and has been a visiting instructor at the Federal Financial Institutions Examination Council and the American Bankers Association's National Graduate Trust School at Northwestern University. Mr. Maloney has also served as an expert witness in both judicial and legislative settings on matters relating to fiduciary compensation, will construction, and prudent investing.

Gene received his B.A. from Holy Cross College in Worcester, Massachusetts, and his J.D. from Fordham Law School in New York City. He attended the Wharton School of the University of Pennsylvania, focusing on the financial management of commercial banks. He was an officer in the Army from 1969 to 1972 and served as an infantry officer for 1 year in Vietnam.

I think we all recognize the importance of hearing testimony from different sides of an issue, and I thank the Chairman and Members of the Committee for their consideration of this witness. I look forward to hearing the testimony presented today.

PREPARED STATEMENT OF MARY L. LANDRIEU

A. U.S. SENATOR FROM THE STATE OF LOUISANA

JUNE 22, 2004

Good Morning, Mr. Chairman and Members of the Committee. It is my pleasure to appear before this Committee today to talk about Federal rent-to-own legislation. Let me begin by thanking you, Chairman Shelby, for scheduling hearings on regulatory relief in general, including legislation that I introduced earlier in this Congress, S. 884, which you and many others on this Committee have agreed to cosponsor. The bill has broad bipartisan support, including several Members of this Committee and I hope that the Committee will include my legislation in future regulatory relief legislation.

S. 884, standing alone or as part of this regulatory relief package, proposes to regulate the rent-to-own, or rental-purchase, transaction, for the first time at the Federal level. In introducing this legislation, I have tried to ensure the interests of the consumers are protected while providing a Federal floor of consumer protections.

Preemption is an important issue for many of us. Those of us who have previously served in our respective State legislatures hold our colleagues in the State legislatures in high esteem. If enacted, this legislation would serve only to establish a *floor of regulation* of the rent-to-own transaction. State legislatures would have full opportunity to pass stronger laws and regulations, modify existing statutes, or even outlaw the transaction entirely if that is what those bodies believed was appropriate. *My bill does not preempt any State statute.* This bill, however, would finally establish a Federal or national definition of the term "rental-purchase," consistent with the definitions found in these various existing State statutes and within the

Internal Revenue Code. Just as is the case under other Federal consumer protection laws, including TILA and the CLA, States would not be permitted to define or "mischaracterize" the rent-to-own transaction in a manner that would be inconsistent with the definition in this bill.

Now let me turn to what the bill does in terms of providing consumer protection and uniformity in terms of a floor of Federal consumer protections.

The rent-to-own, or rental-purchase industry, offers household durable goods—appliances, furniture, electronics, computers, and musical or band instruments are the primary product lines—for rent on a weekly or monthly basis. Customers are never obligated to rent beyond the initial term, and can return the rented product at any time without penalty or further financial obligation. Of course, customers also have the option to continue renting after the initial or any renewal rental period, and can do so simply by paying an additional weekly or monthly rental payment in advance of the rental period. In addition, rent-to-own consumers have the option to purchase the property they are renting, either by making the required number of renewal payments set forth in the agreement, or by exercising an early purchase option, paying cash for the item at any time during the rent-to-own transaction.

Rental companies typically provide delivery and set up of the merchandise, as well as service and replacement products, throughout the rental at no additional cost to the consumer. Rental companies do not check the credit of their customers, and do not require downpayments or security deposits, nor do they report to credit agencies information regarding consumers. Consequently, this is a transaction that is very easy to get into and out of, ideal for the customer that wants and/or needs financial flexibility that only this unique, hybrid rental-and-purchase transaction affords.

The rent-to-own transaction appeals to a wide variety of customers, including parents of children who this week want to learn to play the violin, only to find that, 2 weeks later, the child is more adept at—and interested in—fiddling around. Military personnel who are frequently transferred from base-to-base, who want quality furnishings for their apartments or homes but who often cannot afford, or do not want, to purchase these items, use rent-to-own. College students sharing apartments or dorms rent furniture, appliances and electronics from rent-to-own companies. The transaction serves the needs of campaign offices, summer rentals, Super Bowl and Final Four parties, and other similar short-term needs or wants.

Importantly, however, this transaction is also frequently used by individuals and families who are just starting out and have not yet established good credit, or who have damaged or bad credit, and whose monthly income is insufficient to allow them to save and make major purchases with cash. For these consumers, rent-to-own offers an opportunity to obtain the immediate use, and eventually ownership if they so desire, of things that most of the rest of us take for granted—good beds for our children to sleep on, washers and dryers so they do not have to spend all weekend at the Laundromat, dropping coins into machines that they will never own. Computers so the kids can keep up in school, decent furniture to sit on and eat at, and so on. Rent-to-own gives these working class individuals and families a chance, without the burden of debt, and with all the flexibility they need to meet their sometimes uncertain economic circumstances. This is certainly a more viable alternative than garage sales, flea markets and second-hand stores.

The Internal Revenue Service, as a matter of law, has determined that fewer than 50 percent of rent-to-own transactions result in purchases and the rent-to-own industry statistics confirm that approximately one in four transactions results in the renter electing to acquire ownership of the rented goods. In the other 75 percent, according to the industry numbers, customers rent for a short period of time and then return the goods to the store, typically in just a few weeks or months.

There are roughly 8,000 rent-to-own furniture, appliance and electronic stores throughout the country, and in Puerto Rico. Additionally, there are several hundred musical instrument stores. The majority of companies operating in this business are "mom-and-pop" family owned businesses, with one or two locations in a particular city or town, with less than one-half of these stores being owned by major, multistate corporations.

Over the past 20 years, there has been a healthy and vigorous public debate, played out primarily at the State level, and to some extent here in Washington as well, about the appropriate method of regulating this transaction. Some individuals and groups have argued that rent-to-own is most similar to a credit sale, and consequently should be regulated as such. However, as you have just heard me describe, this transaction differs from consumer credit is a number of respects, most importantly in that the rent-to-own customer is never obligated to continue renting beyond the initial rental term, and has the unilateral right to terminate the agreement and have the products picked up at any time, without penalty. This is *the* crit-

ical distinction—under traditional credit transactions, the consumer *must make all of the payments over a predetermined period of time* or risk default, repossession, deficiency judgments and, in worst cases, damaged credit and personal bankruptcy. By way of stark contrast, the rent-to-own customer enjoys complete control over his or her use of the rented goods, and the terms of the rental transaction itself. To this point, the Federal Trade Commission distinguished between the rent-to-own transaction and a credit-sale transaction in its seminal report on the rent-to-own industry in 2000 saying that:

> *Unlike a credit sale, rent-to-own customers do not incur any debt,* can return the merchandise at any time without obligation for the remaining payments, and do not obtain ownership rights or equity in the merchandise until all payments are completed.

Every State legislature that has enacted rent-to-own specific legislation, beginning with Michigan in 1984, has agreed that this unique transaction is *not* a form of consumer credit, but instead is something very different. My bill, S. 884, is consistent with the approach taken by all these various State laws. However, as I explained earlier, this proposal would set a floor of regulation, beyond which States would be free to regulate if the State legislatures saw the need to do so in response to local concerns and conditions. And in fact, any number of the existing State laws provide greater consumer protections than those imbedded in this bill, and those stronger regulatory frameworks would remain controlling in those States if this bill were to be enacted. One other note: This bill, if enacted, would align Federal consumer protection law with Federal tax law, which treats rent-to-own transactions as true leases and not as credit sales for income reporting and inventory depreciation purposes. In short, no State legislature would be precluded from regulating this transaction in any way. It would however, no be allowed to redefine this transaction as something it is not. This is consistent with how Congress has dealt with consumer leases over 4 months in length and true credit transactions.

Finally, this bill enjoys the unanimous support of the rental-purchase industry, from its largest members to its smallest.

This bill strikes a balance between the needs for consumer protection and the need to establish and maintain a fair and balanced competitive marketplace in which businessmen and—woman can survive and thrive and continue to provide a financial transaction the consumer wants. I believe that it is this balance that has made the bill so attractive to such a variety of cosponsors, evenly split between Democrats and Republicans.

The bill does 5 major things:

- One, it defines the transaction in a manner that is consistent with existing State rent-to-own laws, as well as Federal tax provisions. As an aside, this definition is also consistent with the views of both the Federal Reserve Board Staff and the Federal Trade Commission, as expressed in their testimony before the House Financial Services Committee in the 107th Congress.
- Two, it provides for comprehensive disclosure of key financial terms in advertising and on price cards on merchandise displayed in these stores, as well as in the body of the rental contracts themselves. *These disclosure requirements were adopted in part from the recommendation of the FTC in its seminal report on the rent-to-own industry from 2000.* Overall, these requirements exceed the disclosure mandates under Truth in Lending as well as the Federal Consumer Leasing Act.
- Three, the bill establishes a list of prohibited practices in the rent-to-own industry, a list similar in content and substance to the practices prohibited under the Federal Trade Commission Act, and under most State deceptive trade practices statutes. These provisions are unique—neither Truth in Lending nor the Consumer Leasing Act contains similar provisions.
- Four, the bill adopts certain universal substantive regulations shared by all of the existing State rental laws. For example, the bill would mandate that consumers who have terminated their rental transactions and returned the goods to the merchant be provided an extended period of time in which to "reinstate" that terminated agreement—that is, to come back to the store and rent the same or similar goods, starting on the new agreement at the same place the customer left off on the previous transaction.
- Finally, the bill adopts the remedies available to aggrieved and injured consumers under the Truth in Lending Act, including a private right of action for consumers.

In summary, this legislation would go farther in providing substantive protections for rent-to-own consumers than does any other Federal consumer protection law on the books today. And yet, it enjoys the unanimous support of the industry, because it is fundamentally fair and balanced.

For release on delivery
10:00 a.m. EDT
June 22, 2004

Statement of

Donald L. Kohn

Member

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

June 22, 2004

Chairman Shelby, Senator Sarbanes, and members of the Committee, thank you for the opportunity to testify on issues related to regulatory relief. The Federal Reserve strongly supports this and other efforts to review the federal banking laws periodically to determine whether they may be streamlined without jeopardizing the safety and soundness of this nation's insured depository institutions or undermining consumer protection or other important policy principles that Congress has established to guide the development of our financial system.

Earlier this spring, Chairman Shelby and Senator Crapo asked the Federal Reserve Board to identify its top two or three legislative priorities for regulatory relief. In his letter of April 23, Chairman Greenspan highlighted three proposals that the Board has supported for many years: authorization for the Federal Reserve to pay interest on balances held by depository institutions in their accounts at Federal Reserve Banks, repeal of the prohibition against the payment of interest on demand deposits by depository institutions, and increased flexibility for the Federal Reserve in setting reserve requirements.

As we have previously testified, unnecessary legal restrictions on the payment of interest on demand deposits at depository institutions and on balances held at Reserve Banks distort market prices and lead to economically wasteful efforts by depository institutions to circumvent these artificial limits. In addition, authorization of interest on all types of balances held at Reserve Banks would enhance the toolkit available for the continued efficient conduct of monetary policy. And the ability to pay interest on a variety of balances, together with increased authority to lower or even eliminate reserve requirements, could allow the Federal Reserve to reduce the regulatory and reporting burden on depository institutions of reserve requirements. Let me explore each of these topics at greater length.

Interest on Reserves and Reserve Requirement Flexibility

For the purpose of implementing monetary policy, the Federal Reserve is obliged by law to establish reserve requirements on certain deposits held at depository institutions. Banks, thrifts, and credit unions may satisfy their reserve requirements either by holding cash in their vaults and ATM machines, which they need in any case for normal business activities, or by holding balances at Reserve Banks. Because no interest is paid on the balances held at Reserve Banks to meet reserve requirements, depositories have an incentive to reduce their reserve requirements to a minimum. To do so, they engage in a variety of reserve avoidance activities, including sweep arrangements that move funds from deposits that are subject to reserve requirements to those that are not and to money market investments. These sweep programs and similar activities absorb real resources and therefore diminish the efficiency of our banking institutions. The payment of interest on required reserve balances would remove a substantial portion of the incentive for depositories to engage in such reserve avoidance measures, and the resulting improvements in efficiency should eventually be passed through to bank borrowers and depositors.

Although paying interest on reserves would yield significant benefits, even greater efficiencies and regulatory burden reduction might be realized by substantially reducing, or even eliminating, reserve requirements. To understand how elimination of reserve requirements could be consistent with effective monetary policy and the other legislative changes that would be necessary to realize this greater reduction in regulatory burden, I need to review with you the role of reserve requirements in the implementation of monetary policy and alternatives that might be possible.

The Federal Reserve's Federal Open Market Committee (FOMC) conducts monetary policy by setting a target for the overnight federal funds rate–the interest rate on loans between

depository institutions of balances held at Reserve Banks. While the federal funds rate is a market interest rate, the Federal Reserve can strongly influence its level by adjusting the aggregate supply of balances held at Reserve Banks. It does so through open market operations–the purchase or sale of securities that causes increases or decreases in such balances. However, in deciding on the appropriate level of balances to supply in order to achieve the targeted funds rate, the Federal Reserve's Open Market Desk must estimate the aggregate demand for such balances.

At present, a depository institution may hold three types of balances in its account at a Federal Reserve Bank–required reserve balances, contractual clearing balances, and excess reserve balances. As noted above, required reserve balances are the balances that a depository institution must hold to meet reserve requirements. A depository institution holds contractual clearing balances when it needs a higher level of balances than its required reserve balances in order to pay checks or make wire transfers out of its account at the Federal Reserve without incurring overnight overdrafts. Currently, such clearing balances do not earn explicit interest, but they do earn implicit interest for depository institutions in the form of credits that may be used to pay for Federal Reserve services, such as check clearing. Finally, excess reserve balances, which earn no interest, are funds held by depository institutions in their accounts at Reserve Banks in excess of their required reserve and contractual clearing balances.

To conduct policy effectively, it is important that the combined demand for these balances be predictable, so that the Open Market Desk knows the volume of reserves to supply to achieve the FOMC's target federal funds rate. Required reserve and contractual clearing balances are predictable in that depository institutions must maintain these balances over a two-week maintenance period, and the required amounts of both types of balances are known in advance. It is also helpful for policy implementation that, when the level of balances unexpectedly deviates

from the desk's intention, banks engage in arbitrage activities that help to keep the funds rate near its target. Depository institutions have an incentive to engage in this arbitrage activity because required reserve and contractual clearing balances must be maintained, not day-by-day, but only on an average basis over a two-week period. Thus, for example, if the funds rate were higher than usual on a particular day, some depository institutions could choose to hold lower balances on that day, and their reduced demand would help to alleviate the upward pressure on the funds rate. Later in the period, when the funds rate might be lower, those institutions could choose to hold extra balances to make up the shortfall in their average holdings of reserve balances.

The averaging feature is only effective in stabilizing markets, however, if the sum of required reserve and contractual clearing balances is sufficiently high that banks hold balances, on the margin, as a means of hitting their two-week average requirements. If the sum of required reserve and contractual clearing balances declined to a very low level so that depositories held balances at Reserve Banks on the margin only to meet possible payments out of their accounts late in the day, the demand for balances would be more variable from day to day and more difficult to predict. While overnight interest rates have exhibited little volatility in recent years, even when the sum of required and contractual balances was considerably smaller than at present, volatility nevertheless could potentially become a problem at some future time if such balances fell to very low levels. Such a development might be possible if interest rates were to rise to high levels, which would reduce the demand for required and contractual balances and provide extra incentives for reserve avoidance. Paying interest on such balances is one way to ensure that they do not drop too low.

If increased flexibility in setting reserve requirements were authorized, the Federal Reserve nonetheless could consider substantial reductions in reserve requirements, or even their

eventual removal, as long as balances held at Reserve Banks other than required reserve balances could serve the purpose of ensuring the effective implementation of monetary policy. To enable the alternative types of balances to play a more important policy implementation role, it would be essential for the Federal Reserve to be authorized to pay explicit interest on them. In particular, in the absence of reserve requirements, the Federal Reserve would need to be able to pay explicit interest on contractual clearing balances or a similar type of voluntary instrument maintained over a two-week average period. This could potentially provide a demand for Federal Reserve balances that would be high and stable enough for monetary policy to be implemented effectively through existing procedures for open market operations, even with lower or zero required reserve balances. A number of other countries, including Canada, Switzerland, Sweden, Australia, and New Zealand, have found that they are able to implement monetary policy satisfactorily without the aid of reserve requirements. One method central banks in some of these countries employ to mitigate potential volatility in overnight interest rates is to attempt to establish a ceiling and floor for such rates through the central bank's own lending and deposit rates. If a central bank lends freely at a penalty interest rate, that rate tends to act as a ceiling on overnight market interest rates. Last year, the Federal Reserve changed its discount window operations to institute a lending facility of this type that should help to mitigate large upward spikes in overnight interest rates. If the Federal Reserve had the authority to pay interest on excess reserve balances, and did so, that interest rate would act as a minimum for overnight interest rates, because banks would not generally lend to other banks at a lower rate than they could earn by keeping their excess funds at the Federal Reserve. However, our depository institutions are much more heterogeneous than those in other countries and it is not entirely clear how well a ceiling and floor arrangement would work in the United States. Although the Federal Reserve sees no need to pay interest on excess

reserves in the near future, the ability to do so nevertheless would be a potentially useful addition to the monetary toolkit of the Federal Reserve.

Interest on Demand Deposits

The efficiency of our financial sector also would be improved by repealing the prohibition of interest on demand deposits. This prohibition was enacted during the Great Depression, due to concerns that large money center banks might have earlier bid deposits away from country banks to make loans to stock market speculators, depriving rural areas of financing. It is doubtful that the rationale for this prohibition was ever valid, and it is certainly no longer applicable. Today, funds flow freely around the country, and among banks of all sizes, to find the most profitable lending opportunities, using a wide variety of market mechanisms, including the federal funds market. Moreover, Congress authorized interest payments on household checking accounts with the approval of nationwide NOW accounts in the early 1980s. The absence of interest on demand deposits, which are held predominantly by businesses, is no bar to the movement of funds from depositories with surplus funds–whatever their size or location–to the markets where the funding can be profitably employed. Moreover, in rural areas, small firms with extra cash are able to bypass their local banks and invest in money market mutual funds with check-writing and other transaction capabilities. Indeed, smaller banks have complained that they are unable to compete for the deposits of businesses precisely because of their inability to offer interest on demand deposits.

The prohibition of interest on demand deposits distorts the pricing of transaction deposits and associated bank services. In order to compete for the liquid assets of businesses, banks have been compelled to set up complicated procedures to pay implicit interest on compensating balance accounts. Banks also spend resources–and charge fees–for sweeping the excess demand deposits

of businesses into money market investments on a nightly basis. To be sure, the progress of computer technology has reduced the cost of such systems over time. However, the expenses are not trivial, particularly when substantial efforts are needed to upgrade such automation systems or to integrate the diverse systems of merging banks. From the standpoint of the overall economy, such expenses are a waste of resources and would be unnecessary if interest were allowed to be paid on both demand deposits and the reserve balances that must be held against them.

The prohibition of interest on demand deposits also distorts the pricing of other bank products. Many demand deposits are not compensating balances, and because banks cannot pay explicit interest, they often try to attract these deposits by pricing other bank services below their actual cost. When services are offered below cost, they tend to be overused to the extent that the benefits of consuming them are less than the costs to society of producing them.

Interest on demand deposits would clearly benefit small businesses, which currently earn no interest on their checking accounts. But larger firms would also benefit as direct interest payments replaced more costly sweep and compensating balance arrangements. For banks, paying interest on demand deposits likely would increase costs, at least in the short run. However, to the extent that banks were underpricing some services to attract these "free" deposits, those prices would adjust to reflect costs. Moreover, combining interest on demand deposits with interest on required reserve balances and possibly a lower burden associated with reduced or eliminated reserve requirements would help to offset the rise in costs for some banks. Many banks will benefit from the elimination of unnecessary costs associated with sweep programs and other reserve-avoidance procedures.

Over time, these measures should help the banking sector attract liquid funds in competition with nonbank institutions and direct market investments by businesses. Small banks

in particular should be able to bid for business demand deposits on a more level playing field *vis-a-vis* both nonbank competition and large banks that currently use sweep programs for such deposits.

The payment of interest on demand deposits would have no direct effect on federal revenues, as interest payments would be deductible for banks but taxable for the firms that received them. However, the payment of interest on required reserve balances, or reductions in reserve requirements, would lower the revenues received by the Treasury from the Federal Reserve. The extent of the potential revenue loss, however, has fallen over the last decade as banks have increasingly implemented reserve-avoidance techniques. Paying interest on contractual clearing balances would primarily involve a switch to explicit interest from the implicit interest currently paid in the form of credits, and therefore would have essentially no net cost to the Treasury.

Industrial Loan Companies

Although the Federal Reserve Board strongly supports repealing the prohibition of interest payments on demand deposits, the Board opposes any amendment–such as the one contained in H.R. 1375–that would permit industrial loan companies (ILCs) to offer NOW accounts to businesses. ILCs are state-chartered FDIC-insured banks that were first established early in the twentieth century to make small loans to industrial workers, but over time have been granted by the states many of the powers of commercial banks and in some cases now hold billions of dollars of assets. Under a special exemption in current law, ILCs that are chartered in certain states are excluded from the definition of "bank," and their parent companies are not considered "bank holding companies" for purposes of the Bank Holding Company Act. This special exemption allows *any* type of company–including a commercial or retail company–to own an FDIC-insured

bank without complying with either the limitations on activities or the consolidated supervision requirements that apply to bank holding companies under the Bank Holding Company Act. An amendment that would allow ILCs to offer NOW accounts to businesses would permit ILCs to become the functional equivalent of full-service insured banks. These expanded powers are inconsistent with both the historical functions of ILCs and the terms of their special exemption in current law. Granting these powers to ILCs would provide their owners a competitive advantage over the owners of other insured banks. Moreover, such an amendment would raise significant questions for the Congress concerning the nation's policy of maintaining the separation of banking and commerce and the desirability of permitting large, diversified companies to control insured depository institutions without consolidated supervision.

H.R. 1375 also included ILCs in a provision removing limitations on de novo interstate branching by banks. The Federal Reserve supports expanding the de novo branching authority of depository institutions. Current limitations on de novo branching are anti-competitive obstacles to interstate entry for banks and also create an unlevel playing field between banks and federal savings associations, which have long been allowed to open new branches in other states. But we also believe that Congress should not grant this new branching authority to ILCs unless the corporate owners of these institutions are subject to the same type of consolidated supervision and activities restrictions as the owners of other insured banks. With de novo branching, a large retail company could potentially open a branch of an ILC in each of the company's retail stores nationwide. As mentioned above, allowing a commercial or financial firm to operate an insured nationwide bank outside the supervisory framework established by Congress for the other owners of insured banks raises significant safety and soundness concerns, creates an unlevel competitive playing field, and undermines the policy of separating banking and commerce that Congress

reaffirmed in the Gramm-Leach-Bliley Act of 1999. These important questions should be addressed in a more comprehensive and equitable manner than would be possible in the consideration of minor amendments to legislation on demand deposits or de novo branching.

Conclusion

In conclusion, the Federal Reserve Board strongly supports, as its key priorities for regulatory relief, legislative proposals that would authorize the payment of interest on demand deposits and on balances held by depository institutions at Reserve Banks, as well as increased flexibility in the setting of reserve requirements. We believe these steps would improve the efficiency of our financial sector, make a wider variety of interest-bearing accounts available to more bank customers, and better ensure the efficient conduct of monetary policy in the future.

STATEMENT OF

JOHN M. REICH
VICE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

CONSIDERATION OF REGULATORY REFORM PROPOSALS

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

June 22, 2004 -- 10:00 AM
538 Dirksen Senate Office Building

Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, I very much appreciate this opportunity to testify on our efforts to reduce unnecessary regulatory burden on the nation's banks and the regulatory review process mandated by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). As a former community banker with 23 years of experience in the industry, and as the current leader of the inter-agency effort to reduce regulatory burden, I have a strong personal commitment to eliminate all unnecessary burden while maintaining the safety and soundness of the industry and protecting important consumer rights.

My testimony will discuss the accumulation of regulations over the years and their impact on the nation's financial institutions. Next, I will outline our efforts to review our regulations and address, on an inter-agency basis, some of the existing regulatory burden, as mandated by EGRPRA. I will describe some actions the Federal Deposit Insurance Corporation (FDIC) is taking internally to reduce burdens imposed by our own regulations and operating procedures. Finally, I will review the need for legislative action to reduce burden and outline some legislative proposals we are discussing with the other agencies.

THE ACCUMULATION OF REGULATIONS AND THEIR IMPACT ON THE NATION'S BANKS

Regulatory burden is clearly an issue for all FDIC-insured institutions. Since enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, the bank and thrift regulatory agencies have promulgated a total of 801 final rules. There were good and sufficient reasons for many of these rules and, in fact, some were actually sought by the industry. However, 801 regulatory changes over a

15 year period is certainly a lot for banks to digest, particularly smaller community banks with very limited staff. Rule changes can be quite costly since implementation often requires computers to be reprogrammed, staff retrained, manuals updated and new forms produced. Even if some of the rules do not apply to a particular institution, someone has to at least read the rules and make that determination.

While there are no definitive studies of the total cost of regulation, a survey of the evidence by a Federal Reserve Board economist in 1998 found that total regulatory costs account for 12 to 13 percent of banks' noninterest expense, or about $36 billion in 2003 ("The Cost of Bank Regulation: A Review of the Evidence," Gregory Elliehausen, Federal Reserve Bulletin, April 1998). For the banking industry, every change in reporting requirements or modification of business practices involves new capital expenditures and increased human resources, computer programming costs and vendor expenses. The same research indicates that start up costs for new or changing regulations may be very expensive and insensitive to the size of the changes. In other words, the process of learning about and adopting regulatory changes is expensive for banks, whatever the magnitude of the change. Frequent small, incremental changes may be much more expensive than large, one time changes.

While my strong personal view is that regulatory burden has a disproportionate impact on community banks, which I discuss below, we are committed to addressing the problem of regulatory burden for every insured financial institution. Banks, large and small, labor under the cumulative impact of regulations that divert resources and capital away from economic development, credit extension and job creation. Most of the

proposals we are examining would provide significant relief to all financial institutions and I commend the Committee for its attention to this pressing issue.

THE IMPACT OF REGULATORY BURDEN ON COMMUNITY BANKS

New regulations have a greater impact on some community banks, especially small community banks (under $100 million in assets), than on larger institutions due to their inability to spread start up and implementation costs over a large number of transactions. Economies of scale associated with regulatory compliance have been confirmed in implementation cost studies of the Truth in Savings Act, the Equal Credit Opportunity Act and the Electronic Funds Transfer Act, where the incremental cost of regulation declines as the number of transactions or accounts rise. Jim Hance, Vice Chairman of Bank of America, summed the situation up at a recent conference at the Federal Reserve Bank of Chicago: "[A]ll banks are being mandated to install more and more compliance-related technology—for issues ranging from anti-money laundering to Basel II. Scale allows us to do so far more efficiently than smaller competitors."

The magnified impact of regulatory burden on small banks is a significant concern to me. As a former community banker, I know the importance of community banks in our economy. Community banks play a vital role in the economic wellbeing of countless individuals, neighborhoods, businesses and organizations throughout our country, often serving as the lifeblood of their communities.

These banks are found in all communities—urban, suburban, rural and small towns. Whether a minority-owned urban neighborhood institution or an agricultural bank, community banks have several things in common. They are a major source of local

credit. Data from the June 2003 Call Reports shows that the overwhelming share of commercial loans at small community banks were made to small businesses. In addition, the data indicate that commercial banks with assets between $100 million and $1 billion account for a large share of all small business and small farm loans.

Community banks are the bankers for municipalities and school districts. Community bankers generally know personally many small business owners and establish lending relationships with these individuals and their businesses. These small businesses, in turn, provide the majority of new jobs in our economy. Small businesses with fewer than 500 employees account for approximately three-quarters of all new jobs created every year in this country. The loss of community institutions can result in losses of civic leadership, charitable contributions, and local investment in school and other municipal debt.

My concern is that the volume and complexity of existing banking regulations, coupled with new laws and regulations, may ultimately threaten the survival of our community banks. This concern is not new. The conclusion of the 1998 Federal Reserve study states:

> Average compliance costs for regulations are substantially greater for banks at low levels of output than for banks at high levels of output. This conclusion has important implications. Higher average regulatory costs at low levels of output may inhibit the entry of new firms into banking or may stimulate consolidation of the industry into fewer, larger banks.

Over the last 20 years, there has been substantial consolidation in the banking industry. This can be seen most dramatically in small community banks. At the beginning of 1985, there were 11,780 small community banks with assets of less than $100 million in today's dollars. At year end 2003, their number had dropped by 63

percent to just 4,390 (see Chart 1). Even more dramatically, the total market share of those institutions decreased from nine percent at the beginning of 1985 to two percent at yearend 2003 (see Charts 2 and 3). The decline had three main components: mergers, growth out of the community bank category, and failures. The decrease was offset somewhat by the creation of more than 2,400 new banks. In the above calculations, bank asset size was adjusted for inflation. Thus, a bank with $100 million in assets today is compared with one having about $64 million in assets in 1985.

A number of other market forces, such as interstate banking and changes to state branching laws have affected the consolidation of the banking industry. The bank and thrift crisis of the 1980s and the resulting large number of failures and mergers among small institutions serving neighboring communities also contributed to the decline in the smallest financial institutions. It is probable that together those factors were the greatest factors in reducing small bank numbers. However, I believe that in looking to the future, regulatory burden will play an increasingly significant role in shaping the industry and the number and viability of community banks. While many new banks have been created in the past two decades, I fear that, left unchecked, regulatory burden may eventually pose a barrier to the creation of new banks. Keeping barriers to the entry of new banks low is critical to ensuring that small business and consumer wants and needs are met, especially as bank mergers continue to reduce options in some local markets.

It may seem a paradox to discuss profitability concerns at a time when the banking industry is reporting record earnings. Last year the industry as a whole earned a record $120.6 billion, surpassing the previous annual record of $105 billion set in 2002. When you look behind the numbers, however, you see a considerable disparity in the

earnings picture between the largest and smallest banks in the country. The 110 largest banks in the country (those with assets over $10 billion), which represent 1.2 percent of the total number of insured institutions, earned $87.7 billion or about 73 percent of total industry earnings, while the 4,390 banks with assets under $100 million, which represent 48 percent of the total number of insured institutions, earned about $2.1 billion, which represents only 1.7 percent of total industry earnings (see Chart 4). Moreover, when you further examine the data, you find that banks with assets over $100 million had an average return on assets (ROA) of 1.39 percent, while those with assets under $100 million had an average ROA of 0.95 percent (see Chart 5).

While the banks under $100 million had the highest yield on earning assets (5.86 percent) they also had the lowest non-interest income (1.43 percent), and the highest noninterest expense to asset ratio (3.71 percent). This combination resulted in about one in ten banks under $100 million in assets being unprofitable in 2003. This is almost five times the ratio for banks between $100 million and $10 billion and almost ten times greater than the largest banks. These numbers make it clear that community banks, while healthy in terms of their supervisory ratings, are operating at a lower level of profitability than the largest banks in the country. At least part of this disparity in earnings stems from the disproportionate impact that regulations and other fixed noninterest costs have on community banks (see Chart 6).

Bankers are becoming increasingly worried that their institutions—and all that they mean to their communities—may not be able to operate at an acceptable level of profitability for their investors for too many more years under what they describe as a "never-ending avalanche" of regulations. In some cases, the cost of complying with that

burden is pushing some smaller banks out of the market. As reported in the American Banker (May 25, 2004), regulatory burden was an important factor in the decision by two community banks to sell their institutions. One bank CEO of a consistently high performing community bank confided that at a recent meeting of his bank's board, the institution's directors remarked that the bank's return on assets had been slipping in recent years, in part attributable to the increasing costs of compliance, and asked how much longer the bank can afford to remain independent without giving consideration to maximizing current shareholder value through a merger or sale. These conversations are likely occurring in community bank boardrooms all over the United States today.

An additional challenge bankers face is maintaining the capacity to respond to the steady stream of new regulations while continuing to comply with existing regulations. Some of the new regulations and reporting requirements facing the industry include those required by the FACT Act legislation enacted by Congress last year, USA PATRIOT Act, the Sarbanes-Oxley Act, and the Check 21 Act. These laws reflect important public policy choices concerning, for example, the quality of the credit reporting system, identity theft, national security and changes in technology. However, it is incumbent upon the regulators who write implementing regulations, as well as the Congress, to be mindful of the need to avoid unnecessarily increasing regulatory burdens on the industry as we implement new reporting requirements and regulations required by legislation.

It is not just the total volume of regulatory requirements that pose problems for banks, but also the relative distribution of regulatory burden across various industries that could hit community banks hard in the future. For example, community bankers are increasingly subject to more intense competition from credit unions, which have, in many

cases, evolved from small niche players to full-service retail depository institutions. In the past ten years, the number of credit unions with assets exceeding $1 billion has increased four-fold, from 20 institutions in 1994 to 87 institutions today and the credit union industry continues to grow nationwide. With ever-expanding fields of membership and banking products, credit unions are now competing head-to-head with banks and thrifts in many communities, yet the conditions under which this competition exists enable credit unions to operate with a number of advantages over banks and thrifts. These advantages include exemption from taxation, not being subject to the Community Reinvestment Act, and operation under a regulatory framework that has supported and encouraged the growth of the credit union movement, including broadening the "field of membership." These advantages make for an uneven playing field, a condition that Congress should reexamine and seek to resolve.

I am a strong proponent of market forces determining economic outcomes. If community banks lose out in a fair and square competition with competing institutions, so be it – let the market speak and the chips fall where they may. But if smaller banks are weakened in the market not by competition or technology, but inadvertently or unintentionally by the disproportionate effect of regulatory burden, that outcome seems to be inequitable and unfortunate. We need to be vigilant and careful to assure the appropriate public policy response to prevent this outcome.

As you can tell, I have some serious concerns about the future of community banking, and I see regulatory burden as an important factor in the equation for their future success. I personally believe the stakes are high for community bankers in this fight to

reduce regulatory burden, and the very future of community banking may well depend on the success of our efforts.

INTER-AGENCY EFFORT TO REDUCE REGULATORY BURDEN

In 1996, Congress passed the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). Section 2222 of EGRPRA requires the Federal Financial Institutions Examination Council (FFIEC) and each of its member agencies to review their regulations at least once every ten years, in an effort to eliminate any regulatory requirements that are outdated, unnecessary or unduly burdensome. Last year, FDIC Chairman Don Powell, as Chairman of the FFIEC, asked me to oversee this inter-agency effort. I accepted with enthusiasm.

From the beginning of this process, each of the agency principals— Chairman Powell, Comptroller Hawke, Director Gilleran, Governor Bies and former Chairman Dollar—have given their full support. We also have received enthusiastic cooperation and support from the Conference of State Bank Supervisors (CSBS) and the national and state trade associations in working towards regulatory burden relief. We established an inter-agency EGRPRA task force consisting of senior level staff from the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), and the FDIC. Under the EGRPRA statute, the agencies are required to categorize their regulations by type (such as "safety and soundness" or "consumer protection" rules) and then publish each category for public comment. The inter-agency task force divided the agencies' regulations into the following 12 categories (listed alphabetically):

- Applications and Reporting
- Banking Operations
- Capital
- Community Reinvestment Act
- Consumer Protection
- Directors, Officers and Employees
- International Operations
- Money Laundering
- Powers and Activities
- Rules of Procedure
- Safety and Soundness and
- Securities

The agencies agreed to put one or more categories out for public comment every six months, with 90-day comment periods, for the remainder of the review period (which ends in September, 2006). Spreading out comments over three years will provide sufficient time for the industry, consumer groups, the public and other interested parties to provide meaningful comments on our regulations, and for the agencies to carefully consider all recommendations.

The agencies published their first joint EGRPRA Federal Register notice on June 16, 2003, for a 90-day comment period, seeking comment on our overall regulatory review plan, including the way in which we categorized the regulations. The first notice also requested burden reduction recommendations on the initial three categories of regulations: Applications and Reporting; Powers and Activities; and International Operations. These three categories of regulations contained 48 separate regulations for comment. In response, the agencies received 19 written comments that included more than 150 recommendations for changes to our regulations. Each of the recommendations has been carefully reviewed and analyzed by the agency staffs. Based on the recommendations, staff will bring forward proposals to change specific regulations, as appropriate, which will be put out for public comment.

On January 20, 2004, the agencies issued their second joint request for comment under the EGRPRA program. This notice sought public comment on the lending-related consumer protection regulations, which include Truth-in-Lending (Regulation Z), Equal Credit Opportunity Act (ECOA), Home Mortgage Disclosure Act (HMDA), Fair Housing, Consumer Leasing, Flood Insurance and Unfair and Deceptive Acts and Practices. The comment period for that notice closed on April 20, 2004 and staff is currently analyzing the comment letters received to determine which recommendations to pursue. Even though the second Federal Register notice contained far fewer regulations for comment than the initial notice, the agencies received over 570 comment letters.

Banker, consumer and public insight into these issues is critical to the success of our effort. The regulatory agencies have tried to make it as easy as possible for all interested parties to get information about the EGRPRA project and to let us know what they think are the most critical regulatory burden issues. The EGRPRA website, which can be found at www.egrpra.gov, provides an overview of the EGRPRA review process, a description of the agencies' action plan, information about our banker and consumer outreach sessions and a summary of the top regulatory burden issues cited by bankers and consumer groups. There also are direct links to the actual text of each regulation and comments can be sent to the EGRPRA website. Comments submitted through the website are automatically transmitted to all of the financial institution regulatory agencies. Comments are then posted on the EGRPRA website for everyone to see. The website has proven to be a popular source for information about the project, with thousands of hits being reported every month.

While written comments are important to the agencies' efforts to reduce regulatory burden, we believe it is also important to have face-to-face meetings with bankers and consumer group representatives so that they have an opportunity to directly communicate their views on the issues of most concern to them.

Last year, the agencies sponsored five banker outreach meetings in different cities to heighten industry awareness of the EGRPRA project. The meetings provided an opportunity for the agencies to listen to bankers' regulatory burden concerns, hear comments and suggestions, and identify possible solutions. The outreach meetings were held over a six-month period in Orlando, St. Louis, Denver, San Francisco and New York. More than 250 bankers (mostly CEOs) as well as representatives from the national trade groups and a variety of state trade associations participated in the meetings with representatives from FDIC, FRB, OCC, OTS, CSBS and state regulatory agencies.

The banker outreach meetings were extremely useful and productive. Following panel discussions and a question and answer period, the meeting participants were broken into small discussion groups. Senior-level regulators served as moderators of the discussion groups and regulatory staff recorded bankers' concerns and their recommendations to reduce regulatory burden. Summaries of the issues raised were then posted on the EGRPRA website. Since the banker outreach meetings were so successful last year, we decided to hold at least three more meetings this year. The first one was on April 22 in Nashville, Tennessee and the second on June 9 in Seattle, Washington. Our third will be held on September 23 in Chicago, Illinois.

We held an outreach meeting for consumer and community groups on February 20, 2004, in Arlington, Virginia. About 24 representatives from various consumer and

community groups participated in the meeting along with representatives from the FDIC, FRB, OCC, OTS, NCUA and CSBS. The meeting provided a useful perspective on the effectiveness of many existing regulations. We plan to hold at least two more consumer and community group outreach meetings later this year, with one scheduled for June 24 in San Francisco and another tentatively planned for September 23 in Chicago.

THE "TOP 10" LIST OF BANKER CONCERNS

Based on the concerns expressed at our banker outreach meetings, we have identified a "Top 10" list of regulations bankers cite as being the most costly, burdensome or otherwise competitively detrimental. The FDIC and most bankers believe that the objectives of these laws are worthy. However, bankers have told us that these important goals can be achieved in a less burdensome manner. While this is not a scientifically selected survey of all bankers or issues, the most frequently mentioned regulations and the nature of their concerns are as follows:

Bank Secrecy Act (Currency Transaction Reports (CTRs), Suspicious Activity Reports (SARs)): Bankers are more than willing to do their part in the war on terrorism and recognize the importance of CTRs and SARs in the process. However, they would like the reporting process to be more effective and efficient. In addition, bankers say they receive no feedback on their efforts.

USA Patriot Act and Customer Identification Systems: Similarly, bankers recognize the importance of verifying the identities of their customers. However, bankers would like the CIP requirement of the USA PATRIOT Act to be more effective and efficient. Again, bankers have commented regarding lack of feedback on their efforts.

Limitations on Transfers and Withdrawals from Money Market Deposit Accounts (Regulation D): Bankers believe the statutory and regulatory limits on transfers and withdrawals from money market accounts are outdated and suggest easing or repealing the limits. They also suggest eliminating existing restrictions which prohibit the payment of interest on demand deposits.

Home Mortgage Disclosure Act (HMDA) and Regulation C: Some bankers assert that the costs of complying with data collection and reporting requirements is too high in relationship to the usefulness of the data. It also was suggested that the reporting thresholds for banks be raised so that banks with less than $50 or $100 million in assets would be exempt from the reporting requirements.

Community Reinvestment Act (CRA) Regulations: Some bankers would like to see the asset size threshold (currently $250 million) for the small bank CRA test raised to as much as $1 or $2 billion.

Privacy Act Notices: Bankers, particularly those that do not share customer information with third parties, stated that sending annual privacy notices to all customers is costly and often confusing to the consumer.

Truth in Lending (Regulation Z) and Real Estate Settlement Procedures Act (RESPA): A number of bankers complained about the volume and complexity of documents required for closing loans and asked the agencies to reconsider the required disclosures. They also suggested simplifying Annual Percentage Rate calculations.

Truth-in Lending and the Right of Rescission: Bankers reported that few, if any customers had ever exercised their right of rescission and thus customers should be permitted to waive their right. Alternatively, some suggested creating additional exemptions to this requirement.

Extensions of Credit to Insiders and Regulation O: Bankers reported that these lending restrictions often make it difficult to find directors willing to serve on bank boards.

Flood Insurance and the Flood Disaster Protection Act: Bankers strongly suggested that flood maps be kept up to date. Others felt that much of the cost of enforcing flood insurance requirements has shifted from the federal government to banks.

The list above includes some of the most frequently mentioned regulatory burden concerns expressed by bankers to us over the last year. The regulators are examining these concerns to determine whether suggested changes to our regulations and/or current laws may be appropriate at this time. This process will continue until the end of the EGRPRA review process in 2006.

RESPONSE BY REGULATORY AGENCIES

The EGRPRA regulatory review project is still in its early stages, with approximately two years until completion. However, I am pleased to report that the banking and thrift regulatory agencies have been working together closely and harmoniously on a number of projects to address unnecessary burdens. In addition to eliminating outdated and unnecessary regulations, the agencies have begun to identify more efficient ways of achieving important public policy goals of existing statutes. I think it is fair to say that although we have much work ahead of us, there has been significant progress to date. Here are some notable examples:

Privacy Notices

On December 30, 2003, the Federal bank, thrift and credit union regulatory agencies, in conjunction with the Federal Trade Commission, Securities and Exchange Commission, and the Commodity Futures Trading Commission, issued an Advanced Notice of Proposed Rulemaking (ANPR), seeking public comment on ways to improve the privacy notices required by the Gramm-Leach-Bliley Act. Although there are many issues raised in the ANPR, the heart of the document solicits comments on how the privacy notices could be improved to be more readable and useful to consumers, while reducing the burden on banks and other service providers required to distribute the notices. In response to the comments received, the agencies are planning consumer research and testing that will be used to develop privacy notices that meet these goals. As they do so, the agencies will continue to be mindful of the burden implications of changing the privacy notices and the requirements for their distribution.

Community Reinvestment Act Regulations

On February 6, 2004, the Federal bank and thrift regulatory agencies jointly issued a proposal to amend the Community Reinvestment Act (CRA) regulations. The joint proposal would, among other things, reduce regulatory burden by changing the definition of "small institution" to mean an institution with total assets of less than $500 million, without regard to holding company assets. This represents a significant increase in the small bank threshold from the current level of $250 million which was established in the 1995. Under the proposal, just over 1,100 additional banks (those with assets between $250 and $500 million) would be subject to the streamlined CRA examination process for small banks. This streamlined examination focuses primarily on local lending, which is the mainstay of community banks.

This proposal would not exempt these institutions from complying with CRA—all banks, regardless of size, will be required to be thoroughly evaluated within the business context in which they operate. As I indicated at the FDIC Board meeting when this proposal was approved for publication, I think this is a good first step for the agencies. Personally, I would have liked to see the agencies propose a higher threshold, perhaps $1 billion, since I do not think any bank under $1 billion in assets should be judged by the same standards as a bank with $100 billion or $1 trillion in assets. I recognize that there are many competing interests and that community groups, in particular, as well as many members of Congress generally oppose any increase at all in the threshold level. However, I think that this change to the regulation, if adopted as proposed, would result in significant regulatory burden reduction for a number of institutions without weakening the objectives of the Community Reinvestment Act. The comment period for this

proposal closed on April 6, and the agencies received approximately 1,000 comment letters that currently are being analyzed by staff. It is my hope the agencies will consider carefully all comments and agree on a final rule before the end of this year.

RESPA

In July, 2002, the Department of Housing and Urban Development (HUD) proposed a rule intended to improve the process for obtaining mortgages. Given the high level of concern expressed by the banking industry about the closing process, and the tremendous volume of paperwork that consumers have to deal with at real estate closings, I think it is incumbent upon the regulators to continue to play a role in the mortgage reform efforts. I agree with the basic goals of HUD's initiative, which are to: (1) enable people to know their options so they can shop intelligently; (2) clarify and simplify the required disclosures; and (3) provide some certainty that costs won't change before closing. The FDIC has provided some input into HUD's rulemaking process and will continue to provide whatever additional input may be necessary. I think it is important to assist in this effort to simplify and improve the closing process for consumers, while reducing unnecessary burden on the banking industry.

Bank Secrecy Act

There is no question that financial institutions and their regulators must be extremely vigilant in their efforts to implement the Bank Secrecy Act in order to thwart terrorist financing efforts and money-laundering. Last year, bankers filed over 12 million CTRs and SARs with the Financial Crimes Enforcement Network (FinCEN). Bankers reported that they believe they are filing millions of reports that are not utilized for any

law enforcement purpose and consequently a costly burden is being carried which is providing little benefit to anyone. In an effort to address this concern and enhance the effectiveness of these programs, the financial institution regulatory agencies are working together with FinCEN and various law enforcement agencies, through task forces of the Bank Secrecy Act Advisory Group, to find ways to streamline reporting requirements for CTRs and SARs and make the reports that are filed more useful for law enforcement.

I am convinced that we can find ways to make this system more effective for law enforcement, while at the same time making it more cost efficient and less burdensome for bankers. I recently met with FinCEN's new Director, William Fox, and pledged to work with him to make bank reporting under the Bank Secrecy Act more effective and efficient while still meeting the important crime-fighting objectives of anti-terrorism and anti-money-laundering laws.

USA PATRIOT Act and Customer Identification Requirements

Most bankers understand the vital importance of knowing their customers and thus generally do not object to taking the additional steps necessary to verify the identity of their customers. However, bankers wanted guidance from the regulators on how they could comply with this important law. In response, the federal financial institution regulators, the Treasury Department and FinCEN issued interpretive guidance to all financial institutions to assist them in developing a Customer Identification Program (CIP), which was mandated by the USA PATRIOT Act. The inter-agency guidance answered the most frequently asked questions about the requirements of the CIP rule.

FDIC EFFORTS TO RELIEVE REGULATORY BURDEN

In addition to the above-noted inter-agency efforts to reduce regulatory burden, the FDIC, under the leadership of Chairman Powell, is constantly looking for ways to improve our operations and reduce regulatory burden, without compromising safety and soundness or undermining important consumer protections. Over the last several years, we streamlined our examination processes and procedures with an eye toward better allocating FDIC resources to areas that could ultimately pose greater risks to the insurance funds – such as problem banks, large financial institutions, high-risk lending, internal controls and fraud. Some of our recent initiatives to reduce regulatory burden can be summarized as follows:

1) Raised the threshold for well-rated, well-capitalized banks to qualify for streamlined safety and soundness examinations from $250 million to $1 billion so that the FDIC's resources are better focused on managing risk to the insurance funds;

2) Implemented more risk-focused compliance and trust examinations, placing greater emphasis on an institution's administration of its compliance and fiduciary responsibilities and less on transaction testing;

3) Increased the efficiency of the Information Technology (IT) examination procedures and streamlined IT examinations for institutions that pose the least technology risk;

4) Worked with CSBS and the Federal Reserve to develop, through a Nationwide State/Federal Supervisory Agreement, a closely coordinated supervisory system for banks that operate across state lines;

5) Initiated electronic filing of branch applications and began exploring alternatives for further streamlining the deposit insurance application process in connection with new charters and mergers;

6) Simplified the deposit insurance coverage rules for living trust accounts so that the rules are easier to understand and administer;

7) Reviewed existing Financial Institution Letters and other directives to eliminate outdated or unnecessary documents (also developing a more user-

friendly, web-based system for finding communications from the Corporation);

8) Provided greater resources to bank directors, including the establishment of a "Director's Corner" on the FDIC website, as a one-stop site for Directors to obtain useful and practical information to in fulfilling their responsibilities, and the sponsorship of many "Director's Colleges" around the country;

9) Made it easier for banks to assist low and moderate income individuals, and obtain CRA credit for doing so, by developing *Money Smart*, a financial literacy curriculum and providing the *Money Smart Program* free-of-charge to all insured institutions;

10) Implemented an interagency charter and federal deposit insurance application that eliminates duplicative information requests by consolidating into one uniform document, the different reporting requirements of the three regulatory agencies (FDIC, OCC and OTS);

11) Revised our internal delegations of authority to push more decision making out to the field level to expedite decision making and provide institutions with their final Reports of Examination on an expedited basis; and

12) Provided bankers with a customized version of the FDIC Electronic Deposit Insurance Estimator (EDIE), a CD-Rom and downloadable version of the web-based EDIE, which allows bankers easier access to information to help determine the extent to which a customer's funds are insured by the FDIC.

The FDIC is aware that regulatory burden does not emanate only from statutes and regulations, but often comes from internal processes and procedures. Therefore, we continually strive to improve the way we conduct our affairs, always looking for more efficient and effective ways to meet our responsibilities.

LEGISLATION TO REDUCE REGULATORY BURDEN

Mr. Chairman, I wish to commend you and your colleagues on your efforts to develop legislation removing unnecessary regulatory burden on the banking industry. Since most of our regulations are, in fact, mandated by statute, I believe that it is critical that the agencies work hard not only on the regulatory front, but also on the legislative

front, to alert Congress to unnecessary regulatory burden. For that reason, I was gratified to see the House address some of the burden issues and pass H.R. 1375, the Financial Services Regulatory Relief Act. H.R. 1375 contains a number of significant regulatory relief provisions that could reduce regulatory burden. The bill also includes several provisions requested by the regulators, including the FDIC, to help us do our job better. As my testimony indicates, the FDIC staff has been working closely with their colleagues at the FRB, OCC and the OTS over the last several months, in an effort to identify additional legislative proposals to reduce regulatory burden on the industry. As you know, EGRPRA requires the agencies to collect comments from the public on ways to reduce regulatory burden and report their suggestions to the Congress. While we will submit a more formal report as required by EGRPRA, I would like to report to you some of the suggestions we have heard so far. I personally believe these proposals deserve careful review and ultimately consideration by Congress. Some of the bankers' key suggestions are discussed in detail below.

Eliminating Unnecessary Reports From Directors and Officers with Respect to Extensions of Credit (Regulation O)

The Federal bank and thrift regulatory agencies believe that it is no longer necessary for directors and officers to file the following three reports that are currently required to be filed under section 22(g) of the Federal Reserve Act (12 USC 375a) and section 106(b)(2) of the Bank Holding Company Amendments of 1970 (12 USC 1972(2)):

1) a report filed by a bank executive officer with the bank's board of directors whenever the executive officer obtains a loan from another bank in an amount that exceeds the amount the executive officer could obtain from his or her own bank;
2) a report required from banks regarding any loans the bank has made to its executive officers since its previous call report; and
3) an annual report from a bank's executive officers and principal shareholders to the board of directors of any outstanding loans from a correspondent bank.

The information contained in these reports is already collected through the normal examination and supervision programs of the regulatory agencies and through quarterly Call Reports. Therefore, the regulatory agencies believe that the preparation and submission of these reports is not necessary and imposes costs and unnecessary burden on the banks and the individuals required to prepare and file the reports.

Streamlining the Application Process

The Federal bank and thrift regulatory agencies believe that the application process and procedures for certain types of bank mergers can be significantly streamlined, without jeopardizing safety and soundness or weakening important consumer rights, by making the following legislative changes:

1. Amend section 18(c) of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. § 1828(c)), also known as the Bank Merger Act (BMA), to exempt applications for merger transactions between depository institutions and their wholly owned subsidiaries, or with wholly owned subsidiaries of the depository institution's holding company, from a competitive factors review by the Department of Justice and other agency review processes as well as from post-approval waiting periods.

Presently, the BMA requires, among other things, the prior written approval of the appropriate federal banking agency whenever an insured depository institution proposes a merger transaction with any other insured depository institution, or with any noninsured institution, whether or not the institutions are affiliated. Before acting on any merger transaction application (other than one involving a probable failure or an emergency case), the agency must request a competitive factors report from the Attorney General and from each of the other three federal banking agencies and allow 30 days for them to respond. In the case of an emergency, the time period for response is 10 days. In the case of a probable failure, no such request is necessary.

Finally, the BMA provides that the merger transaction (other than a probable failure or emergency case), may not be consummated before the 30th day after approval or, if the Attorney General concurs, the 15th day after approval. In the case of a probable failure, the merger transaction may be consummated upon approval. In the case of an emergency, the merger transaction may be consummated on the 5th day after approval. The post-approval waiting period is generally designed to give the Attorney General an opportunity to file suit to block the merger transaction, if the Attorney General determines that the merger transaction is anticompetitive.

The proposed change would only apply to mergers between an insured depository institution and one or more of its affiliates. It is generally accepted that such mergers do not present any competitive issues. This legislative proposal

would shorten the timeframe for the approval and consummation of corporate reorganizations and by doing so create savings for the applicant without raising safety and soundness issues.

2. Shorten the post-approval waiting time on mergers where there are no adverse effects on competition – This proposal would amend section 11(b) of the BHCA (12 U.S.C. § 1849(b)) and section 18(c)(6) of the FDIA (12 U.S.C. § 1828(c)(6)) to shorten the current 15-day minimum post-approval waiting period for certain bank acquisitions and mergers when the appropriate federal banking agency and the U.S. Attorney General agree that merging with or acquiring another bank or bank holding company would not result in significantly adverse effects on competition to a 5-day period.

Under current law, the post-approval waiting period is generally 30 days. This 30-day period may be shortened to 15 days upon agreement of the appropriate banking agency and the Attorney General. This proposal would give the banking agency and the Attorney General the flexibility to further shorten the post-approval waiting period. The Attorney General would continue to be required to consider the competitive factors involved in each merger transaction. The institutions involved in mergers or acquisitions would benefit from the streamlining of the application review process that reduces bank waiting time and associated costs by allowing faster consummation of a merger where there are no adverse affects on competition or consumers.

3. Eliminate competitive factors report from the other three federal banking agencies – This proposal would amend paragraph (4) of section 18(c) of the FDIA (12 U.S.C. § 1828(c)) to streamline application requirements by eliminating the requirement that each federal banking agency must request a competitive factors report from the other three federal banking agencies as well as from the Attorney General.

The Attorney General would continue to be required to consider the competitive factors involved in each merger transaction. The FDIC, as insurer, would receive a copy of the responsible agency's request to the Attorney General when the FDIC is not the responsible agency for the particular merger, thereby giving the FDIC notice of the transaction. The proposal shortens the timeframe for approval and consummation of transactions and so would decrease regulatory burden associated with the application process.

4. Eliminate the requirement for prior written consent to establish branches by well-managed, well-capitalized, highly-rated institutions – While the regulators have not reached agreement, one additional proposal that we are looking at would amend section 18(d)(1) of the FDIA (12 U.S.C. § 1828(d)(1)) to eliminate the requirement for prior written consent to establish branches by well-managed, well-capitalized, highly-rated institutions. The institutions would need to have at least a satisfactory CRA rating and the agencies are exploring ways to

preserve consumers' ability to raise any CRA concerns in connection with these transactions.

Instead of the requirement for prior written consent, this proposal would require after-the-fact notice. Such a notice procedure should permit well-run banks to establish branches more efficiently without the delay and substantial paperwork associated with an application. This amendment would not affect the requirement for prior approval for the establishment of interstate de novo branches under section 18(d)(4) of the FDIA (12 U.S.C. § 1824(d)(4).

I should note also that the Office of Thrift Supervision has recommended adding a new section 5(d)(3)(B) to the Home Owners' Loan Act (12 U.S.C. 1464(d)(3)) (HOLA) to give federal thrifts authority to merge with one or more of their nondepository institution affiliates. This authority would be equivalent to the authority national banks have pursuant to section 6 of the National Bank Consolidation and Merger Act (12 U.S.C. § 215a-3), which was added by section 1206 of the Financial Regulatory Relief and Economic Efficiency Act of 2000 (Pub. L. No. 106-569, 114 Stat. 2944, 3034). Section 18(c) of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. § 1828(c)), also known as the Bank Merger Act, will continue to apply and the new authority does not give thrifts the power to engage in new activities.

Under current law, a federal thrift may only merge with another depository institution. This proposal reduces regulatory burdens on thrifts by permitting mergers with nondepository affiliates, where appropriate for sound business reasons and if otherwise permitted by law. This amendment reduces regulatory burden by permitting a thrift that wishes to acquire the business of an affiliate to do so without undertaking a costly series of transactions, such as merging the affiliate into a subsidiary and liquidating the subsidiary into the thrift.

Elimination of Annual Privacy Notice Requirement for Institutions That Do Not Share Personal Information

As noted above, an ANPR was issued at the end of last year seeking public comment on ways to improve the privacy notices required by the Gramm-Leach-Bliley Act (GLBA). In addition to our efforts to improve the content of the notice, the banks have urged that the law be changed to relax the requirement for banks to send annual privacy notices to all of their customers if, in fact, they do not share information with third parties or their affiliates subject to the "opt-out" right under either the GLBA or the Fair Credit Reporting Act. For example, after providing the initial privacy notice, an institution would only provide subsequent notices when its privacy policy actually changes in some material way, rather than requiring that notices be provided on an annual basis.

Waiver of the Three-Day Right of Rescission

The Truth in Lending Act provides consumers with a significant right that gives them three days to re-think the consequences of pledging their home as collateral on certain loans. There is no question that this is a valuable right that must be preserved.

However, bankers note that consumers are often perplexed and sometimes disturbed by the fact that the Federal government limits their access to borrowed funds for three days following loan closing. Bankers have described that consumer dissatisfaction is particularly acute when they are paying interest on their new loan without access to the funds. Although banks can allow consumers to waive their right of rescission, bankers believe the waiver criteria are very restrictive and narrow.

This is a sensitive area. There is no question about that. There need to be ways to address the issues we have heard about while still protecting consumer rights. There are several possibilities to explore and we are open to exploring them with consumers and the industry. For example, perhaps we should look at expanding the waiver criteria to allow a consumer to voluntarily choose not to be protected by the right of rescission. Another possibility is to provide the closing documents three days prior to closing and incorporate the right of rescission into this three-day period, much like the Federal Reserve Board and Department of Housing and Urban Development proposed to Congress in 1998.

Increased Flexibility of the Flood Insurance Law

Bankers have suggested several changes in the law to increase the flexibility of regulators and lenders to implement flood insurance program requirements and provide the federal financial regulatory agencies with discretion to impose civil money penalties in findings of patterns or practices of violations of flood insurance requirements. Specifically, the suggestions would address the situation where the official flood maps are more than ten years old; increase the "small loan" exception (currently $5,000) and allow adjustments for inflation on a regular basis; and amend the forced-placement rules to allow lenders to force-place flood insurance within 30 days (instead of the current 45 days) of notifying the borrower.

Other banker suggestions include removing the requirement of mandatory Civil Monetary Penalties (CMPs) when federal regulators discover a pattern and practice of certain violations of the National Flood Insurance Program (NFIP). In accordance with each agency's authority to impose CMPs pursuant to its own implementing act, the regulators can tailor their actions more closely to individual cases. The bankers' argue these proposals would reduce burden by increasing the speed with which flood map information may be obtained when maps are out of date, lowering risk when forced placement of insurance is necessary, adjusting for inflation periodically the threshold for loans covered by the NFIP, and replacing mandatory penalties with penalties crafted to match the violation.

Repeal of the CRA Sunshine Law

The agencies have heard from both bankers and consumer groups that paperwork requirements of the CRA Sunshine law are burdensome. The sunshine provisions are found in section 48 of the FDIA (12 U.S.C. § 1831y), enacted by section 711 of the Gramm-Leach-Bliley Act. One way to address these burdens would be to recommend repealing the law. However, the ramifications would need to be carefully studied before advocating repeal. Under current law, depository institutions, nongovernmental entities, and other parties to agreements providing for cash payments, grants, or other consideration with a value in excess of $10,000 or for loans exceeding $50,000 annually made pursuant to or in connection with, the fulfillment of the Community Reinvestment Act of 1977 must make a report of all such covered agreements annually to the appropriate Federal banking agency. Removing the annual reporting requirement would reduce regulatory burden on depository institutions, nongovernmental entities (i.e., consumer groups) and other parties to covered agreements, as well as the Federal banking agencies. There are no safety and soundness concerns about the repeal of this law.

The above-noted legislative proposals are just some of the ideas I am pursuing on an inter-agency basis to reduce unnecessary burdens on the banking industry without diluting important consumer protections and I hope to pursue many others over the course of the EGRPRA regulatory review process. I very much look forward to working with the Committee on developing a comprehensive legislative package that provides real regulatory relief for the industry. I am certain that this hearing will provide valuable input for the comprehensive package.

CONCLUSION

Mr. Chairman, as I mentioned at the outset, the EGRPRA effort is committed to addressing the problem of regulatory burden for every insured financial institution. Bankers, large and small, labor under the cumulative impact of regulations. However, I believe that if we do not do something to stem the tide of ever increasing regulation, a vital part of the banking system will disappear from many of the communities that need

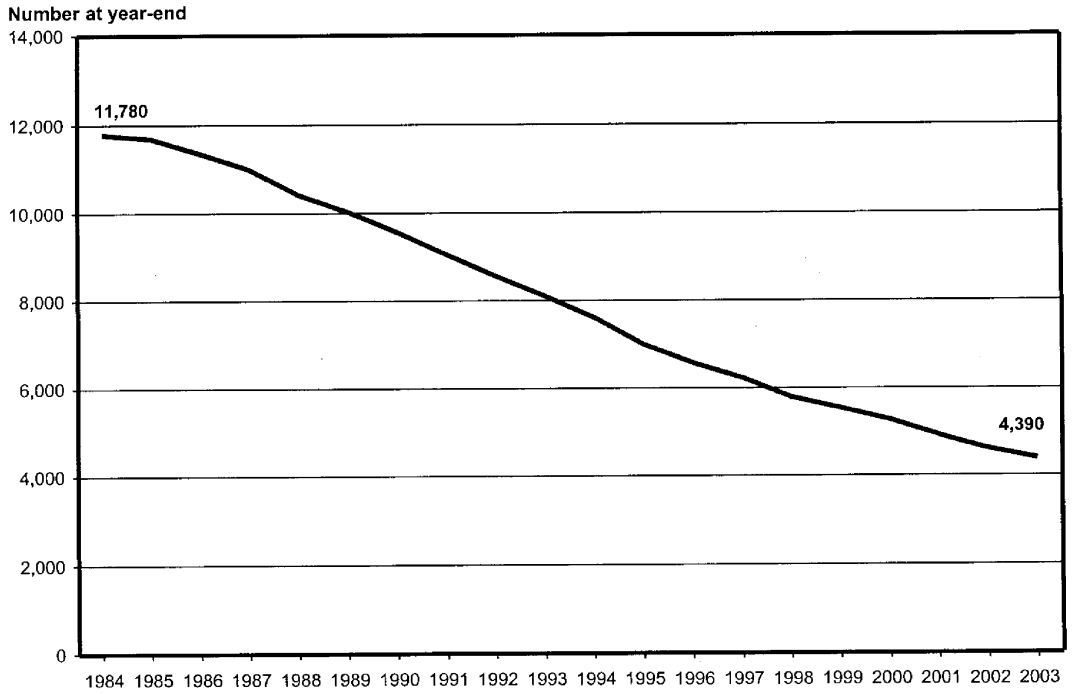
them the most. That is why I think it is incumbent upon all of us – Congress, regulators, industry and consumer groups – to work together to eliminate any outdated, unnecessary or unduly burdensome regulations. I am personally committed to accomplishing that objective.

I am confident that, if we all work together, we can find ways to regulate that are both more effective and less burdensome, without jeopardizing the safety and soundness of the industry or weakening important consumer protections.

Thank you for providing me with this opportunity to testify.

Chart 1

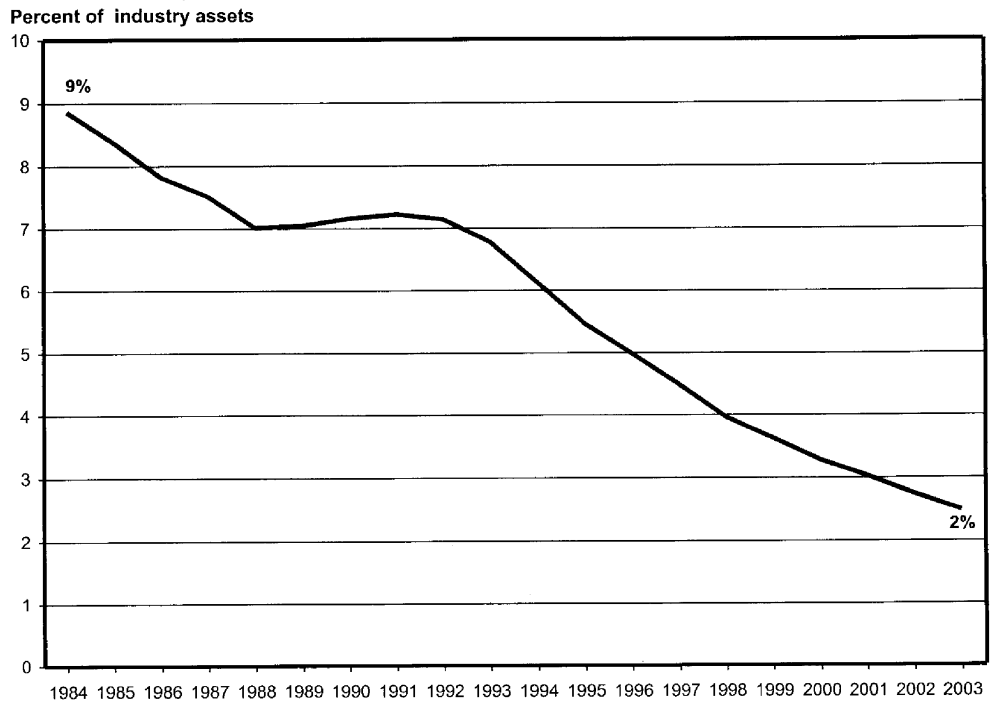
THE NUMBER OF COMMUNITY BANKS HAS BEEN DECLINING
FDIC-Insured Commercial Banks & Savings Institutions with Assets < $100 Million*



*Based on 2003 Dollars; $100MM in 2003 = $63.6MM in 1984.

Chart 2

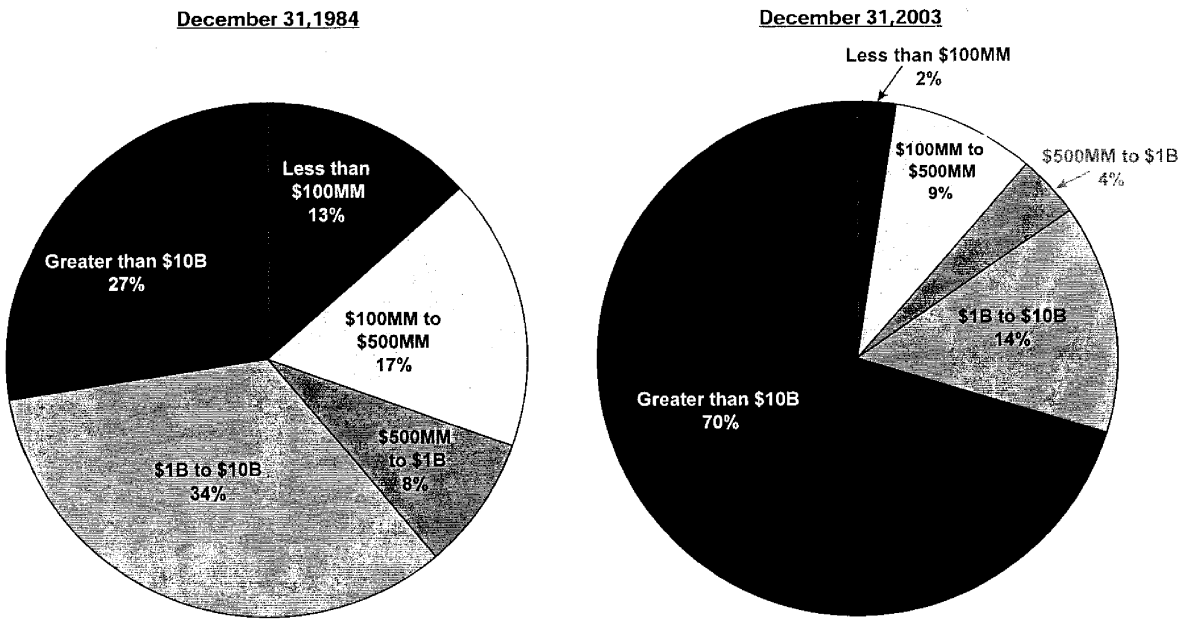
COMMUNITY BANKS' SHARE OF INDUSTRY ASSETS CONTINUES TO FALL
FDIC-Insured Commercial Banks & Savings Institutions With Assets < $100 Million*



*Based on 2003 Dollars; $100MM in 2003 = $63.6MM in 1984.

Chart 3

Change in Shares of Industry Assets
FDIC-Insured Commercial Banks and Savings Institutions



Asset sizes are not adjusted for inflation.

Chart 4

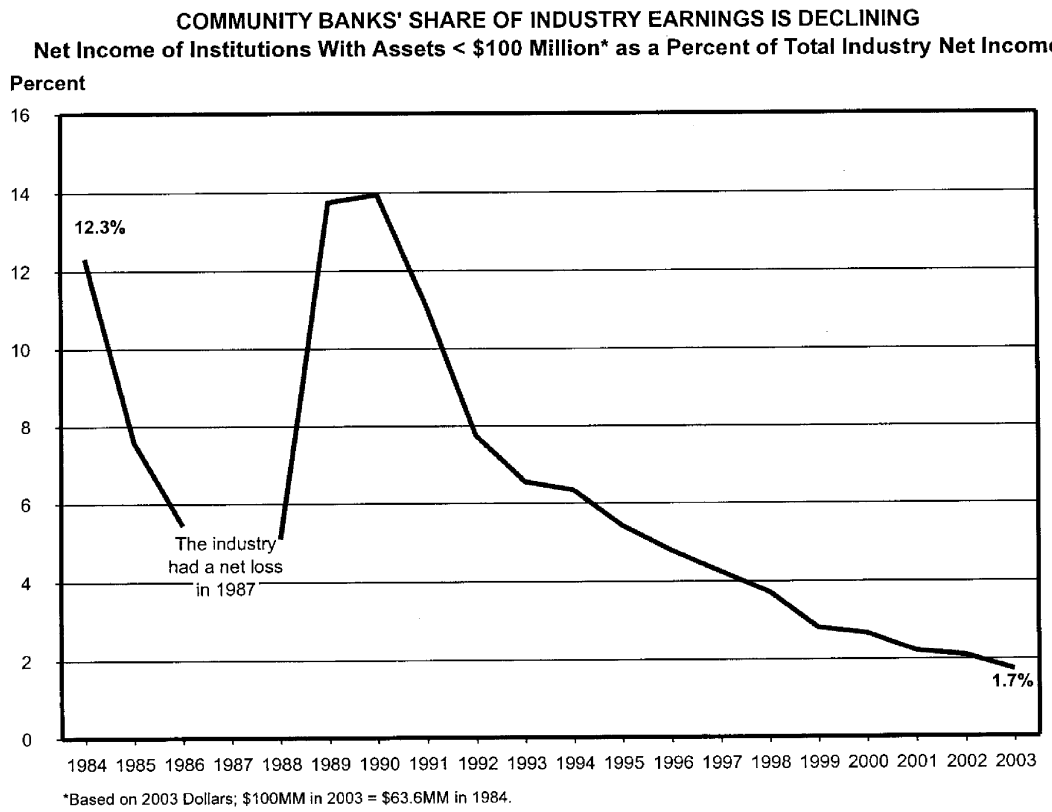
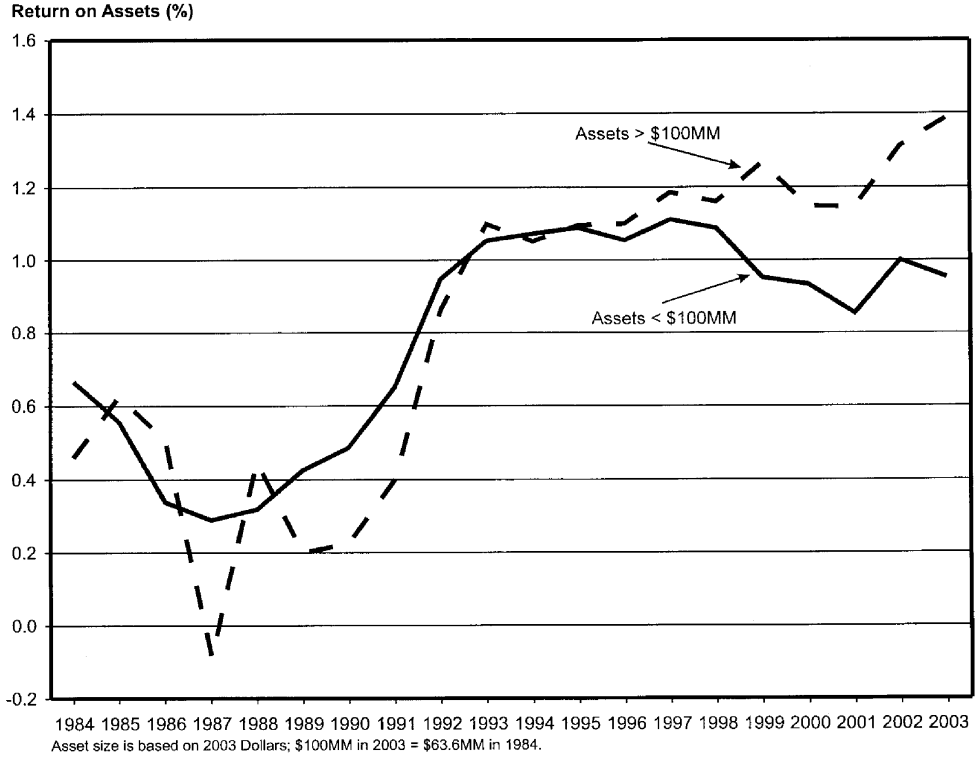

COMMUNITY BANKS' SHARE OF INDUSTRY EARNINGS IS DECLINING
Net Income of Institutions With Assets < $100 Million* as a Percent of Total Industry Net Income
Percent
16
14
12
10
8
6
4
2
0
12.3%
The industry had a net loss in 1987
1.7%
1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003
*Based on 2003 Dollars; $100MM in 2003 = $63.6MM in 1984.

Chart 5

LARGE INSTITUTIONS HAVE BECOME MORE PROFITABLE THAN COMMUNITY BANKS
All FDIC-Insured Commercial Banks and Savings Institutions, 1984 - 2003

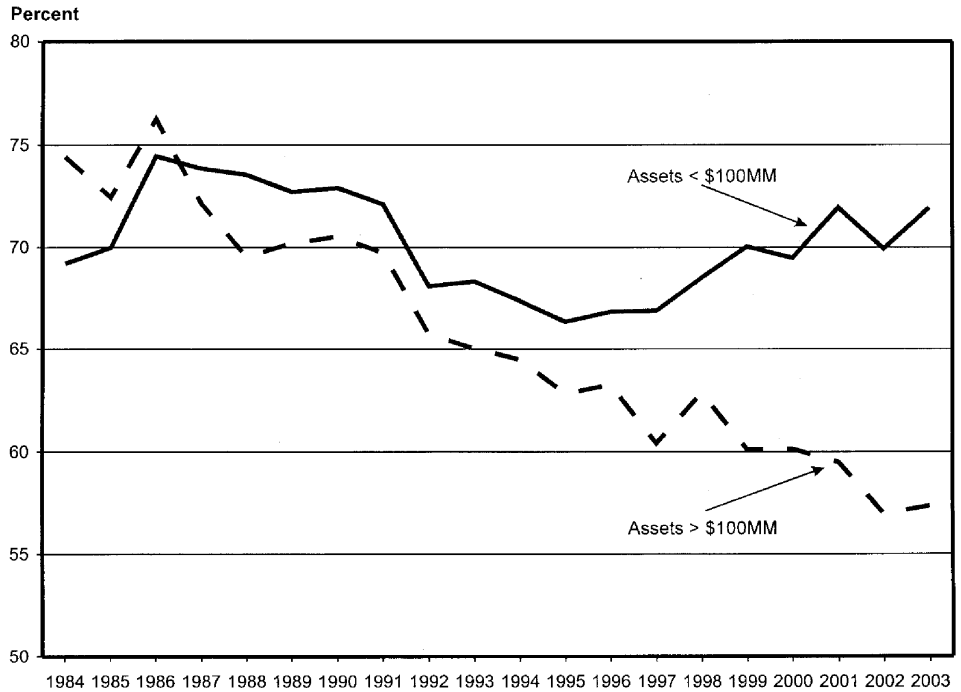


Asset size is based on 2003 Dollars; $100MM in 2003 = $63.6MM in 1984.

Chart 6

OVERHEAD COSTS ABSORB A GROWING SHARE OF COMMUNITY BANKS' REVENUES

Noninterest Expense as a Percent of Net Operating Revenue*



* Net operating revenue = net interest income + total noninterest income.
Asset size is based on 2003 Dollars; $100MM in 2003 = $63.6MM in 1984.

STATEMENT

OF

THE HONORABLE JOANN JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"CONSIDERATION OF REGULATORY REFORM PROPOSALS"

BEFORE THE

COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 22, 2004

Chairman Shelby, Senator Sarbanes, and Members of the Committee: thank you for inviting me to appear on this panel today. On behalf of the National Credit Union Administration (NCUA) I am pleased to provide our agency's views on regulatory efficiency recommendations. Many of the recommendations I will address today have been previously provided to you by NCUA in 2003 and 2004. I will also suggest other items for your consideration today, report to you what we are doing through our own annual review of regulations, and comment on progress NCUA is making under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA).

Effective regulation, not excessive regulation is our guiding principle.

NCUA ANNUAL REVIEW OF REGULATIONS AND EGRPRA

NCUA is participating with the other four federal financial institution regulatory agencies in the review project mandated by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). We will soon be publishing our third request for public comment on ways in which we might improve or eliminate regulations that are burdensome or unnecessary. NCUA is carefully coordinating with the other agencies. However, because of the unique nature of credit unions and their differences from other financial institutions, NCUA is publishing separate notices.

We are also coordinating the EGRPRA effort with our own internal regulatory review process. Annually, we scrutinize one-third of our entire body of existing regulations to find ways to simplify or improve any regulation that is outdated or in need of revision. This internal process, which NCUA has had in place for a number of years, has brought about important regulatory reform for credit unions, including complete overhaul and modernization of NCUA's rules on lending, share accounts and incidental powers.

We expect that both EGRPRA and our internal review will continue to further a critical and strategic initiative of reducing or eliminating unduly burdensome regulation on the credit union system, and that the EGRPRA effort will result in additional recommendations for legislative reform as we work to complete the EGRPRA review by the 2006 statutory deadline.

LEGISLATIVE RECOMMENDATIONS

The legislative proposals I am presenting are consistent with the mission of credit unions and the principles of safety and soundness. One is time sensitive, some address regulatory efficiency and modernization, others are in the public interest and the technical corrections are clerical. All should benefit credit union members and have a positive effect for credit unions on the cost of doing business and complying with regulations and the Federal Credit Union Act.

I hope to gain your support for these recommendations and I would be pleased to assist your further deliberations on these in any way I can. I don't believe any of these should be considered controversial.

Accounting Treatment of Net Worth in Credit Union Mergers

A time-sensitive recommendation involves an expected Financial Accounting Standards Board (FASB) decision coming later this year with a January 2006 effective date. This is a recent development, therefore, it is not included in current legislation under consideration in Congress. The issue arises from the interface between the statutory definition of "net worth" in the Federal Credit Union Act and the accounting treatment of net worth in credit union mergers. This issue is important separate and apart from the question of converting to a system of risk-weighted net worth requirements addressed elsewhere in NCUA's testimony.

The Credit Union Membership Access Act of 1998 established a statutory system of capital standards and prompt corrective action (PCA) for federally insured institutions. Capital, or the term "net worth" for credit unions, is defined as being limited to their retained earnings as determined in accordance with generally accepted accounting principles (GAAP). In the context of credit union mergers, where the "pooling method" of accounting has traditionally been used, the retained earnings of the two credit unions are pooled and the sum of these retained earnings become the net worth of the combined credit union. This is a logical result that facilitates the ability of credit unions to merge when it is in the best interests of their members.

A proposed change to the accounting standards for credit union mergers that FASB expects to implement as early as January 1, 2006, will dramatically alter this treatment of retained earnings and net worth in a manner that will make it difficult or impossible for many credit unions to consider combining their strengths through merger. Specifically, FASB's proposed change to accounting rules will require, in a merger, that the retained earnings of one credit union be carried over as "acquired equity" rather than retained earnings. Thus, only the retained earnings of the remaining credit union will count as net worth after the merger. This seriously reduces the post-merger net worth ratio, because that ratio is the retained earnings stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has strongly adverse implications under the statutory PCA scheme, and it is this result that will strongly discourage voluntary mergers and, on occasion, make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF).

The solution, which has been reviewed by FASB, is to redefine net worth for PCA purposes as equity, rather than just retained earnings. NCUA has suggested

statutory language, as well as report language, clarifying the very limited purpose of this amendment, and they are attached for the Committee's consideration.

Prompt Corrective Action: Risk-Based Net Worth

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This principle is consistent with our fiduciary responsibility to the insurance fund. However, the current statutory net worth structure establishes a system based largely on net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA's ability to incorporate behavioral incentives related to higher risk activities.

The Committee heard the consensus among all the financial regulators at the April 20th hearing on the "Condition of the Banking and Credit Union Industries" about the value of an accurate risk-based capital system for different types of financial institutions. On April 21, 2004, NCUA sent a letter to Senator Crapo and all members of this Committee that included a recommendation for risk-basing PCA for federally insured institutions.

Legislation introduced in the House of Representatives in November 2003, H.R. 3579, the Credit Union Regulatory Improvements Act of 2003" (CURIA), has begun the deliberations over how such a risk-based system could be applied to federally insured credit unions.

Section 301 of CURIA would address these inequities by establishing a risk-based system for PCA. NCUA strongly supports such a risk-weighted system. A well-designed risk-based system would alleviate regulatory concerns by not penalizing low risk activities and by providing credit union management with the ability to manage their compliance through adjustments to their assets and activities. A PCA system that is risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

Since first advocating the idea of an entirely risk-based PCA system, NCUA has envisioned a system similar to that currently employed in the banking system where assets are weighted by risk. However the Basel accords do not appropriately apply to credit unions as not-for-profit financial cooperatives that can only build net worth through retained earnings. In addition, unlike the current bank PCA system, which is intended only to address credit risk, we believe a risk-based credit union PCA system should be designed to address all relevant and material risks.

While NCUA supports a statutorily mandated PCA system, the system should contain a statutory definition of net worth with NCUA provided the ability through regulation to exclude certain accounts as necessary from what qualifies as net

worth. The system should also establish a minimum core leverage requirement (net worth in relation to total assets) set by statute both for critically undercapitalized and adequately capitalized classifications, and statutory thresholds based on risk-assets defined by the NCUA Board for all of the net worth classifications. For the remaining elements of the risk-based PCA system, NCUA should be provided with the authority to set these by regulation to ensure the system remains relevant and up-to-date with emerging trends in credit unions and the marketplace.

Check Cashing, Wire Transfer and Other Money Transfer Services

The Federal Credit Union Act authorizes federal credit unions to provide check cashing and money transfer services to members (12 USC 1757(12)). To reach the "unbanked," federal credit unions should be authorized to provide these services to anyone eligible to become a member. This is particularly important to federal credit unions in furthering their efforts to serve those of limited income or means in their field of membership. These individuals, in many instances, do not have mainstream financial services available to them and are often forced to pay excessive fees for check cashing, wire transfer and other services. Allowing federal credit unions to provide these limited services to anyone in their field of membership would provide a lower-fee alternative for these individuals and encourage them to trust conventional financial organizations.

The Twelve-Year Maturity Limit on Loans

Federal credit unions are authorized to make loans to members, to other credit unions and to credit union organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a twelve-year maturity limit that is subject to only limited exceptions (12 USC 175(5)). This maturity limit should be eliminated. It is outdated and unnecessarily restricts federal credit union lending authority. Federal credit unions should be able to make loans for second homes, recreational vehicles and other purposes in accordance with conventional maturities that are commonly accepted in the market today. It is our view that NCUA should retain the rulemaking authority to establish any maturity limits necessary for safety and soundness.

Increase One Percent Investment Limit in CUSOs to Three Percent

The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than one percent of its shares and undivided earnings in these organizations (12 USC 1757(7)(I)). These organizations, commonly known as credit union service

organizations or "CUSOs," provide important services. Examples are data processing and check clearing for credit unions, as well as services such as estate planning and financial planning for credit union members. When these services are provided through a CUSO, any financial risks are isolated from the credit union, yet the credit unions that invest in the CUSO retain control over the quality of services offered and the prices paid by the credit unions or their members. The one percent aggregate investment limit is unrealistically low and forces credit unions to either bring services in-house, thus potentially increasing risk to the credit union and the NCUSIF, or turn to outside providers and lose control. The one percent limit should be eliminated and the NCUA Board should be allowed to set a limit by regulation. NCUA is comfortable with increasing the CUSO investment limit from 1 percent to 3 percent.

Expanded Investment Options

The Federal Credit Union Act limits the investment authority of federal credit unions to loans, government securities, deposits in other financial institutions and certain other very limited investments (12 USC 1757(7)). This limited investment authority restricts the ability of federal credit unions to remain competitive in the rapidly changing financial marketplace. The Act should be amended to provide such additional investment authority as approved by regulation of the NCUA Board. This would enable the Board to approve additional safe and sound investments of a conservative nature which have a proven track record with state chartered credit unions or other financial institutions. Section 303 of H.R. 1375, as passed by the House of Representatives, appropriately addresses the issues NCUA has presented in our recommendation, limits additional investment to corporate debt securities (as opposed to equity) and further establishes specific percentage limitations and investment grade standards.

Voluntary Merger Authority

The Federal Credit Union Act, as amended by the Credit Union Membership Access Act, allows voluntary mergers of healthy federal credit unions, but requires that NCUA consider a spin-off of any group of over 3,000 members in the merging credit union (12 USC 1759(d)(2)(B)(i)). When two healthy federal credit unions wish to merge, and thus combine their financial strength and service to their members, they should be allowed to do so. There is no reason to require in connection with such mergers that groups over 3,000, or any group for that matter, be required to spin off and form a separate credit union. A spin-off would most likely undermine financial services to the affected group and may create safety and soundness concerns. These groups are already included in a credit union in accordance with the statutory standards, and that status should be unaffected by a voluntary merger.

Regulatory Relief from SEC Registration Requirements

NCUA is seeking a provision to provide regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker-dealers when engaging in certain de minimus securities activities.

The Gramm Leach Bliley Act, enacted in 1999, created exemptions from the broker-dealer registration requirements of the Securities and Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisers Act of 1940. The principle established by these exemptions is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate.

Section 313 of HR 1375, and an identical provision in CURIA, would provide similar exemptions for federally insured credit unions. NCUA supports these exemptions. Because of significant differences between broker-dealer capital requirements and depository institution capital requirements, it is virtually impossible for depository institutions, including credit unions, to register as a broker-dealer and submit to broker-dealer requirements. Without an exemption credit unions may find that although they are authorized under their chartering statutes to engage in particular securities-related activities, their inability to register as a broker-dealer would keep them from engaging in these activities.

Recently, the Securities and Exchange Commission proposed a rule that would exempt credit unions from the definition of broker and dealer for a few of the activities exempted for banks under Gramm Leach Bliley, including third party brokerage arrangements and sweep account arrangements. NCUA supports the SEC proposal. We believe, however, that the SEC's proposal does not go far enough, and we continue to support legislative relief.

The relief sought for credit unions would be more limited in scope and application than that which is available to banks and requested by thrifts. Credit union powers are limited by their chartering statutes, and credit unions do not have certain powers, such as general trust powers, that are available to banks and thrifts. The requested parity relief for credit unions would apply only to those activities otherwise authorized for credit unions under applicable credit union chartering statutes, currently including third-party brokerage arrangements, sweep accounts, and certain safekeeping and custody activities.

Authority to Examine Credit Union Vendors

Unlike the other federal financial institution regulators, NCUA does not have direct authority to examine third party vendors that provide data processing and other related services to insured credit unions. Statutory authority did previously exist for NCUA, but under a sunset provision that expired in 2001. We are

currently required to work through credit unions to obtain vendor information or seek voluntary cooperation from vendors. We do not have direct examination authority nor related powers to enforce full disclosure and cooperation in a case where that might become necessary.

We believe that in these times, when privacy, money laundering and financing of terrorism are issues of such paramount national interest, as well as safety and soundness concerns, NCUA should have direct examination, but not regulatory, authority over those vendors providing services to federally insured credit unions. Direct examination authority would provide NCUA parity with other financial regulators with respect to examinations and would eliminate the need for us to approach the matter indirectly through credit unions, thus providing some measure of regulatory relief.

I should also note that the Government Accounting Office (GAO), in its October 2003 report on credit unions stated:

> To improve oversight of third-party vendors, Congress may wish to consider granting NCUA legislative authority to examine third-party vendors that provide services to credit unions and are not examined through FFIEC. (GAO-04-91)

Attached for the Committee's consideration are suggested legislative and report language to accomplish this recommendation.

Updating NCUA Authority to Address Qualified Financial Contracts

Qualified financial contracts, or "QFCs," are certain types of derivatives contracts. Since 1989, the Federal Deposit Insurance Act and the Federal Credit Union Act have had parallel provisions governing how the FDIC and NCUA should handle QFCs in the event of the failure of an insured bank or credit union that holds QFCs. These statutory QFC provisions help protect the stability of the derivatives market by ensuring that a receiver or liquidator does not "cherry-pick" among derivatives at a failed institution: that is, that the receiver or liquidator cannot damage a QFC counterparty by unfairly repudiating some QFCs while affirming others.

NCUA supports legislation to update the Federal Credit Union Act's 1989 QFC provisions and ensure that these federal credit union Act provisions mirror the parallel Federal Deposit Insurance Act provisions. Title IX of H.R. 975 the Bankruptcy Abuse and Consumer Protection Act of 2003, as passed by the U.S. House of Representatives, includes the needed changes as does H.R. 2120, now ready to proceed to the floor of the House.

Specifically, the amendments expand and clarify the types of derivatives that must be treated as QFCs, clarify a QFC counterparty's rights to net QFCs, and clarify NCUA's rights, as liquidator, to transfer QFCs to third parties.

These amendments are consistent with the recommendations of the other financial regulatory agencies for dealing with derivatives, as expressed by the President's Working Group on Financial Markets.

Additional Credit Union Provisions

I would also like to take this opportunity to comment on credit union provisions not originating from NCUA, but included in H.R. 1375 as passed by the House of Representatives, and referred to this committee.

NCUA has reviewed all of the additional credit union provisions included in H.R. 1375 and the agency has no safety and soundness concerns with these provisions. Among these are provisions which address leases of land on Federal facilities for credit unions (Section 302); member business loans for non-profit religious organizations (Section 306); criteria for continued membership of certain member groups in community charter conversions (Section 309); credit union governance changes (Section 310); and revising the economic factors the NCUA Board must use when considering adjustments to the statutory 15% interest rate that can be charged by federal credit unions on loans (Section 311). Again, though we recognize these issues as statutory in nature and therefore a public policy decision only the Congress can make, we have carefully examined each and have determined that these provisions present no safety and soundness concerns for the credit unions we regulate and/or insure. Also, Section 312 of H.R. 1375 was added by the Committee on the Judiciary and provides for an exemption from pre-merger notification requirements of the Clayton Act. We have likewise reviewed this provision, and have no objections and actually see benefit from a safety and soundness perspective.

Privately Insured Credit Unions and Federal Home Loan Bank Membership

It is important to recognize that NCUA is neither the regulator nor the insurer of state-chartered credit unions whose deposits are not insured by the National Credit Union Share Insurance Fund.

NCUA has no official position on the public policy issue related to privately insured state-chartered credit unions being eligible to join the Federal Home Loan Bank System. However, we find ourselves uncomfortable with changes to Section 301 in HR 1375, as it passed the U.S. House of Representatives.

Our concerns stem from language added to the basic provision which makes it appear that oversight responsibility for non-federally insured credit unions and certain state regulated private share insurance companies rests with NCUA. NCUA has no legal authority and no regulatory or supervisory jurisdiction over

these non-federally insured credit unions or commercial insurance companies (nor do we seek it). In our view, the language requiring private insurance providers to submit copies of their annual audit reports to NCUA should be removed to avoid potential consumer confusion and misunderstanding. Likewise, we believe that the consultation language which seeks to bring the federal regulatory authority into a role that appropriately rests with state credit union and insurance regulators should also be removed. In its passage of the Federal Deposit Insurance Corporation Improvement Act in 1991 (FDICIA), Congress designated the Federal Trade Commission as the agency responsible for oversight of private deposit insurance companies and the protection of consumers through appropriate disclosure provisions. As the matter remains one of consumer awareness, disclosure and notification -- and not of federal credit union regulation -- NCUA feels strongly that the Federal Trade Commission should retain this oversight responsibility. The additional language which could be interpreted to infer an NCUA role that is neither appropriate nor statutorily authorized to provide oversight to either state-chartered privately insured credit unions or a private insurance company regulated by an agency designated by state statute should be removed from Section 301.

Technical Corrections to the Federal Credit Union Act

NCUA has also submitted a list of technical corrections that we hope can be included in legislation in the near future.

Conclusion

As we implement regulatory reforms through our own annual review of regulations, through the EGRPRA process or through any legislative improvements the Congress ultimately chooses to enact, effective regulation, not excessive regulation, should be the basis of fulfilling our mission and ensuring the safety and soundness of our nation's credit unions.

Thank you.

ADDENDUM TO CHAIRMAN JOHNSON'S TESTIMONY

Proposed Language to the Federal Credit Union Act Regarding Mergers and Net Worth

Proposed technical correction to Section 216 of the Federal Credit Union Act (12 USC 1790d(o)(2)(A)):

(2) **Net Worth**.---The term 'net worth'--

(A) with respect to any insured credit union, means equity as determined under generally accepted accounting principles and as authorized by the Board; and

(B) with respect to a low income credit union, includes secondary capital accounts that are---

(i) uninsured; and
(ii) subordinate to all other claims against the credit union, including claims of creditors, shareholders, and the Fund.

Draft Report Language

This amendment to Section 216 of the Federal Credit Union Act (FCU Act) (12 USC 1790d(o)(2)(A)) redefines the term "net worth" for PCA purposes by replacing the phrase "retained earnings balance" with the phrase "equity" and by inserting the phrase "and as authorized by the Board" (i.e., NCUA Board) where indicated. The amendment is necessary to cure the unintended consequence of business combination accounting rules the Financial Accounting Standards Board (FASB) is intending to apply to the combinations of mutual enterprises (e.g., credit unions).[1]

[1] In June 2001, the FASB adopted Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations*, requiring the acquisition method for business combinations and effectively eliminating the pooling method. The pooling method has typically been used by credit unions to account for credit union mergers. The standards became effective for combinations initiated after June 30, 2001. Paragraph 60 of the standard deferred the effective date for mutual enterprises (i.e., credit unions) until the FASB could develop purchase method procedures for those combinations. In the interim, credit unions have continued to account for mergers as poolings (simple combination of financial statement components).

When FASB lifts the paragraph 60 deferral of the acquisition method that credit unions have enjoyed, this will eliminate the practice of accounting for mergers as a pooling of interests. The acquisition method would require the valuation of the target credit union at fair value; the recognition of identifiable intangibles (e.g., core deposit intangibles and/or goodwill), when relevant; and the application of a market-based acquisition model to a non-bargained transaction. The FASB intends to expose a statement for public comment in the 2nd quarter of 2004 and to finalize the standard in the 2005 with an effective date in early 2006.

Currently, under the FCU Act, a credit union's capital is measured based on the retained earnings balance as determined under GAAP. The FASB is preparing to revise GAAP in relation to the combination of mutual enterprises (i.e., credit unions) with the effective result that the interplay between the capital definition in the FCU Act and FASB's new rules will create a disincentive to otherwise desirable credit union mergers. Additionally, the change will make it more difficult for the NCUA to carry out its responsibilities to protect the public interest in managing and minimizing losses to the National Credit Union Share Insurance Fund (NCUSIF) through the merger option. The FASB has expressed support for a legislative solution and has indicated that a legislative redefinition of capital (net worth) will not affect their standards-setting activities. The remedy needed is an expanded definition of capital in the FCU Act in advance of the FASB rule effective date (expected January 2006) to mitigate this unintended result. Banks and their insurers do not have the same concerns because their existing capital definition under relevant law is broader.

This amendment is intended to address a narrow and technical accounting issue and in the process remove the unintended disincentive to credit union mergers that FASB's imminent action will create.

The "as authorized by the Board language" has the limited effect of allowing the Board comparable authority as federal banking regulators to exclude items within the capital structure that do not have value to the insurance fund in a liquidation scenario, e.g., core deposit intangibles, goodwill, etc., thus not "overvaluing" resulting post-merger capital. The "as authorized" language does not provide the Board any other authority to either limit the definition of net worth or alter the PCA net worth categories. The authority would be exercised only after due deliberation and public comment through a federal register notice and rulemaking process.

Unlike FDIC-insured financial institutions, credit unions are permitted by law to count as capital only their "retained earnings" as determined under GAAP. The law excludes all other equity components. Federally-insured credit unions are required to comply with a Congressionally-mandated system of minimum regulatory capital standards known as "prompt corrective action." 12 U.S.C.§1790d. A credit union's "net worth ratio" determines its classification among five statutory net worth categories. The lower the category, the more supervisory actions the credit union must comply with and implement. The denominator of the net ratio is the balance of a credit union's total assets. The numerator of the ratio is narrowly limited by law to the "retained earnings" component of equity. 12 U.S.C.§1790d(o)(2)(A). In contrast, the numerator of an FDIC-insured financial institution's equivalent "leverage ratio" may include virtually all GAAP equity components.

Under FASB's expected approach, however, a combination between credit unions would cause the acquiring credit union's capital ratio to *decline* in most cases. Potential acquiring credit unions would naturally find the prospect of being demoted to a lower net worth category, and potentially subject to more supervisory actions, too high a price to pay to merge with another credit union. In contrast, the expected approach would not inflict this problem on acquiring banks and thrifts because they are allowed to include virtually all components of equity in their capital.

The adverse impact on an acquirer's post-merger capital level will be a disincentive to otherwise desirable credit union mergers. In turn, it will be much more difficult for NCUA to carry out its responsibility to protect the public interest. Fewer potential merger partners will come forward to rescue a troubled credit union when they realize that the reward for doing so is a reduction in post-merger capital. This also will undermine the purpose of "prompt corrective action" which is to resolve the problems of credit unions while minimizing losses to the NCUSIF. Fewer willing merger partners mean fewer opportunities to avert losses to the NCUSIF by merging a troubled credit union. Credit union mergers have traditionally been effective in accomplishing both objectives while preserving the continuity of credit union service to the target credit union's members. We have no doubt that Congress neither intended nor expected to discourage mergers when it adopted GAAP retained earnings as the definition of credit union capital.

Proposed Amendment to the Federal Credit Union Act Regarding Vendor Examinations.

The Federal Credit Union Act, (12 U.S.C. §1752 et seq.) is amended by deleting existing Section 206A, 12 U.S.C. §1786a, and adding the following new section:

§1786a

Examination of credit union service providers -

(a) If an insured credit union causes to be performed for itself, by contract or otherwise, any service that provides information systems support, technology services, data processing services, loan services or other services related to the credit union's operations (as those terms are defined by the Board, by regulation) such service shall be subject to examination by the Board to the same extent as if such services were being performed by the insured credit union itself on its own premises.

(b) Administration by the Board – The Board may issue such regulations and orders as may be necessary to enable it to carry out examinations under this Section.

Draft Report Language on Authority to Examine Credit Union Vendors

Unlike the other federal financial institution regulators, NCUA does not have direct authority to examine third party vendors that provide data processing and other services to federally insured credit unions. This statutory authority did previously exist for NCUA, but under a sunset provision that expired in 2001. Indeed, the authority that expired in 2001 allowed NCUA to examine and regulate all third-party service providers, and was thus broader than the authority now being provided to NCUA.

As of December 2003 approximately 25% of all federally insured credit unions contract with outside vendors to perform many of their automated back room accounting processes. Another 70% use vendor supplied software and data processing programs that rely upon vendor servicing and maintenance to function effectively. These services may include such things as electronic money transfers, check clearance, transactional internet services, and varying levels of internal controls to assist credit unions in identifying and reporting suspicious activity. Other third-party vendors provide processing and support services in areas such as loan processing and overdraft protection.

This heavy and increasing reliance on vendors by credit unions for many critical functions makes it essential for NCUA to have the authority to examine and evaluate vendor operations. The General Accounting Office in October 2003 recommended that Congress consider giving NCUA the authority to examine third-party vendors. NCUA's ability to timely identify weaknesses and require their correction is critical to our ability to assure credit unions operate in a safe and sound manner.

For Release Upon Delivery
9:30 a.m., June 22, 2004

TESTIMONY OF

JULIE L. WILLIAMS

FIRST SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

June 22, 2004

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee,

I appreciate this opportunity to appear before you to discuss the challenge of reducing unnecessary regulatory burden on America's banking system. The Office of the Comptroller of the Currency (OCC) welcomes the opportunity to discuss this challenge and to offer suggestions for reforms, including some suggestions particularly affecting the national banking system. We also want to express appreciation to Senator Crapo for his commitment and dedication to this issue.

Imposition of unnecessary regulatory burdens is not simply an issue of bank costs. When unnecessary regulatory burdens drive up the cost of doing business for banks, bank customers feel the impact in the form of higher prices and, in some cases, diminished product choice. Unnecessary regulatory burden also can become an issue of competitive viability, particularly for our nation's community banks, where bankers face competitors that offer comparable products and services but are not subject to comparable regulatory requirements.

This is a challenge that we must confront on several levels. First, at the level of bank regulation, when regulators adopt regulations, and as we review the regulations we already have on the books, we have a responsibility to ensure that regulations are effective to protect safety and soundness, foster the integrity of bank operations, and safeguard the interests of consumers. We also have a responsibility to regulate efficiently, so that we do not impose regulatory burdens that are unnecessary to achieve those goals, and which then

act as a drag on banks' efficiency and competitiveness. In the first portion of my testimony, I summarize initiatives the OCC has undertaken in the past decade, and the efforts in which we are currently involved on an interagency basis, to review and revise regulations to reduce unnecessary regulatory burdens stemming from our rules.

Second, there are regulatory burden reduction initiatives that must come from Congress in the form of federal legislation – adding provisions to law to provide new flexibilities, modifying requirements to be less burdensome, and in some cases, eliminating certain requirements currently in the law altogether. This hearing today is a crucial stage in that process, and we and the other witnesses you will hear from have a number of suggestions to offer. My testimony will highlight several of the OCC's priority recommendations, and an Appendix to my testimony contains a more extensive set of suggestions.

Finally, it is important to recognize that many of the areas that are often identified as prospects for regulatory burden reduction involve requirements put in place by Congress for the protection of consumers. Over the years, those requirements have accreted, and in the disclosure area, in particular, consumers receive disclosures so voluminous and so technical that many simply don't read them – or when they do, don't understand them. At some point as we continue our efforts to address regulatory burdens, we are going to run out of discrete fixes to make, and face more fundamental questions about basic approaches. If we were to undertake that task, and do it responsibly, we need much better data on the costs resulting from particular regulatory requirements, and the benefits of those requirements – particularly relative to other approaches that might be used to achieve

Congress' goals – than we have now. I would urge the Committee to consider what sort of information and analysis would need to be assembled as a foundation for such an undertaking.

REGULATORY INITIATIVES TO ADDRESS REGULATORY BURDEN

The OCC constantly reviews its regulations to identify opportunities to streamline regulations or regulatory processes, while still ensuring that the goals of protecting safety and soundness, ensuring the integrity of bank operations, and safeguarding the interests of consumers are met. In the mid-1990's, pursuant to our "Regulation Review" project, we went through every regulation in our rulebook with that goal in mind. We have since conducted several supplemental reviews focused on particular areas where we thought further improvements could be made.

With respect to regulatory processes, the OCC recently adopted a final rule that allows national banks to file licensing applications electronically, utilizing the agency's new electronic filing system, called e-Corp. This ruling materially reduces the paperwork burden on national banks and achieves greater efficiency in the OCC's regulatory processes.

The OCC, together with the banking agencies, the FTC, SEC and CFTC also have undertaken an effort to simplify the privacy notices to consumers required under the Gramm-Leach-Bliley Act (GLBA). The agencies asked for comments on whether to

consider amending their privacy regulations to allow, or require, financial institutions to provide alternative types of privacy notices, such as a short-form privacy notice, that would be more consumer friendly and easier for consumers to understand and banks to implement. The agencies also asked commenters to provide sample privacy notices that they believe work well for consumers, and to provide the results of any consumer testing that has been conducted in this area. We also will be conducting a series of focus groups with consumers to find out – from them – what sort of information they find most meaningful, and the most effective way to disclose it to them. This project has the potential to be a win-win for consumers and financial institutions – more effective and meaningful disclosures for consumers, and reduced burden on institutions to produce and distribute privacy notices.

We are also active participants and supporters of the regulatory burden reduction initiative being led by Vice Chairman Reich of the Federal Deposit Insurance Corporation (FDIC). Under Vice Chairman Reich's capable and dedicated leadership, the Federal banking agencies currently are conducting the 10-year regulatory review required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). Section 2222 requires the Federal Financial Institutions Examination Council and each Federal banking agency to conduct a review of all regulations every 10 years to identify outdated, unnecessary regulatory requirements. The current review period ends in September, 2006.

As part of the EGRPRA process, the banking agencies have broken out their regulations

into twelve categories. The agencies have agreed to ask for public comments every six months on the regulations in one or more of these categories throughout the review period. To date, the agencies have issued two joint notices for public comment and are about to put out a third. Each of the comments received is being carefully reviewed and will be considered in formulating the agencies' recommendations for specific regulatory changes that also will be published for public comment.

Moreover, in addition to soliciting written comments, the Federal banking agencies, in conjunction with the Conference of State Bank Supervisors and state regulatory agencies, held five banker outreach meetings last year in different cities so that the regulators could hear first-hand the bankers' concerns and suggestions to reduce burden.[1] These meetings were so well attended and successful that at least three more are being held this year. In addition, we held a consumer and community groups outreach meeting earlier this year in the Washington, D.C. area and we have tentative plans to hold two more meetings in other locations.

The agencies are making every effort to ensure that there is ample opportunity for consumers and the industry to participate in this process. I would like to thank Vice Chairman Reich for his work on this important project and his efforts to make sure that our review is as comprehensive and encompassing of as many different viewpoints as possible.

Moreover, as you know, section 2222 of EGRPRA recognizes that some of the changes

[1] During the EGRPRA outreach sessions held by the interagency working group, some bankers also identified the requirements under the current privacy regulations as a significant burden.

suggested by the public comments may require legislative changes and cannot be appropriately addressed through a regulatory amendment. Thus, the banking agencies have been discussing jointly recommending certain legislative changes to reduce burden that have been raised by commenters as part of the EGRPRA process and we welcome the opportunity to make further suggestions.

OCC SUPPORT FOR REGULATORY BURDEN RELIEF LEGISLATION

The results that Congress can achieve by removing or reducing regulatory burden imposed by Federal statutes can be broader and more far-reaching than regulatory changes that we can make under the current law. My testimony will highlight some of the important items that the OCC believes will reduce regulatory burden on our banking system and will benefit consumers. We have highlighted other changes that the OCC believes will significantly enhance safety and soundness. These and other suggestions are discussed in more detail in an appendix to my testimony.[2]

NATIONAL BANKS

Repealing State Opt-In Requirements for *De Novo* Branching. As both national and state banks seek to establish branch facilities to enhance service to customers, a change that would reduce burden would be to repeal the state opt-in requirement that applies to banks

[2] Many of the suggested changes that we discuss are included in H.R. 1375, the Financial Services Regulatory Relief Act of 2004, as passed by the House on March 18, 2004. However, we also are recommending some new amendments that were not part of the House-passed bill and have identified these new provisions in the appendix.

that choose to expand interstate by establishing branches *de novo*. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. Under the time frames in the statute, interstate bank mergers are now permissible in all 50 states. *De novo* branching, however, is permissible only in those approximately 17 states that have affirmatively opted-in to allow the establishment of new branches in the state. In many cases in order to serve customers in multi-state metropolitan areas or regional markets, banks must, under current law, structure artificial and unnecessarily expensive transactions in order to establish a new branch across a state border. Enactment of this recommended amendment would relieve these unnecessary and costly burdens on the industry.

Providing Relief for Subchapter S National Banks. Another priority item supported by the OCC is an amendment that would allow directors of national banks that are organized as Subchapter S corporations to purchase subordinated debt instead of capital stock to satisfy the directors' qualifying shares requirements in national banking law. As a result, the directors purchasing such debt would not be counted as shareholders for purposes of the 75-shareholder limit that applies to Subchapter S corporations. This relief would make it possible for more community banks with national bank charters to organize in Subchapter S form while still requiring that such national bank directors retain their personal stake in the financial soundness of these banks.

Simplifying Dividend Calculations for National Banks. Under current law, the formula for calculating the amount that a national bank may pay in dividends is both complex and antiquated and unnecessary for purposes of safety and soundness. The amendment supported by the OCC would make it easier for national banks to perform this calculation, while retaining safeguards in the current law that provide that national banks (and state member banks)[3] need the approval of the Comptroller (or the FRB in the case of state member banks) to pay a dividend that exceeds the current year's net income combined with any retained net income for the preceding two years. The amendment would ensure that the OCC (and the FRB for state member banks) would continue to have the opportunity to deny any dividend request that may deplete the net income of a bank that may be moving towards troubled condition. Other safeguards, such as Prompt Corrective Action, which prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 U.S.C. § 1831o(d)(1)) would remain in place.

Resolving Ambiguities About Federal Court Diversity Jurisdiction. Also among our priority items is an amendment that would provide a single-state citizenship rule for national banks and other Federally chartered depository institutions for purposes of determining Federal court diversity jurisdiction. Under this uniform rule, a Federally chartered depository institution, *i.e.,* a national bank or a Federal savings association, would be a citizen only of the state in which it has its main office. Our suggested amendment would apply comparable treatment to national banks and Federal thrifts. Both

[3] See 12 U.S.C. 324 and 12 C.F.R. 208.5 generally applying the national bank dividend approval requirements to state member banks.

national banks and Federal thrifts are Federally chartered and neither is incorporated under the laws of any state. Providing more certainty on this issue would reduce burden and costs on national banks and Federal thrifts.

Modernizing Corporate Governance. The OCC also supports an amendment that would eliminate a requirement in current law that precludes a national bank from prescribing, in its articles of association, the method for election of directors that best suits its business goals and needs. Unlike most other companies and state banks, national banks cannot choose whether or not to permit cumulative voting in the election of their directors. Instead, current law requires a national bank to permit its shareholders to vote their shares cumulatively. Providing a national bank with the authority to decide for itself whether to permit cumulative voting in its articles of association would conform the National Bank Act to modern corporate codes and provide a national bank with the same corporate flexibility available to most corporations and state banks.

Modernizing Corporate Structure Options. Another amendment that is strongly supported by the OCC is an amendment to national banking law clarifying that the OCC may permit a national bank to organize in any business form, in addition to a "body corporate." An example of an alternative form of organization that may be permissible would be a limited liability national association, comparable to a limited liability company. The provision also would clarify that the OCC by regulation may provide the organizational characteristics of a national bank operating in an alternative form, consistent with safety and soundness. Except as provided by these organizational characteristics, all

national banks, notwithstanding their form of organization, would have the same rights and privileges and be subject to the same restrictions and enforcement authority.

Such an amendment would allow a national bank to choose the business form that is most consistent with the banks' business plans and would, thus, improve the efficiency of a national bank's operations. For example, if the OCC should permit a national bank to organize as a limited liability national association, this may be a particularly attractive option for community banks. The bank may then be able to take advantage of the pass-through tax treatment for comparable entities organized as limited liability companies (LLCs) under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends. Some states currently permit state banks to be organized as unincorporated LLCs and the FDIC adopted a rule allowing certain state bank LLCs to qualify for Federal deposit insurance. This amendment would clarify that the OCC can permit national banks to organize in an alternative business form, such as an LLC, in the same manner.

Paying Interest on Demand Deposits. The OCC supports amendments to the banking laws to repeal the statutory prohibition that prevents banks from paying interest on demand deposits. The prohibition on paying interest on demand deposits was enacted approximately 70 years ago for the purpose of deterring large banks from attracting deposits away from community banks. The rationale for this provision is no longer true today and financial product innovations, such as sweep services, allow banks and their customers to avoid the statutory restrictions. Repealing this prohibition would reduce

burden on consumers, including small businesses, and reduce costs associated with establishing such additional accounts to avoid the restrictions.

FEDERAL BRANCHES AND AGENCIES OF FOREIGN BANKS

The OCC also licenses and supervises Federal branches and agencies of foreign banks. Federal branches and agencies generally are subject to the same rights and privileges, as well as the same duties, restrictions, penalties, liabilities, conditions and limitations and laws that apply to national banks. Thus, Federal branches and agencies will benefit equally from legislation that would reduce burden on national banks. Branches and agencies of foreign banks, however, also are subject to other requirements under the International Banking Act of 1978 (IBA) that are unique to their organizational structure and operations in the U.S. as an office of a foreign bank. In this regard, the OCC is recommending amendments to reduce certain unnecessary burdens on Federal branches and agencies while preserving national treatment with national banks.

Implementing Risk-Based Requirements for Federal Branches and Agencies. A priority item for the OCC is an amendment to the International Banking Act of 1978 (IBA) to allow the OCC to set the capital equivalency deposit (CED) for Federal branches and agencies to reflect their risk profile. We support an amendment that would allow the OCC, after consultation with the Federal Financial Institutions Examination Council, to adopt regulations setting the CED on a risk-based institution-by-institution basis. This approach would closely resemble the risk-based capital framework that applies to both national and state banks.

AGENCY OPERATIONS

Improving Ability to Obtain Information from Regulated Entities. Another item that we recommend be adopted is an amendment that would permit all of the Federal banking agencies -- the OCC, FDIC, OTS, and the Federal Reserve Board -- to establish and use advisory committees in the same manner. Under current law, only the Board is exempt from the disclosure requirements under the Federal Advisory Committee Act (FACA). The OCC, FDIC, and OTS, however, also supervise insured depository institutions and these institutions and their regulators have the same need to share information and to be able to conduct open and frank discussions about important supervisory and policy issues without fear of information being withheld because it must be publicly disclosed. Because of the potentially sensitive nature of this type of information, the public meeting and disclosure requirements under FACA could inhibit the supervised institutions from providing the OCC, FDIC, or OTS with their candid views. Our amendment would enhance the free exchange of information between all depository institutions and their Federal bank regulators with resulting safety and soundness benefits.

SAFETY AND SOUNDNESS

The OCC also supports a number of amendments that would promote and maintain the safety and soundness and facilitate the ability of regulators to address and resolve problem situations.

banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution (institution-affiliated parties (IAP)). To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a Federal banking agency to take action against the accountant for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This standard is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. The OCC supports removing the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other IAPs.

Strengthening the Supervision of Stripped-Charter Institutions. The OCC supports an amendment to the CBCA to address issues that have arisen for the banking regulators when a stripped-charter institution (*i.e.,* an insured bank that has no ongoing business operations because, for example, all of the business operations have been transferred to another institution) is the subject of a change-in-control notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a *de novo* charter and an application for deposit insurance even though the risks presented by the two transactions may be substantively identical. In general, the scope of review of a *de novo* charter application or deposit insurance application is more comprehensive than the statutory

grounds for denial of a notice under the CBCA. There also are significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the Federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. To address these concerns, the OCC supports an amendment that (1) would expand the criteria in the CBCA that allow a Federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider business plan information, and (2) would allow the agency to use that information in determining whether to disapprove the notice.

CONCLUSION

Mr. Chairman, on behalf of the OCC, I thank you for your leadership in holding these hearings. As I have indicated, the OCC supports initiatives that will reduce unnecessary burden on the industry in a responsible manner. We believe that the changes outlined in my testimony today will further these objectives. We would be pleased to work with you and your staff on these issues.

We thank you for this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

APPENDIX

SUMMARY OF THE REGULATORY BURDEN RELIEF LEGISLATION SUPPORTED BY THE OFFICE OF THE COMPTROLLER OF THE CURRENCY

NATIONAL BANKS

Repealing State Opt-In Requirements for *De Novo* Branching. The OCC supports amending section 5155(g) of the Revised Statutes of the United States (12 U.S.C. § 36(g)), section 18(d)(4) of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. § 1828(d)(4)), section 9 of the Federal Reserve Act (FRA) (12 U.S.C. § 321), and section 3(d)(1) of the Bank Holding Company Act (BHCA) (12 U.S.C. § 1842(d)(1)) to ease certain restrictions on banks' interstate banking and branching. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act), an out-of-state national or state bank may establish a de novo branch in a state only if that state has adopted legislation affirmatively "opting in" to de novo branching. This amendment would repeal the requirement that a state expressly must adopt an "opt-in" statute to permit the de novo branching form of interstate expansion. The amendment also would repeal the state age requirement for interstate mergers. The Riegle-Neal Act permits a state to prohibit an out-of-state bank or bank holding company from acquiring an in-state bank unless the state bank has been in existence for a minimum period of time (which may be as long as five years).

Under the Riegle-Neal Act, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. While two states "opted out" at the time, interstate bank mergers are now permissible in all 50 states. By contrast, de novo branching by banks requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. This requires banks in many cases to structure artificial and unnecessarily expensive transactions in order for a bank to simply establish a new branch across a state border. However, Federal thrifts are not similarly restricted and generally may branch interstate without the state law "opt-in" requirements that are imposed on banks. Also, repeal of the state age requirement would remove a limitation on bank acquisitions by out-of-state banking organizations that is no longer necessary if interstate de novo branching is permitted.

Enactment of this amendment should enhance competition in banking services with resulting benefits for bank customers. Moreover, it will ease burdens on banks that are planning interstate expansion through branches and would give banks greater flexibility in formulating their business plans and in making choices about the form of their interstate operations.

Providing Relief for Subchapter S National Banks. The OCC supports amending section 5146 of the Revised Statutes of the United States (12 U.S.C. § 72) to provide more

flexible requirements regarding director qualifying shares for national banks operating, or seeking to operate, as Subchapter S corporations. The National Banking Act currently requires all directors of a national bank to own "shares of the capital stock" of the bank having an aggregate par value of at least $1,000, or an equivalent interest, as determined by the Comptroller, in a bank holding company that controls the bank. This amendment would permit the Comptroller to allow the use of a debt instrument that is subordinated to the interests of depositors, the Federal Deposit Insurance Corporation (FDIC), and other general creditors to satisfy the qualifying shares requirement for directors of national banks seeking to operate in Subchapter S status.

The requirement in current law creates difficulties for some national banks that operate in Subchapter S form. It effectively requires that all directors be shareholders, thus making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for the benefit of Subchapter S tax treatment, which avoids double tax on the bank's earnings. Such a subordinated debt instrument would have features resembling an equity interest, since the directors could only be repaid if all other claims of depositors and nondeposit creditors of the bank were first paid in full, including the FDIC's claims, if any. It would thus ensure that directors retain their personal stake in the financial soundness of the bank. However, the holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S.

Resolving Ambiguities in Federal Court Jurisdiction. The OCC supports amending chapter three of title LXII of the Revised Statutes of the United States (12 U.S.C. § 81, *et seq.*) to provide that, in determining whether a Federal court has diversity jurisdiction over a case in which a national bank is a party, a national bank is considered to be a citizen only of the state in which the bank has its main office. Other versions of this proposal have provided the single-state rule only for Federal savings associations. The OCC supports expanding these versions to include national banks, as well as Federal thrifts. National banks, like Federal thrifts, are chartered by the Federal Government and not by any state. As a result, national banks also have been subject to differing court rulings on their citizenship status for purposes of diversity jurisdiction. There is no reason to have this unique, special citizenship rule only for Federally chartered thrift institutions. It makes sense to treat all Federally chartered depository institutions the same and end the confusion.

National banks' diversity jurisdiction is governed by 28 U.S.C. § 1348. This statute provides that generally national banks are "citizens" of the states in which they are "located." The term "located" is not defined in § 1348 and the Federal courts have not defined the term consistently. For example, in 2001, a U.S. Circuit Court concluded that a national bank is "located" in and a citizen of the state of its principal place of business and the state listed in its organization certificate. *See Firstar Bank, N.A. v. Faul*, 253 F.3d 982 (7th Cir. 2001) (*Firstar*). This circuit court opinion has created some confusing issues for national banks. The state listed in a national bank's organization certificate may not necessarily be the state in which the national bank currently has its main office. Under Federal law, a national bank can relocate its main office to a state other than that designated in its organization certificate.[4] However, no new organization certificate would need to be

[4] 12 U.S.C. § 30.

issued. After such a relocation, it is possible that the national bank may no longer have any offices in the state listed in its organization certificate. Under *Firstar*, however, the bank would continue to be deemed a citizen of that state for diversity purposes because it is the state listed in its organization certificate.

Courts generally have followed the *Firstar* decision since it was issued. However, more recently other courts have held that a national bank is "located" in the state where it has its principal place of business and in the state specified in its *articles of association. See RDC Funding Corp. v. Wachovia Bank, N.A.*, No. 3:03cv1360 (JBA), 2004 U.S. Dist. LEXIS 5524 (D.C. Conn. March 31, 2004); *Evergreen Forest Products of Georgia v. Bank of America,* 262 F. Supp. 2d 1297, 1306-07 (M.D. Ala. 2003). Under these cases, because a national bank's articles of association must be updated to reflect the bank's current main office, the articles of association and not the bank's organization certificate should be used to determine citizenship status in diversity cases. However, even under this interpretation, a national bank also could potentially be a citizen of two states but a different criterion is used to identify one of the two states.

The OCC's suggested amendment would resolve these ambiguities and provide relief to national banks, as well as Federal thrifts. It would provide a clear uniform rule for determining the citizenship of all Federally chartered depository institutions and put into place a simple, single-state rule.

The amendment recommended by the OCC is a new provision and was not included in the House-passed version of H.R. 1375, the Financial Services Regulatory Relief Act of 2004 (FSRRA).

Modernizing Corporate Governance. The OCC supports amending section 5144 of the Revised Statutes of the United States (12 U.S.C. § 61). Section 5144 imposes mandatory cumulative voting requirements on all national banks. This law currently requires that, in all elections of national bank directors, each shareholder has the right to (1) vote for as many candidates as there are directors to be elected and to cast the number of votes for each candidate that is equal to the number of shares owned, or (2) cumulate his or her votes by multiplying the number of shares owned by the number of directors to be elected and casting the total number of these votes for only one candidate or allocating them in any manner among a number of candidates. The OCC support an amendment that would permit a national bank to provide in its articles of association the method of electing its directors that best suits its business goals and needs and would provide the OCC with authority to issue regulations to carry out the purposes of this section.

The Model Business Corporation Act and most states' corporate codes provide that cumulative voting is optional. The amendment recommended by the OCC would conform this provision of the National Bank Act to modern corporate codes and would provide national banks with the same corporate flexibility available to most state corporations and state banks.

Modernizing Corporate Structure Options. The OCC supports amending the Revised Statutes of the United States (12 U.S.C. § 21 *et seq.*) to clarify the Comptroller's authority to adopt regulations allowing national banks to be organized in different business forms. Notwithstanding the form of organization, however, generally all national banks would continue to have the same rights and be subject to the same restrictions and requirements except to the extent that different treatment may be appropriate based on the different forms of organization. Many of the requirements in the National Bank Act are based on a national bank having stock and shareholders. It is expected that the Comptroller will apply these requirements in a comparable manner to other authorized organizational forms except as warranted by the differences in form.

The OCC's suggested amendment would reduce burden on national banks and allow them to choose among different business organizational forms, as permitted by the Comptroller, and to select the form that is most consistent with the their business plans and operations so that they may operate in the most efficient manner. Certain alternative business structures may be particularly attractive for community banks. For example, if the Comptroller should permit a national bank to be organized as a limited liability national association and establish the characteristics of such a national bank, the bank then may be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends.

Some states currently permit state banks to be organized as unincorporated limited liability companies (LLCs) and the FDIC recently adopted a rule that will result in certain state bank LLCs being eligible for Federal deposit insurance. Clarifying that national banks also may be organized in alternative business forms would provide a level playing field.

Paying Interest on Demand Deposits. The OCC supports repealing section 19(i) of the FRA (12 U.S.C. § 371a), section 5(b)(1)(B) of the Home Owners' Loan Act (HOLA) (12 U.S.C. § 1464(b)(1)(B)) and section 18 of the FDIA (12 U.S.C. § 1828) to permit member banks, thrifts, and nonmember banks, respectively, to pay interest on demand deposits. In a joint report submitted to Congress in September 1996, the OCC, along with the other Federal banking agencies, concluded that the statutory prohibition against the payment of interest on demand deposits no longer serves a useful public purpose. See Joint Report: Streamlining of Regulatory Requirements (September 23, 1996). Because banks can pay interest on NOW accounts held by individuals, it is primarily business checking accounts that are subject to prohibition on paying interest on demand deposits. Banks, however, find ways around this prohibition for their business customers through such financial products as sweep accounts that sweep excess demand deposits into money market investments. These programs are costly for the banks to maintain, an inefficient use of the banks' resources, and an unnecessary burden on business customers to establish such accounts.

Simplifying Dividend Calculations for National Banks. The OCC supports amending section 5199 of the Revised Statutes of the United States (12 U.S.C. § 60) to simplify the formula for calculating the amount that a national bank may pay in dividends. The current law requires banks to follow a complex formula that is unduly burdensome and

unnecessary for safety and soundness. The proposed amendment would retain certain safeguards in the current law that provide that national banks (and state member banks)[5] need the approval of the Comptroller (or the FRB in the case of state member banks) to pay a dividend that exceeds the current year's net income combined with any retained net income for the preceding two years. For purposes of the approval requirement, these Federal regulators would retain the authority to reduce the amount of a bank's "net income" by any required transfers to funds, such as a sinking fund for retirement of preferred stock.

The amendment would reduce burden on banks in a manner that is consistent with safety and soundness. Among other things, the amendment would ensure that the OCC (and the FRB for state member banks) would continue to have the opportunity to deny any dividend request that may deplete the net income of a bank that may be moving towards troubled condition. Importantly, the amendment would not affect other safeguards in the National Bank Act (12 U.S.C. 56). These provisions generally prohibit national banks from withdrawing any part of their permanent capital or paying dividends in excess of undivided profits except in certain circumstances.

Moreover, other safeguards, such as Prompt Corrective Action, have been enacted in the last ten years that provide additional safety and soundness protections for all insured depository institutions. The proposed amendment would not affect the applicability of these safeguards. These additional safeguards prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 U.S.C. § 1831o(d)(1)).

Repealing Obsolete Limitations on the OCC's Removal Authority. The OCC supports amending section 8(e)(4) of the FDIA (12 U.S.C. § 1818(e)(4)) relating to the procedures for the removal of an institution-affiliated party (IAP) from office or participation in the affairs of an insured depository institution. With respect to national banks, current law requires the OCC to certify the findings and conclusions of an Administrative Law Judge to the FRB for the FRB's determination as to whether any removal order will be issued. This amendment would repeal this certification and FRB approval process and allow the OCC directly to issue the removal order with respect to national banks.

The present system stems from historical decisions made by Congress on circumstances that are no longer applicable. Originally, the role of the OCC in removal cases was to certify the facts of the case to the FRB. The FRB then made the decision to pursue the case and made the final agency decision. At that time, the Comptroller was a member of the FRB and, therefore, participated in the FRB's final removal decision. However, Congress later removed the Comptroller from the FRB and gave the OCC the authority directly to issue suspensions and notices of intention to remove.

All of the Federal banking agencies, except the OCC, may remove a person who engages in certain improper conduct from the banking business. This amendment would give the

[5] See 12 U.S.C. 324 and 12 C.F.R. 208.5 generally applying the national bank dividend approval requirements to state member banks.

Comptroller the same removal authority as the other banking agencies to issue orders to remove persons who have been determined under the statute to have, for example, violated the law or engaged in unsafe or unsound practices in connection with an insured depository institution. Like the other banking agencies, the Comptroller should make these decisions about persons who engage in improper conduct in connection with the institutions for which the Comptroller is the primary supervisor. This is a technical change to streamline and expedite these actions and has no effect on a person's right to seek judicial review of any removal order. The FRB also supports this amendment.

Repealing Obsolete Intrastate Branch Capital Requirements. The OCC supports amending section 5155(c) of the Revised Statutes of the United States (12 U.S.C. § 36(c)) to repeal the requirement that a national bank, in order to establish an intrastate branch office in a state, must meet the capital requirements imposed by the state on state banks seeking to establish intrastate branches.

This technical amendment would repeal the obsolete capital requirement for the establishment of intrastate branches by national banks. This requirement is not necessary for safety and soundness. Branching restrictions are already imposed under other provisions of law to limit the operations of a bank if it is in troubled condition. See 12 U.S.C. § 1831o(e) (prompt corrective action).

Clarifying the Waiver of Publication Requirements for Bank Merger Notices. The OCC supports amending sections 2(a) and 3(a)(2) of the National Bank Consolidation and Merger Act (12 U.S.C. § 215(a) and 215a(a)(2), respectively) concerning the newspaper publication requirement of a shareholder meeting to vote on a consolidation or merger of a national bank with another bank located within the same state. This change would clarify that the publication requirement may be waived by the Comptroller in the case of an emergency situation or by unanimous vote of the shareholders of the national or state banks involved in the transaction.

This amendment does not affect other requirements in the law. The current law also requires that the consolidation or merger must be approved by at least a 2/3 vote of the shareholders of each bank involved in the transaction. In addition, the shareholders of the banks generally must receive notice of the meeting by certified or registered mail at least ten days prior to the meeting. These provisions are not changed.

Repealing Obsolete References to the Main Place of Business of a National Bank. The OCC supports amending two sections of the Revised Statutes of the United States (12 U.S.C. §§ 22 and 81) to replace obsolete language that is used in these two sections with the modern term "main office."

The change to 12 U.S.C. § 22 would clarify that the information required to be included in a national bank's organization certificate is the location of its *main office*. The change of 12 U.S.C. § 81 would clarify that the general business of a national bank shall be transacted in its *main office* and in its branch or branches. Both statutes currently use obsolete terms to describe a main office of a national bank.

Deleting Obsolete Language in the National Bank Act. The OCC supports amending section 5143 of the Revised Statues of the United States (12 U.S.C. § 59) to delete obsolete language. Generally, 12 U.S.C. § 59 permits a national bank to reduce its capital and distribute cash or other assets to its shareholders that become available as a result of the reduction if approved by a vote of two-thirds of its shareholders and by the OCC. The current statute, however, also references two obsolete provisions. The first provision limits the amount of the capital reduction to a "sum not below the amount required by this chapter to authorize the formation of associations." This limitation refers to the obsolete minimum capital requirement for a de novo institution that was provided under 12 U.S.C. § 51; however, 12 U.S.C. § 51 was repealed in 2000 by the American Homeownership and Economic Opportunity Act of 2000, Pub. L. No. 106-569, Title XII, § 1233(c). The second obsolete provision limits the amount of a bank's capital that can be reduced to the "amount required for its outstanding circulation." The reference to "outstanding circulation" relates to the obsolete practice by national banks of issuing circulating notes to serve as currency.

This amendment would delete the obsolete language in the statute but would maintain the current relevant requirement that a national bank cannot reduce its capital and distribute assets to its shareholders unless approved by two-thirds of its shareholders and by the OCC.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

SAFETY AND SOUNDNESS

Enforcing Written Agreements and Commitments. The OCC supports amending the FDIA (12 U.S.C. § 1811, *et seq.*) to add a new section that provides that the Federal banking agencies may enforce the terms of (1) conditions imposed in writing in connection with an application, notice, or other request, and (2) written agreements.

This amendment would enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses. This amendment is intended to reverse some court decisions that question the authority of the agencies to enforce such conditions or agreements against institution-affiliated parties (IAP) without first establishing that the IAP was unjustly enriched. In addition, the amendment would clarify that a condition imposed by a banking agency in connection with the nondisapproval of a notice, *e.g.*, a notice under the Change in Bank Act (CBCA), can be enforced under the FDIA.

Barring Convicted Felons From Participating in the Affairs of Depository Institutions. The OCC supports amending section 19 of the FDIA (12 U.S.C. § 1829) to give the Federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs

of an *un*insured national or state bank or *un*insured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to *insured* depository institutions. The OCC believes that this amendment would help to enhance the safe and sound operations of uninsured, as well as insured, institutions.

Ensuring That Accountants of Insured Depository Institutions Are Held to the Same Standard as Other IAPs. The OCC supports amending section 3(u)(4) of the FDIA (12 U.S.C. § 1813(u)(4)) to remove the "knowing and reckless" requirement. This change would hold independent contractors to a standard that is more like the standard that applies to other IAPs. Under current law, independent contractor IAPs are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution. To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a Federal banking agency to take action against the accountant as an IAP for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This amendment would strike the "knowing and reckless" requirement.

The knowing and reckless standard in the current law is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. The amendment will strengthen the agencies' enforcement tools with respect to accountants and other independent contractors.

This amendment is a new provision and is not included in the House-passed version of the FSSRA.

Strengthening the Supervision of Stripped-Charter Institutions. The OCC supports amending the CBCA in section 7(j) of the FDIA (12 U.S.C. § 1817(j)) to expand the criteria to allow a Federal banking agency to extend the time period to consider a CBCA notice. Under the CBCA, a Federal banking agency must disapprove a CBCA notice within certain time frames or the transaction may be consummated. Initially, the agency has up to 90 days to issue a notice of disapproval. The agency may extend that period for up to an additional 90 more days if certain criteria are satisfied and this amendment provides for new criteria that would allow an agency to extend the time period under this additional up to 90-day period. The new criteria that an agency could use to extend the time period can provide the agency more time to analyze the future prospects of the institution or the safety and soundness of the acquiring party's plans to sell the institution or make changes in its business operations, corporate structure, or management. Moreover, the amendment would permit the agencies to use that information as a basis to issue a notice of disapproval.

The OCC believes that this amendment will address issues that have arisen for the banking regulators when a stripped-charter institution (*i.e.*, an insured bank that has no ongoing

business operations because, for example, all of the business operations have been merged into another institution) is the subject of a CBCA notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a *de novo* charter and an application for deposit insurance.

In general, the scope of review of a *de novo* charter application or deposit insurance application is more comprehensive than the statutory grounds for the denial of a notice under the CBCA. There are also significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the Federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the requirement for prior approval and without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. The recommended amendment would expand the criteria in the CBCA that allows a Federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider the acquiring party's business plans and the future prospects of the institution and use that information in determining whether to disapprove the notice.

Providing a Statute of Limitations for Judicial Review of Appointment of a Receiver for a National Bank. The OCC supports amending section 2 of the National Bank Receivership Act (12 U.S.C. § 191) to provide for a 30-day period to judicially challenge a determination by the OCC to appoint a receiver for a national bank. Current law generally provides that challenges to a decision by the OTS to appoint a receiver or conservator for an insured savings association or the FDIC to appoint itself as receiver or conservator for an insured state depository institution must be raised within 30 days of the appointment. 12 U.S.C. §§ 1464(d)(2)(B), 1821(c)(7). There is, however, no statutory limit on a national bank's ability to challenge a decision by the OCC to appoint a receiver of an insured or uninsured national bank.[6] As a result, the general six-year statute of limitations for actions against the U.S. applies to the OCC's receiver appointments. See James Madison, Ltd. v. Ludwig, 82 F.3d 1085 (D.C. Cir. 1996).

The six-year protracted time period under current law severely limits the OCC's authority to manage insolvent national banks that are placed in receivership by the agency and the ability of the FDIC to wind up the affairs of an insured national bank in a timely manner with legal certainty. (In the case of an insured national bank that is placed in receivership by the OCC, the FDIC must be appointed the receiver.) The recommended amendment would make the statute of limitations governing the appointment of receivers of national banks consistent with the time period that generally applies to other depository institutions. The amendment would not affect a national bank's ability to challenge a decision by the OCC to appoint a receiver, but simply require that these challenges must be brought in a

[6] Under current law, there is a 20-day statute of limitations for challenges to the OCC's decision to appoint a conservator of a national bank. 12 U.S.C. § 203(b)(1).

timely manner and during the same time frame that generally applies to other depository institutions.

Allocating Examiner Resources More Efficiently. The OCC supports amending section 10(d) of the FDIA (12 U.S.C. § 1820(d)) to provide that an appropriate Federal banking agency may make adjustments in the examination cycle for an insured depository institution if necessary for safety and soundness and the effective examination and supervision of insured depository institutions. Under current law, insured depository institutions must be examined by their appropriate Federal banking agencies at least once during a 12-month period in a full-scope, on-site examination unless an institution qualifies for the 18-month rule. Small insured depository institutions with total assets of less than $250 million and that satisfy certain other requirements may be examined on an 18-month basis rather than a 12-month cycle. The amendment would permit the banking agencies to make adjustments in the scheduled examination cycle as necessary for safety and soundness.

Such an amendment would give the appropriate Federal banking agencies the discretion to adjust the examination cycle of insured depository institutions to ensure that examiner resources are allocated in a manner that provides for the safety and soundness of insured depository institutions. For example, as deemed appropriate by a Federal banking agency, a well-capitalized and well-managed bank's examination requirement for an annual or 18-month examination could be extended if the agency's examiners were needed to immediately examine troubled or higher risk institutions. This amendment would permit the agencies to use their resources in the more efficient manner.

Enhancing the Ability of Banking Agencies to Suspend or Remove Bad Actors From Depository Institutions. The OCC supports amending section 8(g) of the FDIA (12 U.S.C. § 1818(g)) to clarify that the appropriate Federal banking agency may suspend or prohibit IAPs charged or convicted with certain crimes (including those involving dishonesty, breach of trust, or money laundering) from participating in the affairs of <u>any</u> depository institution and not only the institution with which the party is or was last affiliated. The amendment also would clarify that the section 8(g) authority applies even if the IAP is no longer associated with the depository institution at which the offense allegedly occurred or if the depository institution with which the IAP was associated is no longer is existence. Moreover, the amendment would allow the banking agency to suspend or remove an individual who attempts to become involved in the affairs of an insured depository institution <u>after</u> being charged with a covered crime. It makes little sense to allow the agencies to suspend or remove a person who is charged with such a crime while serving at an insured depository institution, but deny the agencies the ability to remove a person that becomes affiliated with an insured depository institution while under indictment for the same type of crime.

Under current law, if an IAP is charged with such a crime, the suspension or prohibition will remain in effect until the charge is finally disposed of or until terminated by the agency. If the individual is convicted of such a crime, the party may be served with a notice removing the party from office and prohibiting the party for further participating in

the affairs of a depository institution without the consent of the appropriate Federal banking agency.[7] Before an appropriate Federal banking agency may take any of these actions under section 8(g), the agency must find that service by the party may pose a threat to interests of depositors or impair public confidence in a depository institution. The statute further provides that an IAP that is suspended or removed under section 8(g) may request a hearing before the agency to rebut the agency's findings. Unless otherwise terminated by the agency, the suspension or order of removal remains in effect until the hearing or appeal is completed. Current law, however, applies only to the depository institution with which the IAP is then associated. This amendment will help to ensure that, if a Federal banking agency makes the required findings, the agency has adequate authority to suspend or prohibit an IAP charged with such crimes from participating in the affairs of any depository institution if any of the various circumstances described above should occur.

The amendment that the OCC supports is more comprehensive and covers more circumstances under which an IAP who is charged with such a crime may be suspended or removed than the amendment to section 8(g) that is included in the House-passed version of the FSSRA.

FEDERAL BRANCHES AND AGENCIES OF FOREIGN BANKS.

Implementing Risk-Based Requirements for Federal Branches and Agencies. The OCC supports an amending section 4(g) of the International Banking Act of 1978 (IBA) (12 U.S.C. § 3102(g)) concerning the Comptroller's authority to set the amount of the capital equivalency deposit (CED) for a Federal branch or agency. The CED is intended to ensure that assets will be available in the U.S. for creditors in the event of liquidation of a U.S. branch or agency. The current CED statute that applies to foreign banks operating in the U.S. through a Federal license may impose undue regulatory burdens without commensurate safety and soundness benefits. These burdens include obsolete requirements about where the deposit must be held and the amount of assets that must be held on deposit. As a practical matter, the IBA sets the CED at 5% of total liabilities of the Federal branch or agency and provides that the CED must be maintained in such amount as determined by the Comptroller. As a result, Federal branches and agencies often must establish a CED that is larger than the capital that would be required for a bank of corresponding size or for a similar size State-chartered foreign branch or agency in major key States.

The OCC recommends that section 4(g) be amended to allow the OCC, after consultation with the Federal Financial Institutions Examination Council (FFIEC), to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely parallel the risk-based capital framework

[7] Under another provision of the FDIA, any person convicted of any crime involving dishonesty, breach of trust, or money laundering may not, among other things, become or continue as an IAP with respect to any insured depository institution without the prior consent of the FDIC. 12 U.S.C. § 1829. As discussed above, the OCC also supports amending § 1829 to apply to *un*insured, as well as insured, depository institutions and to give the OCC the authority to keep these convicted felons out of uninsured national banks or Federal branches or agencies.

that applies to national and state banks. The Federal Reserve Board has no objections to the OCC's amendment.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Allowing the Option for a Federal Representative Office License. The OCC supports amending section 4 of the IBA (12 U.S.C. § 3102) to permit the OCC to license Federal representative offices. Representative offices of foreign banks generally engage in representational functions. They do not engage in core banking activities, such as accepting deposits or lending money. Although the IBA sought to provide foreign banks with a Federal option for their U.S. offices by giving the OCC the authority to license Federal branches and agencies, it did not provide the OCC with the authority to establish Federal representative offices. In this respect, the IBA does not fully implement the dual banking option, nor does it advance the goal of national treatment for foreign banks seeking to establish a representative office in the United States.

The absence of a Federal representative office option has in some cases resulted in additional regulatory burden for those foreign banks that would want to have their entire U.S. operations under a Federal license. If foreign banks with an existing Federal branch or agency want to have a representative office, they are required to establish them under state law provisions, and thus gain another U.S. regulator (the state).

The amendment supported by the OCC would provide foreign banks with the option of establishing Federal representative offices with OCC approval and under the OCC's supervision. Specifically, it would authorize the OCC to approve the establishment of a representative office, provided that state law does not prohibit this establishment. In acting on an application to establish a Federal representative office, the OCC generally would apply the same criteria that it applies when it acts on Federal branch or agency applications.

The amendment also would provide that the OCC would have the authority to regulate, supervise, and examine representative offices that it licenses. Finally, to ensure that the OCC has adequate authority to enforce this provision, the proposal would amend section 3(q) of the FDI Act to include a Federal representative office as an entity for which the Comptroller serves as the appropriate Federal banking agency and, would further amend the FDI Act to clarify that representative offices are subject to the enforcement authority of the Federal Reserve and OCC under 12 U.S.C. § 1818.

This amendment would not affect or in any way diminish the Federal Reserve's authority under current law to approve (in addition to the primary, or licensing, authority) the establishment of foreign banks' U.S. offices (Federal- or state-licensed branches, agencies, or representative offices) and to examine any of these entities under the IBA. Moreover, the Federal Reserve would have the same ability to recommend to the OCC that the license of a Federal representative office be terminated that it has under current law to recommend that the license of a Federal branch or agency be terminated.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Providing Equal Treatment for Federal Agencies of Foreign Banks. The OCC supports amending section 4(d) of the IBA (12 U.S.C. § 3102(d)) to provide that the prohibition on uninsured deposit-taking by Federal agencies of foreign banks applies only to deposits from U.S. citizens or residents. As a result, a Federal agency would be able to accept uninsured foreign source deposits from non-U.S. citizens. State agencies of foreign banks may accept uninsured deposits from parties who are neither residents nor citizens of the United States, if so authorized under state law. However, due to slight language differences in the IBA, the D.C. Circuit Court of Appeals has held that Federal agencies cannot accept any deposits, including those from noncitizens who reside outside of the United States. Conference of State Bank Supervisors v. Conover, 715 F.2d 604, 623 (D.C. Cir. 1983).

The amendment supported by the OCC would allow Federal agencies to accept the limited *uninsured* foreign source deposits that state agencies may accept under the IBA. As a result, the amendment would repeal an unnecessary regulatory burden that has competitively disadvantaged Federal agencies and prevented them from offering the same services to foreign customers that may be offered by state agencies. Because these deposits are not insured, this amendment does not pose any risks to the deposit insurance fund.

Maintaining a Federal Branch and a Federal Agency in the Same State. The OCC supports an amendment to section 4(e) of the IBA (12 U.S.C. § 3102(e)) to provide that a foreign bank is prohibited from maintaining both a Federal agency and a Federal branch in the same state only *if* state law prohibits maintaining both an agency and a branch in the state. Current law prohibits a foreign bank from operating both a Federal branch and a Federal agency in the same state notwithstanding that state law may allow a foreign bank to operate both types of offices.

According to the legislative history of the current provision, this prohibition was included in the IBA to maintain parity with state operations. However, today some states permit foreign banks to maintain both a branch and agency in the same state. Florida law permits a foreign bank to operate more than one agency, branch, or representative office in Florida (*see* Fla. Stat. Ann. § 663.06). Other states, such as Connecticut, also may permit a foreign bank to have both a state branch and a state agency (*see* Conn. Gen. Stat. Ann. § 36a-428). This amendment would repeal an outdated regulatory burden in current law and permit a foreign bank to maintain both a Federal branch and a Federal agency in those states that do not prohibit a foreign bank from maintaining both of these offices. This change would enhance national treatment and give foreign banks more flexibility in structuring their U.S. operations.

INFORMATION SHARING

Improving Information Sharing With Foreign Supervisors. The OCC supports amending section 15 of the IBA (12 U.S.C. § 3109) to add a provision that ensures that the FRB, OCC, and FDIC cannot be compelled to disclose information obtained from a foreign supervisor if public disclosure of this information would be a violation of foreign law and the U.S. banking agency obtained the information pursuant to an information sharing arrangement with the foreign supervisor or other procedure established to administer and enforce the banking laws. The banking agency, however, cannot use this provision as a basis to withhold information from Congress or to refuse to comply with a valid court order in an action brought by the U.S. or the agency.

This amendment would provide assurances to foreign supervisors that the banking agencies cannot be compelled to disclose publicly confidential supervisory information that the agency has committed to keep confidential, except under the limited circumstances described in the amendment. This authority is similar to the authority provided to the Securities and Exchange Commission under the securities laws (15 U.S.C. § 78q(h)(5)). Some foreign supervisors have been reluctant to enter into information sharing agreements with U.S. banking agencies because of concerns that the U.S. agency may not be able to keep the information confidential and public disclosure of the confidential information provided could subject the supervisor to a violation of its home country law. This amendment will be helpful to ease those concerns and will facilitate information sharing agreements that enable U.S. and foreign supervisors to obtain necessary information to supervise institutions operating internationally.

Improving Ability to Obtain Information from Regulated Entities. The OCC supports amending the FDIA (12 U.S.C. § 1811, *et seq.*) to permit the OCC, FDIC, Fed, and OTS to establish and use advisory committees in the same manner. All of these agencies have the same need to be able to conduct open and frank discussions with the banking industry and other members of the public about a variety of supervisory, policy, and consumer issues. Moreover, frequently, the banking agencies are discussing the same issues with industry and public officials.

In particular, given the significant changes occurring in the structure of the banking system and the way banks deliver products and services, the agencies need the ability to efficiently -- and quickly -- keep abreast of these changes and how they will impact the continuing ability of banks to be responsive to customer and community needs. Because of the potentially sensitive nature of information about these issues, any public meeting requirements could inhibit the banking agencies from obtaining frank, open, and candid advice from industry and community representatives and the customers the banks serve.

The Federal Advisory Committee Act (5 U.S.C. App.) (FACA) generally requires that the meetings of advisory committees must be open to the public, and that advance notice of a committee meeting must be published in the Federal Register. The minutes of the meeting and all working papers and other documents prepared for or by the advisory committee also must be publicly available. Under current law, the Federal Reserve System is exempt from

FACA. However, all of the other Federal banking agencies must follow FACA's procedures and requirements when establishing or using committees to provide advice or recommendations to the agency relating to their supervisory responsibilities.

This amendment, which is recommended by the OCC and FDIC, would ensure that all of the other Federal banking agencies can benefit from the same free exchange of information with the banks and others that currently only is available to the Federal Reserve System. The amendment would permit the OCC, FDIC, and OTS also to establish and use committees to provide advice and recommendations with respect to safety and soundness, product and service developments and delivery, and consumer issues affecting supervised institutions without concerns that confidential information will be publicly disclosed. Moreover, by enhancing the free exchange of information between banks and all Federal bank regulators, the amendment further strengthens the safety and soundness of insured depository institutions.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Improving Information Sharing. The OCC supports amending the FDIA (12 U.S.C. § 1811, *et seq.*) to provide that a Federal banking agency has the discretion to furnish any confidential supervisory information, including a report of examination, about a depository institution or other entity examined by the agency to another Federal or state supervisory agency and to any other person deemed appropriate.

Such an amendment would give the other Federal banking agencies parallel authority to share confidential information that was given to the FRB in Sec. 727 of the Gramm-Leach-Bliley Act (GLBA). This provision is discretionary and nothing in this provision would compel a banking agency to disclose confidential supervisory information that it has agreed to keep confidential pursuant to an information sharing or other agreement with another supervisor.

OTHER RECOMMENDATIONS

Reducing Reporting Burdens Relating to Insider Lending Reporting. The OCC supports amending section 22(g) of the Federal Reserve Act (12 U.S.C. § 375a) and section 106(b)(2) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. § 1972(2)) to eliminate certain reporting requirements concerning loans made to insiders. Specifically, the reports that would be eliminated are (1) the report that must be filed with a bank's board of directors when an executive officer of the bank obtains certain types of loans from another bank that exceeds the amount the officer could have obtained from his or her own bank, (2) the supplemental report a bank must file with its quarterly call report identifying any loans made to executive officers during the previous quarter, and (3) an annual report filed with a bank's board of directors by its executive officers and principal shareholders regarding outstanding loans from correspondent banks.

Nothing in these amendments affects the insider lending restrictions that apply to national banks or the OCC's enforcement of those restrictions. Moreover, the OCC believes that it will continue to have access to sufficient information during the examination process to review a national bank's compliance with the insider lending laws. Under the OCC's regulations, national banks are required to follow the FRB's regulations regarding insider lending restrictions and reporting requirements (see 12 C.F.R. § 31.2). The FRB's regulations require member banks to maintain detailed records of all insider lending. In addition, the OCC has the authority under 12 U.S.C. § 1817(k) to require any reports that it deems necessary regarding extensions of credit by a national bank to any of its executive officers or principal shareholders, or the related interests of such persons.

Providing an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act (DIMIA). The OCC supports amending section 203(1) of DIMIA (12 U.S.C. § 3202(1)). Under current law, generally a management official may not serve as a management official of any other nonaffiliated depository institution or depository institution holding company if (1) their offices are located or they have an affiliate located in the same MSA, or (2) the institutions are located in the same city, town, or village, or a city, town, or village that is contiguous or adjacent thereto. For institutions of less than $20 million in assets, the SMSA restriction does not apply. The amendment would increase the current $20 million exemption to $100 million. The OCC supports this amendment. This $20 million cap has not been amended since the current law was originally enacted in 1978. However, the asset size of FDIC-insured commercial banks between 1976 and 2000 has increased over five fold. Depository institutions of all sizes will continue to be subject to the city, town, or village test.

Streamlining Depository Institution Merger Application Requirements. The OCC supports amending the Bank Merger Act (BMA) (12 U.S.C. § 1828(c)) to provide that the responsible agency in a merger transaction, which is generally the Federal banking agency that has the primary regulatory responsibility for the resulting bank, must request a competitive factors report only from the Attorney General, with a copy to the FDIC. Under current law, this report must be requested from all of the other Federal banking agencies but the other agencies are not required to file a report. This amendment would appropriately streamline the agencies' procedures in processing BMA transactions.

Shortening of the Post-Approval Antitrust Review Period. The OCC supports amending section 11(b)(1) of the BHCA (12 U.S.C. § 1849(b)(1)) and section 18(c)(6) of the BMA (12 U.S.C. § 1828(c)(6)) to permit the shortening of the post-approval waiting period for certain bank acquisitions and mergers. Under current law, the post-approval waiting period generally is 30 days from the date of approval by the appropriate Federal banking agency. The waiting period gives the Attorney General time to take action if the Attorney General determines that the transaction will have a significant adverse effect on competition. The waiting period under both the BHCA and BMA, however, may be shortened to 15 days if the appropriate banking agency and the Attorney General agree that no such effect on competition will occur. The proposed amendment would shorten the mandatory 15-day waiting period to 5 days.

The amendment would give the banking agency and the Attorney General more flexibility to shorten the post-approval waiting period as appropriate for those transactions that do not raise competitive concerns. If such concerns exist, the 30-day waiting period will continue to apply. This change will not affect the waiting periods for transactions that involve bank failures or emergencies. In those cases, the statute already provides for other time frames.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Embargoed until
June 22 at 10:00 am

Statement of

John E. Bowman, Chief Counsel
Office of Thrift Supervision

concerning

Regulatory Burden Relief

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

June 22, 2004

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Regulatory Burden Relief
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
June 22, 2004

John E. Bowman, Chief Counsel
Office of Thrift Supervision

I. Introduction

Good morning, Mr. Chairman, Ranking Member Sarbanes, and members of the Committee. Thank you for the opportunity to discuss the regulatory burden relief initiatives of the Office of Thrift Supervision (OTS). It is always important to remove unnecessary regulatory obstacles that hinder profitability, innovation, and competition in our financial services industry. I particularly want to thank Senator Crapo for his leadership in this area. We look forward to working with the Senator and his staff on legislation to address the issues we discuss today.

Our highest priority items for regulatory burden relief legislation are:

- Removing the continuing disparate treatment of thrifts under the federal securities laws by providing thrifts the same exemptions as banks with respect to the investment adviser and broker-dealer activities that each conducts on otherwise equal terms and substantially similar authority.

- Increasing commercial lending limits for federal thrifts to enhance their ability to diversify and to provide small and medium-sized businesses greater choice and flexibility in meeting their credit needs.

- Amending the International Lending Supervision Act of 1983 (ILSA) to support equal representation for OTS on the Basel Committee and to extend ILSA to thrifts to promote consistency in supervising the foreign activities of insured institutions.

I will explain each of these in more detail and describe several other initiatives that we are recommending for enactment.

II. Revising the Federal Securities Laws to Treat Thrifts and Banks Equally

OTS's most important regulatory burden reduction legislative priority is revising the federal securities laws so that thrifts and banks are treated equally with respect to their investment adviser and broker-dealer activities. As described more fully below, this involves exempting thrifts from the investment adviser and broker-dealer registration requirements to the same extent as banks are exempt under the Investment Advisers Act (IAA) and the Securities Exchange Act of 1934 (1934 Act).

Although the SEC has issued several proposals purportedly to address the inequitable treatment of thrifts, the application of the federal securities laws remains anything but charter neutral. Significant disparities remain under the IAA, with thrifts subject to an entirely duplicative SEC oversight regime. Equally significant, in a proposal released to the public last week,[1] the SEC indicated that it would roll back an interim rule that had extended equal treatment to thrifts vis-à-vis banks for purposes of the broker-dealer exemption. Clearly, this is not heading in the direction of charter neutrality between banks and thrifts with respect to the application of the federal securities laws.

Underscoring the case for charter neutrality is the fact that banks and thrifts provide the same investment adviser, trust and custody, third party brokerage, and other related investment and securities services in the same manner and under equivalent statutory authorities. With respect to the oversight and regulation of these activities, OTS examines investment and securities activities of thrifts the same way as the Office of the Comptroller of the Currency (OCC) and the other federal banking agencies examine the same bank activities—with thrift and bank customers equally well-protected.

To avoid the regulatory burden and substantial costs of this duplicative regulatory structure, some previously OTS-regulated thrifts have converted to banks (or to state chartered trust companies) to take advantage of the bank registration exemption. In addition, some institutions have avoided opting for a thrift charter in the first place because of the SEC registration requirements. The different purposes of the various banking charters make our financial services industry the most flexible and successful in the world. While OTS strongly supports charter choice, that decision should be based solely on the merits of the charter—by choosing a charter that fits a particular business strategy—not on

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1. SEC Proposed Rule: Regulation B, Release No. 34-49879, approved by the Commission on June 2, 2004, and released to the public on June 17, 2004.

unrelated and extraneous factors such as registration requirements and avoiding duplicative regulation under the federal securities laws.

The existing inequity under the federal securities laws undermines our collective efforts to maintain a strong and competitive banking system. Eliminating the unnecessary costs associated with the IAA and 1934 Act registration requirements would free up significant resources for thrifts in local communities. It would also avoid the regulatory burden and substantial costs associated with a duplicative regulatory structure that has already dictated some institutions' charter choice—an issue recognized by Chairman Donaldson in the context of the discussion on the SEC's IAA proposal.[2]

A. Investment Adviser Registration

Prior to enactment of the Gramm-Leach-Bliley Act (GLB Act) in 1999, banks—but not thrifts—enjoyed a blanket exemption under the IAA. While the GLB Act slightly narrowed the bank exemption, banks may still provide investment management and advisory services to all types of accounts without registering as an investment adviser. The one exception is that a bank (or a department of the bank) must register when it advises a registered investment company, such as a mutual fund.

On May 7, 2004, the SEC issued a proposal providing a narrow exemption from IAA registration to thrifts that limit their investment management and advisory services to a limited range of accounts. Under the proposal, thrift fiduciary accounts are segregated into two categories. Thrifts that provide services to accounts that include only traditional trust, estate, and guardianship accounts will be exempt from registration. Thrifts providing services to accounts that include investment management agency accounts and other accounts that the SEC has defined as not being for a fiduciary purpose will be required to register as an investment adviser.

The practical effect of this approach is that it provides an extremely limited exemption that is beneficial to few thrifts. This fact was made clear to the SEC Commissioners at a meeting on April 28 when the SEC staff advised the Commissioners that none of the thrifts currently registered under the IAA—there are 47 thrifts currently registered—would be able to take advantage of the

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2. Comment of SEC Chairman William Donaldson, at the April 28, 2004, SEC meeting discussing SEC Proposed Rule: Certain Thrift Institutions Deemed Not To Be Investment Advisers, Release Nos. 34-49639 (May 3, 2004).

proposed exemption since all provide advisory services for both account categories.

While the SEC applies the federal securities laws in two different manners depending on the business operations of a thrift, there is no distinction between these two categories of accounts under the HOLA and OTS regulations applicable to thrifts. The accounts in both categories are fiduciary accounts that receive the same protections under the HOLA and OTS regulations and are subject to similar examination scrutiny. There is no logical basis why thrifts, unlike banks, need duplicative regulatory oversight by the SEC of account activities that OTS already supervises and examines. This is far from functional regulation, but rather over-regulation that accomplishes nothing in the way of a legitimate policy objective.

Thrifts registering as investment advisers have indicated to OTS that registration costs are substantial. IAA costs include registration fees, licensing fees for personnel, and audit requirements, as well as the many hours management must devote to issues raised by duplicative SEC supervision, examinations and oversight. Costs related to legal advice for IAA registration are also a factor. An informal survey of most of our largest IAA-registered thrifts shows aggregate annual costs ranging from $75,000 to $518,200.

Limiting the types of accounts for which a thrift may provide investment management and advisory services to avoid IAA registration has the likely effect of negating any meaningful exemption. Generally, institutions will not opt to enter the trust and asset management business line and then decide to forego the most profitable aspects of the business activity. In fact, from a safety and soundness standpoint, we would have to question the rationale behind such an approach. Thrifts providing investment management and advisory services should be encouraged to do so to the fullest extent practicable and without concern for arbitrary triggers that could significantly increase their compliance costs and supervision. This is particularly important from a regulatory burden reduction perspective when you consider that a bank competitor will incur none of the regulatory costs and burdens as a thrift for engaging in exactly the same activities.

In addressing this issue, it is important to recall that in July 2000 an amendment was offered by Senator Bayh to extend the IAA exemption to thrifts so that thrifts and banks could compete equally in the provision of investment management and advisory services. As the Senator and others on the Committee may recall, the SEC represented to the Committee that legislation was not needed to resolve this problem since the SEC would be able to resolve the issue by

regulation.[3] Four years later the issue remains unresolved with virtually no likelihood of this changing given that the SEC's recent proposal will provide no relief to existing IAA-registered thrifts. This fact, alone, underscores why nothing short of a legislative solution is adequate to resolve this issue going forward.

While OTS will submit a comment letter to the SEC on why the proposed IAA rule is flawed, after much discussion for several years between OTS and the SEC staff, we have made virtually no headway toward a mutually satisfactory solution. We have no reason to believe that a comment letter outlining all of the discussions that we have already had with the SEC staff will sway the SEC's position on this issue. This further underscores the need for legislation such as the provision set forth at section 201 of H.R. 1375, the regulatory burden reduction bill passed by the House in March of this year.

B. Broker-Dealer Registration

Banks—but not thrifts—enjoyed a blanket exemption from broker-dealer registration requirements under the 1934 Act before changes were made by the GLB Act. The GLB Act removed the blanket exemption and permitted banks to engage only in specified activities without having to register as a broker-dealer. All other broker-dealer activities must be "pushed out" to a registered broker-dealer. The SEC issued interim broker-dealer rules on May 11, 2001, to implement the new "push-out" requirements. As part of the broker-dealer "push out" rules, the SEC exercised its authority to include thrifts within the bank exemption. This treated thrifts the same as banks for the first time for purposes of broker-dealer registration. In the interim broker-dealer rule, the SEC recognized it would be wrong to continue disparate, anomalous treatment between thrifts and banks.

The SEC postponed the effective date of the interim rule several times. It published proposed amendments to the interim dealer rule on October 20, 2002 and the final dealer rule on February 24, 2003. The final dealer rule gives thrifts the same exemptions as banks. On June 2, 2004, the SEC approved a new proposed rule governing when a bank or thrift must register as a broker, with comments due by August 1. Based on our preliminary view of the text of the broker rule, which became available June 17, 2004, it appears that the SEC has proposed rolling back the parity it had extended to thrifts in an interim rule that

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3. During deliberations on the Competitive Markets Supervision Act before the Senate Banking Committee in July 2000, Senator Bayh proposed an amendment to extend the IAA exemption to thrifts. As noted in Senator Bayh's statement and subsequent letter to the SEC (attached), the amendment was withdrawn pending the SEC's offer to resolve the issue by regulation.

granted a blanket exemption from SEC registration requirements to both banks and thrifts until November 12, 2004.

Unlike the SEC's interim broker rule, the new proposal would no longer treat thrifts the same as banks in all respects. Although thrifts would be treated the same as banks for purposes of the 11 statutory activities they may engage in without registering as a broker with the SEC, as provided by the GLB Act, three non-statutory exemptions provided banks would not be extended to thrifts. The SEC describes the three non-statutory exemptions as targeted exemptions that recognize the existing business practices of some banks. We understand that the SEC staff does not believe thrifts are engaged in the exempted securities activities and will only extend relief for thrifts to the securities activities they are currently performing. Based on the information available to us, it appears that thrifts currently engage in some, if not all, of the securities activities covered by the three additional exemptions. Moreover, since the exemptions apply to all banks—whether or not they are currently engaged in one of the exempted activities—this approach is not logical, and OTS will strongly urge the SEC to remove this new disparity.

As was the case in the SEC's investment adviser proposal, in issuing its proposed broker rule, the SEC passed on the opportunity to provide equivalent treatment to thrifts. In both instances, the SEC has proposed to treat thrifts differently than banks in fundamentally important respects. Both of these very recent actions, occurring within the last two months, demonstrate the immediate need for legislative relief to provide equal treatment of banks and thrifts under the federal securities laws.

III. Enhancing Small Business and Consumer Lending by Federal Thrifts

Another OTS legislative priority is enhancing the ability of federal thrifts to meet the small business and other commercial lending needs of their communities by providing businesses greater choice and flexibility for their credit needs. HOLA now caps the aggregate amount of loans for commercial purposes at 20 percent of a thrift's assets. Commercial loans in excess of 10 percent of assets must be in small business loans. OTS supports provisions in H.R. 1375 that remove the current limit on small business lending and that increase the cap on other commercial lending from 10 percent to 20 percent of assets.

There are several reasons why we have concluded that these changes make sense from a policy perspective. First, this will give thrifts greater flexibility to promote safety and soundness through diversification. Additional flexibility, particularly in small business lending, would provide opportunities to counter the

undulations of a cyclical mortgage market. This would enable thrift managers to continue to meet their ongoing customers' mortgage and consumer lending needs, while providing additional resources to manage their institutions safely and soundly. In addition, some thrifts are at or near the current statutory limits and must curtail otherwise safe and sound business lending programs.

This proposal would increase competition for, and the availability of, small business and other commercial loans now and in the future as thrifts develop this line of business. This will be particularly welcome to smaller businesses that have experienced difficulty in obtaining relatively small loans from large commercial banks that set minimum loan amounts as part of their business strategy—a problem that may increase with industry consolidation. Finally, the proposal will also assist businesses that prefer borrowing from entities like thrifts that meet the needs of borrowers with personal service.

In addition to the legislative proposals that OTS has already submitted to the Committee, we are considering submitting an additional item that would eliminate anomalies that exist under HOLA relating to thrift lending authority. Currently, consumer loans are subject to a 35 percent of assets limitation, while there is no limit on loans a thrift may make through credit card accounts, even though the borrower may use the loan for the same purposes. Ironically, consumer loans subject to the 35 percent cap are typically secured loans, whereas credit card loans—subject to no limit—are not secured.

In addition, for purposes of computing qualified thrift investments, a thrift may count 100 percent of its credit card loans, but other consumer loans only count to the extent that these and other categories of loans do not exceed 20 percent of the thrift's "portfolio assets." This restriction is arbitrary, unduly complex, and unique to the thrift industry. It bears no relationship to the relative risks presented by the loans and, in our experience, the existing limit is irrelevant to the safe and sound operation of an institution. Removing this artificial limit would enable thrifts to perform more effectively as the retail institutions their customers need and expect, without impairing safety and soundness.

IV. Amending ILSA to Support Consistency and Equal Representation

OTS has identified two proposals that we believe will promote greater consistency among U.S. regulators in supervising the foreign activities of insured depository institutions.

A. Applying ILSA to Savings Associations

OTS recommends making federal and state thrifts (and their subsidiaries and affiliates) subject to ILSA on the same basis as other banking institutions. This will eliminate regulatory burden by promoting the uniform supervision of insured depository institutions. OTS is already covered by ILSA along with the other federal banking agencies (FBAs), but thrifts are not. In enacting ILSA, Congress sought to assure that the economic health and stability of the United States and other nations would not be adversely affected by imprudent lending practices or inadequate supervision. A depository institution subject to ILSA must, among other things:

- Establish special reserves necessary to reflect risks of foreign activities; and

- Submit to the appropriate FBA quarterly reports on its foreign country exposure.

The legislative history of ILSA is silent on the international lending activities of thrifts because thrifts were not active in international finance in 1983. While thrifts maintain a predominantly domestic focus—providing credit for housing and other consumer needs within the United States—some thrifts have significant foreign activities. These include investing in foreign currency-denominated CDs, offering foreign currency exchange services, and making loans on the security of foreign real estate or loans to foreign borrowers. In addition, numerous thrift holding companies have international operations (including several foreign-based holding companies) that provide opportunities for expanded international operations by the subsidiary thrift.

While OTS has broad supervisory powers under HOLA to oversee all activities of thrifts, their subsidiaries, and their affiliates, making thrifts subject to ILSA will enhance OTS's ability to carry out its responsibilities under ILSA and promote consistency among the federal regulators in supervising the foreign activities of insured depository institutions.

B. OTS Representation on the Basel Committee

Amending ILSA to support equal representation for OTS on the Basel Committee will enable OTS to share its expertise with respect to residential and consumer lending and interest rate risk. This is an important issue for the United States banking system. OTS is one of the preeminent regulators of residential

mortgage lenders. Giving OTS a recognized voice on Basel will help assure that international bank supervision policies do not inadvertently harm residential lending or impose unintended burdens on thrifts. OTS is particularly skilled at assessing interest rate risk, and this experience will be a valuable addition for all depository institutions. OTS's experience and perspective in regulating diverse holding company structures is another important factor for including it on the Committee.

V. Other OTS Proposals

OTS also recommends enactment of other important regulatory burden relief initiatives. We appreciate the opportunity to work with the Committee's staff on these and other provisions that will be of significant benefit to the thrift industry.

A. Enhancing Examination Flexibility

Current law requires the FBAs to conduct a full-scale, on-site examination for the depository institutions under their jurisdiction at least every 12 months. There is an exception for small institutions that have total assets of less than $250 million and are well-capitalized and well-managed and meet other criteria. Examinations of these small institutions are required at least every 18 months.

When originally enacted in 1991, the small institution examination exception was available to institutions with assets less than $100 million (assuming the other statutory criteria were satisfied). This statutory threshold was raised to $250 million in 1994 for institutions in outstanding condition and meeting the other statutory criteria. In 1996, the FBAs were authorized to extend the $250 million threshold to institutions in good condition. Given the fact that the current threshold has been in place for more than eight years, OTS recommends considering whether the $250 million cap should once again be raised. If so, we believe consideration of a $500 million cap for well-capitalized, well-managed institutions is appropriate.

A large majority of thrifts are well-run institutions that do not require full-fledged annual on-site examinations to assure their safety and soundness. This is also true for the majority of banks. This proposal will reduce regulatory burden on low-risk, small institutions and permit the FBAs to more effectively focus their resources on the highest risk institutions.

B. Modernizing Thrift Community Development Investment Authority

OTS supports updating HOLA to give thrifts the same authority as national banks and state member banks to make investments to promote the public welfare. This proposal enhances the ability of thrifts to contribute to the growth and stability of their communities.

Due to changes made to HUD's Community Development Block Grant (CDBG) program more than 20 years ago, thrift investment opportunities that meet the technical requirements of the statute are rare. OTS has found it cumbersome to promote the spirit and intent of Congress's determination to allow thrifts to make such community development investments. Currently, using its administrative authority, OTS may issue a "no action" letter when a thrift seeks to make a community development investment that satisfies the intent of the existing provision, but does not clearly fall within the wording of the statute or the "safe harbor" criteria issued by OTS for these investments. The no-action process, however, takes time and lacks certainty.

The proposal closely tracks the existing authority for banks. Under the proposal, thrifts may make investments primarily designed to promote the public welfare, directly or indirectly by investing in an entity primarily engaged in making public welfare investments. There is an aggregate limit on investments of 5 percent of a thrift's capital and surplus, or up to 10 percent on an exception basis.

C. Eliminating Geographic and Ownership Limits on Thrift Service Companies

OTS strongly supports legislation authorizing federal thrifts to invest in service companies without regard to the current geographic and ownership restrictions. Current law permits a federal thrift to invest in a service company only if (i) the service company is chartered in the thrift's home state, and (ii) the service company's stock is available for purchase only by thrifts chartered by that state and other federal thrifts having their home offices in that states.

HOLA imposed these restrictions before interstate branching and before technological advances such as Internet and telephone banking, and they no longer serve a useful purpose. This restriction needlessly complicates the ability of thrifts, which often operate in more than one state, to join with thrifts and banks to

obtain services at lower costs due to economies of scale or to engage in other approved activities.

Today, a thrift seeking to make investments through service companies must create an additional corporate layer—known as a second-tier service company—to invest in enterprises located outside the thrift's home state or with a bank. Requiring second-tier service companies serves no rational business purpose, results in unnecessary expense and red tape for federal thrifts and banks, and discourages otherwise worthwhile investments. While this proposal simplifies the ability of banks and thrifts to invest together in service companies, it does not expand the powers of thrifts or banks. The activities of the service company must be permitted by whatever rules govern the activities of the thrift or bank.

D. Authorizing Federal Thrifts to Merge and Consolidate with Their Nondepository Affiliates

OTS favors giving federal thrifts the authority to merge with one or more of their nondepository institution affiliates, equivalent to authority enacted for national banks at the end of 2000.[4] The Bank Merger Act will still apply, and the new authority does not give thrifts the power to engage in new activities.

Under current law, a federal thrift may merge only with another depository institution. This proposal reduces regulatory burden on thrifts by permitting mergers with nondepository affiliates where appropriate for sound business reasons and if otherwise permitted by law. Today, if a thrift wants to acquire the business of an affiliate, it must engage in a series of transactions, such as merging the affiliate into a subsidiary and liquidating the subsidiary into the thrift. Structuring a transaction in this way can be costly. Under the OTS proposal, thrifts may merge with affiliates and continue to have the authority to merge with other depository institutions, but may not merge with other kinds of entities.

E. Streamlining Agency Action under the Bank Merger Act

OTS supports streamlining Bank Merger Act application requirements by eliminating the requirement that each federal banking agency request a competitive factors report from the other three banking agencies and the Attorney General. This means five agencies must consider the competitive effects of every proposed bank or thrift merger. The vast majority of proposed mergers do not raise anti-competitive issues, and these multiple reports, even for those few that do raise issues, are not

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4. Section 6 of the National Bank Consolidation and Merger Act (12 U.S.C. § 215a-3).

necessary. The proposal decreases the number to two, with the Attorney General continuing to be required to consider the competitive factors involved in each merger transaction and the FDIC, as the insurer, receiving notice even where it is not the lead banking agency for the particular merger. This will streamline the review of merger applications while assuring appropriate consideration of all anti-competitive issues.

VI. Other Proposals

OTS also supports several proposals that others have offered for your consideration.

A. Clarification of Citizenship of Federal Thrifts for Federal Court Jurisdiction

A federal thrift may sue or be sued in federal court if the claim exceeds $75,000 and the parties are citizens of different states. This is known as diversity jurisdiction. OTS supports an amendment to clarify that, for purposes of determining diversity jurisdiction, a federal thrift is a citizen only of the state where it has its home office.

Some courts have determined that if a thrift that is organized as a stock corporation conducts a substantial amount of business in more than one state, it is not a citizen of any state and, therefore, it may not sue or be sued in federal court under diversity jurisdiction. This proposal would avoid this result. It would also avoid a potential similar problem with respect to mutual thrifts. The general rule for an unincorporated association is that it is a citizen of every state of which any of its members is a citizen. If a court were to apply this general rule to mutual thrifts, those operating regionally or nationally with depositors across the country would find it difficult or impossible to establish diversity jurisdiction. This proposal will establish a uniform rule governing federal jurisdiction when a thrift is involved and, accordingly, reduce confusion and uncertainty.

B. Removal of Qualified Thrift Lender Requirements with Respect to Out-of-State Branches of Federal Thrifts

OTS also supports removing the requirement that federal thrifts meet the QTL test on a state-by-state basis. This requirement is a superfluous regulatory burden because interstate thrifts may easily structure their activities to assure compliance with the state-by-state requirement. The QTL test should, of course, continue to apply to the institution as a whole.

VII. Agency Continuity -- Creation of Statutory OTS Deputy Directors

OTS urges Congress to authorize the Treasury Secretary to appoint up to four Deputy Directors for OTS to assure agency continuity. This would remove any question about a Deputy Director's authority to perform the functions of the Director during a planned or sudden vacancy in the office of the Director or during the absence or disability of the Director. Especially at this time of national emergency, we should take every possible step to assure the stability of the financial system and the regulatory oversight agencies. For example, uncertainty about the authority of an acting OTS Director should not be allowed to impair our participation in the Financial and Banking Information Infrastructure Committee, the entity charged with coordinating federal and state financial regulatory efforts to improve the reliability and security of the U.S. financial system.

The new authority would be based closely on long-standing authority for appointing Deputy Comptrollers in the Office of the Comptroller of the Currency (OCC).[5] Consistent with the existing OCC legislation, the HOLA amendment would require the Treasury Secretary to make the OTS appointments so each Deputy Director would qualify as an "inferior officer" under the Appointments Clause of the Constitution.

The safety and soundness of the banking system depends on regular, uninterrupted oversight by the federal banking agencies. The reality of the appointments process is that there can be a delay of many months before a sub-cabinet level position is filled, and these delays have grown significantly over the last 20 years. An event resulting in numerous vacancies in the Executive Branch would, of course, exacerbate this problem. In light of these growing, and potentially even greater, delays, it is especially important to establish a statutory chain of command within OTS that will avoid the possibility of gaps in authority

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5. 12 U.S.C. § 4.

to regulate and supervise thrifts, eliminate uncertainty for the thrifts OTS regulates, and avoid future litigation over whether the acts of OTS staff are valid.

OTS is the only financial services sector regulator that could be readily exposed to this vacancy problem. During a vacancy, OTS succession now occurs through the process of the Vacancies Act, which does not ensure an immediate succession when the OTS Director departs and limits the period an acting Director may serve. The organic statutes of the other financial regulators minimize or avoid vacancy problems by providing for automatic and immediate succession or by vesting authority in the remaining members of a board or commission.

VIII. Conclusion

OTS is committed to reducing regulatory burden wherever it has the ability to do so, consistent with safety and soundness and compliance with law. We support proposed legislation that advances this objective. I want to thank you, Mr. Chairman, and the others who have shown leadership on this issue. We look forward to working with the Committee to shape the best possible regulatory burden relief legislation.

August 18, 2000

The Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

As you are aware, on July 13, 2000, the Senate Banking Committee held a markup on S. 2107, The Competitive Market Supervision Act, among other legislation. Although I was unable to attend the markup, I submitted a written statement for the record. I thought you might be interested in seeing a copy of the statement, which I attached for you.

In my written statement, as a co-sponsor of S. 2107, I reiterated my belief of the appropriateness of the legislation and its benefits to Americans. Separately, I commented on the Securities and Exchange Committee's rulemaking initiative to exempt savings associations from the Investment Advisors Act. Savings associations should be provided a level playing field with banks, which historically have been exempt from the Act. Because SEC staff determined that this parity issue may be resolved through rulemaking and agreed to move forward with the rulemaking process, I withheld legislative action at the July 13 markup. I look forward to the SEC's timely resolution of this issue.

If I or my staff may be of assistance in this rulemaking effort or other matters, please do not hesitate to call.

Sincerely,

Evan Bayh

STATEMENT OF SENATOR EVAN BAYH
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
COMPETITIVE MARKET SUPERVISION ACT
SAVINGS ASSOCIATION EXEMPTION FROM THE INVESTMENT ADVISORS ACT
July 13, 2000

One of the bills that is before us today is the Competitive Market Supervision Act. This bill, which I have co-sponsored, does two important things for the people of the United States. First, the bill reduces securities fees for a large number of Americans. These fees, while relatively small, put an unnecessary burden on all investors, including those with retirement funds or pension funds. Second, the bill would provide for pay parity for Securities and Exchange Commission professional employees, by permitting the SEC to bring their pay in line with that of employees of other financial regulatory agencies. The SEC is charged with ensuring that investors receive the highest level consumer protections. This bill would help the SEC to attract – and retain – the best minds to fulfill its obligations to the American people.

On a separate issue, I have become aware of disparate treatment between savings associations and banks under the Investment Advisors Act. This Act exempts banks from its scope but does not exempt savings associations. This differing treatment puts savings associations at a competitive disadvantage, without reason. A similar disparity used to exist under a related law, the Investment Company Act of 1940; however, last year the Gramm-Leach-Bliley Act corrected the discordant treatment.

In the past few months, my staff has had discussions with the Securities and Exchange Commission and industry representatives. The SEC has determined that it has the statutory authority to exempt individual institutions and groups of institutions – including savings associations – from the scope of the Investment Advisors Act. Since the SEC has concluded that this parity issue may be resolved through rulemaking and has agreed to work with the industry to reach such resolution, I withhold legislative involvement. I appreciate their commitment and look forward to their resolution.

For Release Upon Delivery
10:00 a.m., June 22, 2004

TESTIMONY OF

JOHN S. ALLISON

COMMISSIONER OF BANKING & CONSUMER FINANCE

For the

STATE OF MISSISSIPPI

On Behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

of the

UNITED STATES SENATE

June 22, 2004

Mr. Chairman and Members of the Committee, I appreciate this opportunity to appear on behalf of the Conference of State Bank Supervisors to present the views of CSBS on the important issue of regulatory burden as it impacts the nation's banking system.

CSBS is the professional association of state officials who charter, regulate and supervise over 6,300 state-chartered commercial and savings banks, and more than 400 state-licensed foreign banking offices nationwide.

As current chairman of CSBS, I am pleased to represent my colleagues in all 50 states and the U.S. territories.

CSBS gives state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of the state banking system. As supervisors of over 74 percent of the nation's banks, state banking regulators have the closest vantage point when it comes to supervisory issues, as well as issues relating to our state and local economies. We have a unique perspective of how legislation and accompanying regulations impact the banking industry.

While most state-chartered banks fall into the category of community bank, I would like to point out that, as of year-end 2003, 47 of the top 100 banks in the nation were state-chartered, and about 225 state banks operated on an interstate basis. This is testimony to the work that CSBS and the states have done to provide seamless supervision through

coordination, innovation and the dynamic use of technology. We are proud of the role we play in maintaining safety and soundness in all the financial institutions we supervise.

First let me mention that CSBS is very concerned over regulatory actions occurring absent federal legislation that could result in a grave imbalance in the dual banking system.

As of year-end 2003, national banks had approximately 56 percent of the total assets in the banking system. Already since February, when the Office of the Comptroller of the Currency finalized its rule preempting national banks and their operating subsidiaries from state licensing requirements and state consumer protection laws, two large state-chartered banks have announced plans to convert their charters to national banks.

We also understand that several of the largest state-chartered banks are evaluating the potential competitive advantages of the preemption that the OCC has offered. With the announced and predicted conversions, the state system will likely shrink from 44 percent of the banking system's assets to under 33 percent in less then a year. Should many more of the banks with interstate operations switch charters, the state system will suffer.

In a worst-case scenario, should all 47 of the largest state-chartered banks convert to a national charter, total assets in state banks would plummet from 44 percent to 17 percent, severely impacting the viability of the state chartering and supervisory system.

To be clear, without the state chartering system, there would not be community based banks. In recent testimony before the Senate Banking Committee, Federal Reserve Chairman Greenspan referred to the American dual banking system and its support of community banks as a "jewel" of our economy. State bank supervisors see the value of this jewel every day. The preservation of a state bank chartering and regulatory system sets the United States' financial system apart from every other developed nation and is a primary contributor to our nation's diverse, vibrant, resilient and responsive economy.

Why am I raising the Comptroller's actions during a regulatory burden hearing? CSBS believes that without a viable dual banking system, one monolithic, unaccountable, federal regulator sitting in Washington, DC has the potential to dramatically increase regulatory burden for our nation's banking system.

Without a doubt, banks, especially community banks, bear a heavy share of regulatory burden. From our discussions with community banks, that burden is almost exclusively federal law and regulations. As FDIC Vice Chairman Reich points out, since the passage of FIRREA in 1989, federal bank and thrift regulatory agencies have issued 801 new rules. That is an average of one new regulation per week.

As the largest banks are pushing for a purely national set of rules for their evolving multi-state and increasingly retail operations, keep in mind that this regulatory scheme will also impose new requirements on state-chartered banks operating in the majority of states that do not already have similar rules in place. If we are to preserve a system of community

banking, Congress and bank regulators should rethink how these highly complex laws and reams of compliance regulations will apply, or even if they should apply, to smaller community banks.

The most important contribution toward reducing regulatory burden may be empowering the state banking system. The vast majority of innovations in banking products, services and business structures are the product of state banks and the flexibility of the state chartering system. CSBS greatly appreciates the commitment of the Congress to preserve and enhance the ability of the states to respond to customer and business needs. Support of dual federal and state chartering will allow our financial markets to continue to be the world's most vigorous.

Choice in the regulatory environment can have many of the same benefits that it has in the business environment. Knowing that banks have a choice, regulators work smarter and more effectively. The safety and soundness of the financial institutions we regulate is our goal, and it is essential that we have the necessary resources to ensure a healthy banking system. Without the existence of a parallel regulatory system, however, an expensive, inefficient and monolithic regulatory regime could easily develop that would burden and restrict financial institutions, disadvantage them in the marketplace, and create a less healthy banking system. As our founding fathers recognized, we need federalism, not just federal, in our banking system.

With this in mind, there are five provisions that we believe should be considered for any regulatory burden relief legislation that will be introduced in the Senate. Two of the provisions are in the House version of the regulatory relief bill, and three of our recommendations have not been addressed in the House bill.

Coordination of State Examination Authority

CSBS and the state banking departments have developed comprehensive protocols that govern coordinated supervision of state chartered banks that operate branches in more then one state. Through the CSBS Nationwide State Federal Cooperative Agreements, states that charter and regulate state banks work closely with either the FDIC or Federal Reserve and bank commissioners in host states where their bank operates branches to provide quality, risk-focused supervision. To further support these efforts we strongly support including language in a Senate regulatory relief bill that reinforces these principles and protocols that have been in place since 1996.

CSBS supports a provision in H.R. 1375 intended to improve the state system for multi-state state-chartered banks by codifying how state-chartered institutions with branches in more than one state are examined. While giving primacy of supervision to the chartering or home state, this provision, as slightly modified, requires both the home and host state bank supervisor to abide by any written cooperative agreement relating to coordination of exams and joint participation in exams.

In addition, the House bill provides that, unless otherwise permitted by a cooperative agreement, only the home state supervisor may charge state supervisory fees on multi-

state banks. Under this provision, however, the host state supervisor may, with written notice to the home state supervisor, examine the branch for compliance with host state consumer protection laws.

If permitted by a cooperative agreement, or if the out-of-state bank is in a troubled condition, the host state supervisor could participate in the examination of the bank by the home state supervisor to ascertain that branch activities are not conducted in an unsafe or unsound manner. If the host state supervisor determines that a branch is violating host state consumer protection laws, the supervisor may, with written notice to the home state supervisor, undertake enforcement actions. This provision would not limit in any way the authority of federal banking regulators and does not affect state taxation authority.

De Novo Interstate Branching

CSBS supports the provision in the House regulatory relief bill (H.R. 1375) allowing de novo interstate branching for banks and trust companies.

Current Federal law takes an inconsistent approach toward how banks may branch across state lines. While Riegle-Neal gave the appearance that states could control how banks could enter and branch within their borders, this has not always been the reality. In fact, state chartered banks are disproportionally affected by Riegle-Neal provisions that restrict state banks ability to establish de novo branches.

Perhaps because many believed that the federal thrift charter would be eliminated at the

time Riegle-Neal was adopted, the law has never applied to federally-chartered thrifts. The result is that a federal thrift can branch without regard to state law and rules of entry.

And through creative interpretations of the National Bank Act, the Office of the Comptroller of the Currency has circumvented the application of Riegle-Neal to national bank "branch-like" operations.

These interpretations have placed state-chartered institutions, particularly community banks in multistate markets, at a competitive disadvantage to those larger, federally-chartered institutions that can branch without restriction.

We encourage you to revisit the Riegle-Neal Act, and we urge Congress to eliminate the disadvantage has been created for state banks because of inconsistent application of federal law. CSBS appreciates the House action to rationalize the application of interstate branching laws between state and federal charters. We strongly encourage you to address this issue in any regulatory relief measure put forward by the committee.

Regulatory Flexibility for the Federal Reserve

Additionally, we would favor a provision that would give the Federal Reserve more flexibility with regard to state member banks.

In particular, CSBS encourages you to grant the Federal Reserve more flexibility to allow state member banks to engage in expanded activities authorized by their chartering state and approved by the FDIC as posing no significant risk to the deposit insurance fund.

This amendment would remove a provision in the Federal Reserve Act that places unnecessary limitations on the powers of a state member bank, limiting state member banks to the activities allowed for national banks. As state-chartered nonmember banks have always been allowed to exercise expanded powers – within the confines of safety and soundness – it is an appropriate regulatory relief effort to eliminate this prejudicial and unnecessary distinction between state-chartered member banks and state nonmember banks. This provision does away with this arcane restriction, which has no basis in promoting safety and soundness.

As you know, Congress has consistently reaffirmed the states' ability to craft banking charters to fit their economic needs and experiment with new products and services. Congress once again reaffirmed this authority in 1991, when the Federal Deposit Insurance Corporation Improvement Act (FDICIA) allowed states to continue to authorize powers beyond those of national banks.

An empowered state banking system is essential to the evolution of our banking system and elemental to state economic development. This change would help to advance those goals.

Limited Liability Corporations

The states and CSBS have a long history of advocating and facilitating innovations

within the banking industry, including organizational structures available to state-chartered banks.

In that regard, CSBS has strongly supported an FDIC proposal to make federal deposit insurance available to state chartered banks that organize as limited liability companies (LLC). An LLC is a business entity that combines the limited liability of a corporation with the pass-through tax treatment of a partnership.

Through a proposal released for public comment last summer and recently finalized, the FDIC has determined that state banks organized as LLCs are eligible for federal deposit insurance if they meet established criteria designed to insure safety and soundness and limit risk to the deposit insurance fund.

Only a small number of states now allow state-chartered banks to organize as LLCs, including Maine, Nevada, Texas and Vermont. Discussions with state banking agencies, however, indicate that additional states may consider this option in the future.

State banking departments and bankers alike are interested in the LLC operational structure because LLCs offer the same tax advantage (pass-through tax treatment) as Subchapter S corporations, with greater flexibility. LLCs, for example, are not subject to the limits on the number and type of shareholders that apply to a Subchapter S corporation. It remains an open question, however, whether pass-through taxation status for federal income tax purposes will be available to state banks organized as LLCs.

An Internal Revenue Service regulation currently blocks pass-through tax treatment for state-chartered banks. We ask the Committee to encourage the IRS to rethink its interpretation of the tax treatment of state-chartered LLCs.

Federal Financial Institutions Examination Council

CSBS would like to see a state banking regulator have a vote on the Federal Financial Institutions Examination Council. I am currently Chairman of the State Liaison Committee, which consists of state bank, credit union and savings bank regulators, and as such am able to provide input at the FFIEC council meetings. However, neither I, nor any other state regulator, has any final say in federal policy or examination procedures impacting the institutions that we charter and supervise.

Improved coordination and communication between regulators clearly benefit bankers and reduce regulatory burdens. In that spirit, we suggest that Congress could improve the Federal Financial Institutions Examination Council (FFIEC) by changing the state position from one of observer to that of full voting member.

As we have stated previously, State bank supervisors are the chartering authorities for over seventy four percent of the banking industry, and are thus vitally concerned with changes in regulatory policy and procedures.

EGRPRA Recommendations

In addition, CSBS has participated in, and has been very supportive of, the FFIEC's EGRPRA initiative since its kickoff last June. Working with our Bankers Advisory Board, we have identified several issues that deserve Congress's attention. We have attached our comment letter to this testimony to be included in the record.

Conclusion

As you can see, much can be done to reduce regulatory burden for our nation's banks. Yet CSBS recognizes that America has the finest banking system in the world. As regulators, we want the banks we supervise to be successful. After all, they fuel our economy and keep the wheels of commerce turning.

As you consider additional ways to reduce burden on our financial institutions, we urge you to remember that the strength of our banking system is its diversity – the fact that we have enough financial institutions, of enough different sizes and specialties, to meet the needs of the world's most diverse economy and society. While some federal intervention may be necessary to reduce burden, relief measures should allow for further innovation and coordination at both the state and federal levels. Centralizing authority or financial power in one agency, or in a small group of narrowly-regulated institutions, would threaten the dynamic nature of our financial system.

The quest to streamline the regulatory process while preserving the safety and soundness of our nation's financial system is critical to our economic well-being and to the health of our nation's financial institutions. Like you, and like our federal agency counterparts, we at the state level are constantly balancing the public benefits of regulatory actions against their direct and indirect costs. Our most important guide is the fundamental principle of safety and soundness.

We commend this Committee for its efforts in this area. State bank supervisors appreciate the Committee's interest in eliminating barriers in federal law to allow more innovation from the state charter. We thank you for this opportunity to testify on this very important subject, and look forward to any questions you and the members of the Committee might have.

September 15, 2003

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attn: Comments/OES

Re: Economic Growth and Regulatory Paperwork Reduction Act of 1996 Request for Comment (Docket No. 2003-20)

Dear Mr. Feldman:

The Conference of State Bank Supervisors ("CSBS") 1 welcomes the opportunity to respond to the Federal Financial Institution Examination Council's ("FFIEC's") request for comment 2 ("request") on its review of the financial institution regulations to reduce burden imposed on insured depository institutions, as required by section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). We believe it is important to support the goals of materially reducing regulatory burden currently imposed on the financial institution industry. In this regard, we applaud the FFIEC's efforts to reduce and simplify regulations that industry comments indicate are outdated, ineffective, or simply no longer meet the requirements initially enacted by Congress.

The FDIC's Vice Chairman John Reich and his Office have taken the leadership role in this regulatory endeavor. In this role, the Project Manager for the Vice Chairman and the EGRPRA comment and review process, Claude Rollin, has coordinated with CSBS to provide a personal request for comment to several state bank commissioners as well as our Bankers Advisory Board (BAB)3. In that request, Mr. Rollin made it clear that the Vice Chairman's Office is very interested in the industry's comments on reducing regulatory burden. Accordingly, CSBS held a conference call with its BAB to obtain the bulk of the comments contained in this letter. In the future, CSBS may share additional comments with the FFIEC from state bank commissioners, including those who serve

1 CSBS is the professional organization of state officials responsible for chartering, regulating and supervising
the nation's 6,395 state-chartered commercial and savings banks and 419 state-licensed branches and agencies
of foreign banks.
2 68 Fed. Reg. 35589, (June 16, 2003).
3 The CSBS Bankers Advisory Board is the organization's bank membership leadership group, which provides advice and support to the Board of Directors, and serves as a resource to CSBS members and staff throughout the year.

on the FFIEC "State Liaison Committee." We ask that the FFIEC consider all comments to reflect CSBS' view on this extremely important issue.

Background

EGRPRA, passed by Congress in 1996, requires the FFIEC and each appropriate Federal banking agency represented on the FFIEC to conduct a review of all regulations prescribed by the FFIEC or by any such appropriate Federal banking agency to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions. This review must take place at least once every ten years. In conducting the review the FFIEC is required to categorize the regulations and at regular intervals, provide notice and solicit public comment on a particular category or categories of regulations, requesting commentators to identify areas of the regulations that are outdated, unnecessary, or unduly burdensome. The FFIEC will publish the categories for which they are seeking comments twice a year. For this first publication, comments are requested for the following three categories of regulations: Applications and Reporting, Powers and Activities, and International Operations. Accordingly, the FFIEC must complete this review, eliminate unnecessary regulations to the extent that such action is appropriate, and provide an update to Congress no later than 2006.

To encourage full participation in the EGRPRA review, the Vice Chairman's Office has conducted several banker outreach sessions in Orlando, Florida, St. Louis, Missouri, and Denver, Colorado. A state bank commissioner, a CSBS representative, and representatives from all of the other Federal regulatory agencies have participated in all of the outreach sessions.

Industry comments from these outreach sessions have continued to develop a consistent list of regulations that should be reviewed and altered to reduce regulatory burden. The issues most frequently identified by financial institutions as burdensome or outdated include the USA PATRIOT Act, Bank Secrecy Act, Regulation D and the limitations on withdrawals from money market deposit accounts, Home Mortgage Disclosure Act, Expedited Funds Availability Act, Community Reinvestment Act, Truth in Lending Act (with special emphasis on the right of rescission), Privacy notices, and limitations on extending credit to insiders.

CSBS' Bankers Advisory Board Comments

During our conference call with the CSBS Bankers Advisory Board, a member highlighted the importance of the EGRPRA regulatory burden reduction process. This BAB member is the president of a $150-million community bank that employs four to five full time equivalent employees that focus exclusively on compliance. He also noted that non-banking entities do not have such compliance requirements and remarked that

this places his small bank at a competitive disadvantage. CSBS looks forward to working with the Federal banking agencies to reduce regulatory burden where possible.

The BAB conference call coordinated through CSBS uncovered items similar to those identified by industry representatives at the EGRPRA outreach meetings. BAB members provided details that might be of assistance when the FFIEC reviews the amount of burden imposed by these regulations. A summary of their comments and suggestions follows:

Currency Transaction Reports (CTR) and Suspicious Activity Reports (SAR)

• Although it was noted that industry representatives have estimated the cost of each CTR to be $25, that price is likely higher for smaller banks.
• One member of the BAB computed the cost of filing CTRs for his bank, assuming the average $25 per CTR is accurate. His bank generates 240 CTRs a day (approximately 65,000 a year). An average cost of $25 per CTR equates to an annual cost of $1.6 million. Separately, the same bank files about 50 SARs per year. The members of the BAB expressed widespread frustration because it appears that law-enforcement authorities do nothing with CTRs and SARs. One member reported that the FBI has failed to follow up on a SAR submitted two years ago involving a $2.4-million check kiting scheme. Another member of the BAB stated that the FBI has yet to act on a $140,000 note forgery. Law enforcement officials have indicated to both bankers that homeland security matters hinder and prevent investigations such as these. Our members question, if the CTRs are not going to be investigated, why the banks should shoulder such high costs to file them.
• CSBS noted to the BAB members that FinCEN is investigating electronic submissions of CTRs. The bankers, however, noted that their biggest cost involves the research and file-checking that are required to generate CTRs and SARs.
• Furthermore, one of the BAB members noted that banks are required to report on CTRs and SARs, at least in summary form, to their Boards of Directors – another cost item.

USA PATRIOT Act and "Know Your Customer"

• Members of the BAB, especially those in smaller communities, felt the "Know Your Customer" requirements add little value in investigating terrorism.
• When asked about documenting (possibly photocopying) customer identification information to be kept with signature cards, the members felt it would merely be "just another gotcha item" on examiners' checklists. BAB members also expressed concern that maintaining pictures of customers could result in claims of racial bias or profiling.

Limitation of Withdrawals from Money Manager Deposit Accounts

• The members of the BAB felt this limitation is completely outdated. It is anticompetitive to smaller banks that do not have sweep accounts or have to compete with non-bank entities that do not have similar restrictions.

Home Mortgage Disclosure Act (HMDA)

• BAB members believe the small bank threshold for reporting under the Home Mortgage Disclosure Act is no longer realistic. The members suggested increasing the asset threshold to at least $500,000, but $1 or $2 million is more realistic.

• Bankers noted that some holding companies keep a number of charters to stay under the HMDA and CRA asset size.

Community Reinvestment Act (CRA)

• BAB members noted that smaller banks are hardest hit by CRA requirements. It's difficult, if not impossible, for many of the smaller banks to meet the investment criteria.

• One member credited the FDIC as setting a precedent by allowing CRA credit for participation in the Money Smart financial education program. The precedent should be extended to give CRA credit for other good works, such as sponsoring Little League teams and the like.

Expedited Funds Availability

• BAB members agreed that this regulation needs to reviewed. The requirement that funds from cashiers' checks be granted on a next-day basis is generating significant fraud losses due to new technologies that allow scanning and/or color-copies.

Real Estate Settlement Regulations

• BAB members suggest that huge improvements could be made to lessen the regulatory burden in documents required for real estate loan settlement. It was suggested that lessening the amount of disclosure required may assist consumers by allowing them to focus on fewer papers. We have enclosed examples of the settlement documents that one of the BAB members suggested could be eliminated.

• BAB members also suggested that the Truth in Lending Act's right of rescission should be eliminated. Bank customers have complained when they do not receive refinance monies immediately upon loan closing. No bank on the BAB has ever had a right of rescission exercised.

Limitations on Insider Dealings

• For smaller banks, these regulations have the effect of driving their potentially best customers to other institutions. Banks can give preferred loan rates to employees, but not to officers and directors.

• BAB members expressed an interest in having regulators separate insider abuses from

justified preferential treatment for insiders who merit it, as banks can do for employees.

Flood insurance

- FEMA flood maps are often years out of date.
- Generally, flood maps are not changed for 10-12 years, even though action has been taken to change the flood plane. Research, however, to change the 100 year flood plane is costly for banks to consider.
- In those cases where banks attempt to update the flood maps, there are paperwork delays. Examiners criticize banks for making a determination on the flood insurance question until some kind of official paperwork is in the loan file, even though "you know the house is on top of a hill and not going to be flooded," said one BAB member.

Conclusion

CSBS commends the FFIEC's and the FDIC's efforts to review all banking regulations in order to reduce regulatory burden. In conclusion, we would like to highlight that new proposed regulations on identity theft were released following the conference call with our BAB. Such regulations certainly may be necessary to protect consumers against malfeasants taking advantage of changing and updated technologies to commit fraud. As regulations continue to proliferate, however, it is critically important that regulators continually evaluate which regulations may no longer be necessary.

We also note that as the difference between banks, savings associations, credit unions, and investment/ brokerage firms continues to blur, it is important to ensure that financial institutions are not placed at a competitive disadvantage. CSBS further recommends regulators use sunset provisions in regulations. Such provisions would require regulations to be reviewed on a regular basis to ensure the need for the regulation still exists.

CSBS welcomes the opportunity to work with the FFIEC to assist in alleviating outdated an unduly burdensome regulations. Thank you for your consideration, and we invite you to contact CSBS for any additional information or assistance.

Best personal regards,

Neil Milner
President and CEO

Testimony of Roger W. Little
Deputy Commissioner, Credit Unions
Michigan Office of Financial and Insurance Services
On behalf of the
National Association of State Credit Union Supervisors
Before the
Committee of Housing, Banking & Urban Affairs
United States Senate
June 22, 2004

NASCUS History and Purpose

Good morning, Chairman Shelby, and distinguished members of the Committee. I am Roger W. Little, Deputy Commissioner of Credit Unions for the Office of Financial and Insurance Services of the state of Michigan. I appear today on behalf of the National Association of State Credit Union Supervisors. NASCUS represents the 48 state and territorial credit union supervisors and the NASCUS Credit Union Council is composed of more than 600 state-chartered credit unions dedicated to defending the dual chartering system for credit unions.

The mission of the National Association of State Credit Union Supervisors (NASCUS) is to enhance state credit union supervision and regulation and advocate policies to ensure a safe and sound state credit union system. We achieve those goals by serving as an advocate for a dual chartering system that

recognizes the traditional and essential role that state government plays as a part of the national system of depository financial institutions.

NASCUS applauds the Committee's continued commitment to providing ongoing regulatory relief that ensures a safe and sound environment for credit unions and the consumers they serve. We appreciate the opportunity to provide the Committee with our legislative priorities for the regulatory relief package that the Committee is now preparing.

NASCUS supports the amendments to the Federal Credit Union Act (FCUA) that are included in H.R. 1375 which has been favorably passed by the House of Representatives, by a vote of 392 – 25 on March 18, 2004. Those amendments will provide regulatory relief for credit unions, both federal and state, and enhance the value of the credit union charter. NASCUS recognizes that a viable dual chartering system requires credit unions continue to be empowered to serve their members' changing financial needs.

NASCUS Priorities for Regulatory Relief

NASCUS priorities for regulatory relief legislation are focused on the reforms that will strengthen the state system of credit union supervision and enhance the capabilities of state-chartered credit unions to meet the financial needs of their

members while assuring that the state system is operating in a safe and sound manner. Some priorities are contained in H.R. 1375. Other priorities NASCUS supports in this testimony are beyond the scope of H.R. 1375.

Provisions NASCUS Supports in H.R. 1375

NASCUS supports Section 306 in H.R. 1375 revising member business lending restrictions in the Federal Credit Union Act, thus lifting the restrictions on member business lending to nonprofit religious organizations for federally insured, state-chartered credit unions.

This is a win-win for everyone involved. The credit union has the ability to expand its member business offerings and members involved with non-profit religious organizations have greater ability to offer lending products benefiting the entire community.

Additionally, NASCUS supports Section 312 in H.R. 1375 giving all federally insured credit unions the same exemptions as banks and thrift institutions from pre-merger notification requirements and fees of the Federal Trade Commission. In fact, we believe it should be expanded to include all state-chartered credit unions.

Another provision in H.R. 1375 that NASCUS supports is Section 313. This provision provides federally insured credit unions and savings institutions parity of treatment with commercial banks with regard to exemptions from SEC registration requirements that banks were provided in the Gramm-Leach-Bliley Act.

Our major concern is that, unless state-chartered credit unions are accorded the same SEC treatment as commercial banks and savings institutions, the powers granted credit unions by state legislatures and state regulators will be unnecessarily preempted by SEC regulation. Unless appropriate regulatory relief is provided, credit unions offering these services may be subject to redundant and costly examination. We urge that credit unions be accorded similar regulatory treatment in the Senate bill.

Privately-Insured Credit Unions Should Be Eligible to Join Federal Home Loan Banks (FHLBs)

NASCUS supports Section 301 in H.R. 1375 that will permit non-federally insured credit unions to be eligible to join the FHLBs.

At this time, all credit unions do not operate with access to the same benefits. Federally insured credit unions now have access to the FHLBs, while privately-insured credit unions do not have the same access.

Today, there are approximately 375 credit unions that are non-federally insured. All of these credit unions are regulated and examined by state regulatory agencies to assure they are operating in a safe and sound manner. Regulatory functions are a primary determinant of the safety and soundness of the credit union system. The function of the credit union regulator is to assure consumers that their deposits are safe. The credit union regulator performs this mission by:

- issuing rules to assure safe and sound financial practices in credit unions;
- ensuring that violations of those safety and soundness rules are corrected;
- performing safety and soundness examinations of credit unions under their supervision;
- requiring correction of financial and operational deficiencies identified during the examination process; and
- taking enforcement actions to assure that financial remedies are implemented by the credit union (including letters of understanding and agreement, closure of the credit union, etc.).

To protect credit union shareholders both federal and private share insurance systems have been established. To manage and price insurance risk, each share insurer relies significantly on the examination reports of the institution's primary regulator. Most state credit union agencies use the NCUA/AIRES examination platform when they examine state-chartered credit unions for safety and soundness purposes. NASCUS agencies participate in the development and testing of NCUA's examination program and procedures. In short, there is an excellent working relationship and substantially similar examination standards for both federally and state-chartered credit unions.

The private insurers, primarily American Share Insurance in the United States and a cooperative insurance fund in Puerto Rico, have established additional solvency standards to minimize risks in their insured credit unions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established a series of safety and soundness requirements both for entities that offer private deposit insurance to credit unions and for credit unions which would opt for private deposit insurance.

FDICIA also requires that privately insured credit unions must be certified to meet eligibility requirements for federal deposit insurance. Specifically, the Act states that no depository institution which lacks federal deposit insurance may use “the

mails or any instrumentality of interstate commerce to receive or facilitate receiving deposits, *unless* the appropriate supervisor of the State in which the institution is chartered has determined that the institution meets all eligibility requirements for Federal deposit insurance ... ." (Emphasis added) As a practical matter, this requirement applies to every state-chartered, privately insured credit union, as every such credit union uses some instrumentality of interstate commerce or the mails.

FDICIA also spells out the manner and extent to which institutions opting for private deposit insurance are required to fully disclose that their deposits are privately insured.

Therefore, there should be no concern that these credit unions are not operated in a safe and sound manner.

Attached to our testimony is a comparative analysis of the financial performance of federally-chartered, state-chartered federally insured and state-chartered non-federally insured credit unions. The data shows the financial performance and safety and soundness of all three groups of credit unions are substantially equivalent.

Permitting non-federally insured institutions to join the FHLBank system would not establish a new membership principle for the system. More than 50 insurance companies, chartered and regulated by state governments with no federal oversight or insurance, are now members of these Banks. Allowing FHLBank membership to privately-insured credit unions to provide additional opportunities for housing finance would not inflict any new or unusual exposure on the Bank System.

Moreover, an additional layer of financial discipline would be introduced. Each Federal Home Loan Bank has a sophisticated credit screening system to assure that any borrower, federally insured or not, is credit worthy. In addition, every advance is secured by marketable collateral. Indeed, even during the savings and loan debacle, we understand that no Federal Home Loan Bank suffered a loss on advances extended to their members.

In the past, Congress has expanded the membership eligibility for the Bank System as a mechanism to help local financial institutions meet the housing and home ownership needs of their communities. The inclusion of this provision, enabling state-chartered, privately insured credit unions to be eligible to join the FHLBank system, is merely one more step in bringing home ownership opportunities to these credit union members.

We would appreciate your support by including this proposal in the Regulatory Relief legislation and urge the Committee to approve this provision which will help achieve our nation's housing and home ownership goals.

Other NASCUS Legislative Priorities

In addition to provisions NASCUS supports in H.R. 1375, we also support the following priorities outside the scope of H.R. 1375.

Expanding PCA Provision of the Federal Credit Union Act (FCUA)

NASCUS strongly urges the Committee to amend the Prompt Corrective Action (PCA) provision of the FCUA to obligate federally insured credit unions to include all forms of capital when calculating the required net worth ratio. Under the current federal statute, credit union net worth is defined as and limited to retained earnings. This exclusive reliance on retained earnings limits a credit union's ability to implement new programs or expand services that meet the changing needs of its membership.

More importantly, though, the failure to obligate these credit unions to include all forms of capital in their PCA net worth calculation distorts the credit union's actual financial position.

Additionally, NASCUS supports federal legislation that would substitute a risk-based capital concept for the current NCUA federal PCA/net worth requirement. NCUA has indicated their support for a risk-based capital regime for credit unions. In addition, legislation has been introduced in Congress on a bipartisan basis, H.R. 3579, that would reform credit union capital requirements by redefining the net worth ratio to include risk-weighted assets rather than total assets.

NASCUS has studied the risk-based capital reform proposal outlined in H.R. 3579 and supports a risk-weighted capital regime for credit unions. We believe that supplemental capital authority and a risk-based system are complementary capital reforms.

NASCUS also supports amending the definition of net worth to cure the unintended consequences for credit unions of business combination accounting rules the Financial Accounting Standards Board (FASB) intends to apply to combinations of mutual enterprises. The new rules may cause significant dilution of net worth in credit union merger transactions if the definition of net worth continues to be limited solely to retained earnings.

In June 2001, the FASB adopted Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations*, requiring the acquisition method for

business combinations and effectively eliminating the pooling method. The pooling method has typically been used to account for credit union mergers. The standards became effective for combinations initiated after June 30, 2001. Paragraph 60 of the standard deferred the effective date for mutual enterprises (e.g., credit unions) until the FASB could develop purchase method procedures for those combinations. In the interim, credit unions have continued to account for mergers as poolings (simple combination of financial statement components).

The FASB is likely to lift the paragraph 60 deferral of the acquisition method for mutual enterprises, thus eliminating the practice of accounting for credit union mergers as a pooling of interests. The acquisition method would require the valuation of the target credit union at fair value; the recognition of identifiable intangibles (i.e., core deposit intangibles and/or goodwill), when relevant, and the application of a market-based acquisition model to a non-bargained transaction. The retained earnings of the merging institution could no longer be combined with those of the continuing credit union, creating a potentially significant dilution of statutory net worth and an unintended impediment to credit union mergers, thereby resulting in regulatory risk. We urge the committee to support amending net worth to resolve the unintended consequences of FASB's rules. FASB supports such an amendment.

Alternative Capital Authority for Credit Unions

NASCUS supports alternative capital reform beyond the risk-weighted capital and FASB merger fix. The combination of PCA requirements established by Congress for credit unions in 1998 and significant deposit growth has created a financial and regulatory dilemma for many state-chartered credit unions. As noted above, the FCUA defines credit union net worth as retained earnings. The NCUA has determined it lacks the regulatory authority to broaden that net worth definition to include other forms of capital as a part of PCA calculations. Thus, credit unions will require an amendment to the Act to rectify this statutory deficiency.

To continue to meet the financial needs of their members for additional services such as financing home ownership and providing financial education and credit counseling, many state-chartered credit unions will not be able to rely solely on retained earnings to meet the capital base required by PCA standards.

With the economic downturn and the flight to safety from the stock market, credit union member savings are growing rapidly and many credit unions are reporting reduced net worth ratios as earnings retention lags growth in assets.

As a regulator, it makes no business sense to deny credit unions the use of other forms of capital that improve their safety and soundness. We should take every financially feasible step to strengthen the capital base of this nation's credit union system.

Recently, the Filene Research Institute published a study on the feasibility of allowing credit unions to count subordinated debt toward their federal PCA capital requirements. The study was prepared by Professor James A. Wilcox of the Haas School of Business, University of California-Berkeley. He concluded that permitting credit unions to issue subordinate debt, as many state statutes now allow, and count it as a part of net worth would be beneficial for credit unions and would achieve important public policy objectives.

The study, *Subordinated Debt for Credit Unions*, is lengthy and detailed and I will not submit it for the record, but will make copies available for the Committee staff and any Members who would like a copy.

NASCUS understands that permitting other forms of capital to be counted as part of net worth for PCA purposes for federally insured credit unions may be beyond the scope of this regulatory relief package. However, we urge that this Committee consider and approve this revision of the definition of net worth for

credit unions when other omnibus financial institutions legislation is considered by this Committee later in this Congress.

Expanding Business Lending Authority

H.R. 1375 expands business lending authority for federal savings associations. NASCUS urges the Committee to include a similar expansion of credit union member business lending (MBL) authority in the new bill. Raising the statutory basket for such credit union loans from 12.25% to 20% of total assets, as the House bill provides for savings institutions, would provide equivalent regulatory relief for credit unions. We also urge that the statutory definition of a credit union MBL be changed from the current $50,000 limit contained in the FCUA. One approach to achieve this purpose would be to redefine credit union MBLs as those that exceed the Fannie/Freddie conforming loan limit, approximately $322,000, a safe and sound, well established and readily understandable index that has served lenders and the public interest well for many years.

Federal Preemption of State Regulation of Consumer Protection Practices

Lastly, as credit union regulators, we have a significant stake in the growing controversy between the Office of the Comptroller of the Currency (OCC) and the National Governors' Association, the National Association of Attorney's General,

the Conference of State Bank Supervisors, the National Conference of State Legislatures and others over the issue of expanding federal preemptions of state laws and regulations.

As a matter of policy NASCUS does not take public positions on issues that only affect the commercial banking industry, but we are concerned about the contagion impact on the credit union dual chartering system if the powers of the state banking regulators were significantly curtailed by these actions of the OCC.

Recent regulations of the OCC will have a broad impact on the dual chartering system for commercial banks and could open the door to similar actions by the federal credit union regulator, the National Credit Union Administration (NCUA), unless Congress intervenes to rein in additional federal preemption powers that the OCC now intends to implement.

Determining the extent to which such additional federal banking powers should be granted by the OCC is an important matter for those who support the dual chartering system for all depository institutions. The importance of this matter dictates that the Congress should resolve these conflicts rather than delegate this fundamental issue to the federal financial institution regulators to determine.

The states, through the dual chartering system, have long served as “laboratories for experimentation” in the financial services business. State governments have pioneered in providing depository institutions new powers that enhance the earnings of those financial institutions and provide consumers innovative new financial services. Later, after a period of experimentation in the state sector, such new powers often were granted to federal financial institutions either by statute or regulation.

In the case of credit unions, almost all innovations in new powers were initiated by the states, and later imitated by the federal credit union regulator after successful experience in the state sector. In this way, the dual chartering system for both commercial banks and credit unions has provided our economy with two very effective financial engines that drive our nation's economic change and growth. We all applaud these dynamic results of the dual chartering system for depository institutions.

But now, when the issue becomes one of consumer protection, some are demanding that the federal banking authorities preempt state consumer protection initiatives in the name of establishing an exclusive national standard for regulating almost all aspects of consumer lending practices.

Historically, states have established predatory lending and other consumer protection statutes that are applicable to both state and federal depository institutions. In general, the rule has been that national banks are subject to such state statues to ensure the same level of protection for citizens of the state opting to use the services of a federally-chartered financial institution.

NASCUS is not comfortable with such federal rulemaking. What the OCC has adopted would override state law and concentrate regulatory power at the federal level. The Governors similarly oppose these rules. The National Conference of State Legislatures has expressed its concerns about the impact of these rules on state law. The Conference of State Bank Supervisors has opposed these rules. Consumer groups have opposed federal preemptions that would vitiate hard won victories in state legislatures that provide additional protection to all consumer borrowers in their states.

Given the widespread, significant and expert opposition to these federal rules, we encourage Congress to intervene and block such precipitous federal actions. Congress should decide if these proposals are consistent with the Riegle-Neal Act which protects state laws regulating activities of commercial banks in several specific areas, or decide to overturn the Riegle-Neal principles on the application of federal and state law to the commercial banking industry.

Conclusion

In conclusion NASCUS strongly supports the following issues for regulatory relief:

- NASCUS supports Section 301 in H.R. 1375 that will permit non-federally insured credit unions to be eligible to join the Federal Home Loan Banks.

- NASCUS supports Section 306 in H.R. 1375 revising member business lending restrictions in the Federal Credit Union Act, thus lifting the restrictions on member business lending for federally insured, state-chartered credit unions.

- NASCUS supports Section 312 in H.R. 1375 giving all federally insured credit unions the same exemptions as banks and thrift institutions from pre-merger notification requirements and fees of the Federal Trade Commission. In fact, we believe it should be expanded to include all state-charted credit unions.

- H.R. 1375 provides regulatory relief to savings associations and credit unions with regard to SEC broker/dealer registration and investment

advisor requirements. We urge that credit unions be accorded the similar regulatory relief treatment in the Senate bill.

- NASCUS urges the Committee to amend the PCA provision of the FCUA to obligate federally insured credit unions to include all forms of capital when calculating the required net worth ratio.

- NASCUS supports federal legislation that would substitute a risk-based capital concept for the current NCUA federal PCA/net worth requirement.

- NASCUS supports amending the definition of net worth to cure the unintended consequences for credit unions of business combination accounting rules FASB intends to apply to combinations of mutual enterprises.

- Raise the statutory definition of a credit union MBLs from 12.25% to 20% of total assets, as the House bill provides for savings institutions, providing equivalent regulatory relief for credit unions.

- We encourage Congress to intervene to block continuing OCC preemption of state laws.

NASCUS appreciates the opportunity to testify today on the pending regulatory relief legislation and we welcome further participation in the discussion and deliberation. We urge this Committee to protect and enhance the viability of the dual chartering system for credit unions by acting favorably on the provisions we have discussed in our testimony.

Competitive Analysis
Credit Unions
As of March 31, 2004

	SCU	PISCU	FCU
Member Growth*	.65%	1.63%	.43%
Share Growth*	2.68%	4.73%	3.03%
Loan Growth*	1.28%	1.73%	.90%
Delinquency	.69%	.66%	.68%
Loans/Shares	71.92%	65.43%	68.16%
Loans/Assets	62.40%	58.07%	59.01%
Return on Assets**	.87%	.95%	.93%
Net Worth	**10.56%**	**10.66%**	**10.71%**

* = First Quarter Only
** = Annualized Data

SCU—State-Chartered Credit Unions
PISCU—Privately Insured, State-Chartered Credit Unions
FCU—Federally Insured Credit Unions

SCU and FCU data are derived from call reports from all federally insured CUs.

PISCU information is derived from American Share Insurance.

Testimony of

America's Community Bankers

on

Consideration of Regulatory Reform Proposals

before the

Committee on Banking, Housing and Urban Affairs

of the

United States Senate

on

June 22, 2004

Mark E. Macomber
President and CEO
Litchfield Bancorp
Litchfield, Connecticut

and

Member, Board of Directors
Chairman, Committee on Mutual Institutions
Member, Government Affairs Steering Committee
America's Community Bankers
Washington, DC

Chairman Shelby, Senator Sarbanes and Members of the Committee, I am Mark Macomber, President and CEO of Litchfield Bancorp in Litchfield, Connecticut. Litchfield Bancorp is a $162 million state chartered community bank, part of a two bank mutual holding company.

I am here this morning representing America's Community Bankers. I serve on ACB's Board of Directors and Executive Committee and am Chairman of the Mutual Institutions Committee. I want to thank Chairman Shelby and Senator Crapo for their leadership in initiating the discussion today of the impact of outdated and unnecessary regulations on community banks and the communities they serve.

ACB is pleased to have this opportunity to discuss with the committee recommendations to reduce the regulatory burden and red tape on community banks. When unnecessary and costly regulation is removed, community banks will be able to better serve consumers and small businesses in their local markets. ACB has a long-standing position in support of reduction of regulatory burden. Community banks operate under a regulatory scheme that becomes more and more burdensome every year.

Community banks today are subject to a host of laws, some over a half-century old, which were originally enacted to address concerns that no longer exist. These laws stifle innovation in the banking industry and put up needless roadblocks to competition without contributing to the safety and soundness of the banking system. The burden of these laws results in lost business opportunities for community banks. But, consumers

and businesses also suffer because their choices among financial institutions and financial products are more limited as a result of these laws, and, in the end, less competition means consumers and businesses pay more for these services.

In addition to the regulations imposed on community banks to ensure safe and sound operation of the bank and to protect the deposit insurance fund, we must comply with an array of consumer compliance regulations, anti-money laundering regulations and new corporate governance standards enacted in the Sarbanes-Oxley Act. As a community banker, I understand the importance of reasonable consumer protection regulations, and I understand the importance of tracking and eliminating terrorist financing mechanisms and also of having a strong corporate governance system in place. As a community banker, I see how much it costs, both financially and in numbers of staff hours for my small mutual community bank to comply with these laws. As a community banker, I see projects that will not get funded, products not offered and consumers not served because I have had to make a large resource commitment to comply with the same regulations with which banks thousands of times larger must comply.

This hearing and this topic are important and timely. Ten years ago there were 12,000 banks in the US. Today, there are only 9,000 of us left. ACB is concerned that community banks are unable to compete with financial services conglomerates and unregulated companies because of the cost of regulation. Community banks are at the heart of cities and towns everywhere and to lose that segment of the industry because of over regulation would be a shame.

Now let me turn to the subject of today's hearing. ACB has a number of recommendations to reduce regulations on community banks that will help make doing business easier and less costly, further enabling community banks to help their communities prosper and create jobs. ACB's specific legislative proposals are attached in an appendix. The House of Representatives adopted many of ACB's recommendations in the Financial Services Regulatory Relief Act of 2003 (H.R. 1375), by an overwhelming bipartisan vote of 392 to 25.

Priority Issues

Expanded Business Lending

A high priority for ACB is a modest increase in the business-lending limit for savings associations. In 1996, Congress liberalized the commercial lending authority for federally chartered savings associations by adding a 10 percent "bucket" for small business loans to the 10 percent limit on commercial loans. Today, savings associations are increasingly important providers of small business credit in communities throughout the country. As a result, even the "10 plus 10" limit poses a constraint for an ever-increasing number of institutions. Expanded authority would enable savings associations to make more loans to small- and medium-sized businesses, thereby enhancing their role as community-based lenders. An increase in commercial lending authority would help increase small business access to credit, particularly in smaller communities where the

number of financial institutions is limited. To accommodate this need, ACB supports eliminating the lending limit restriction on small business loans while increasing the aggregate lending limit on other commercial loans to 20 percent. Under ACB's proposal, these changes would be made without altering the requirement that 65 percent of an association's assets be maintained in assets required by the qualified thrift lender test.

Parity Under the Securities Exchange Act and Investment Advisers Act

ACB vigorously supports providing parity for savings associations with banks under the Securities Exchange Act and Investment Advisers Act. Statutory parity will ensure that savings associations and banks are under the same basic regulatory requirements when they are engaged in identical trust, brokerage and other activities that are permitted by law. As more savings associations engage in trust activities, there is no substantive reason to subject them to different requirements. They should be subject to the same regulatory conditions as banks engaged in the same services. The Securities and Exchange Commission has issued a proposal that would not grant parity for savings associations. We do not believe that the regulatory proposal is adequate and believe that a legislative change is necessary.

The Securities and Exchange Commission has already recognized that it is appropriate to treat banks and savings associations the same under these acts by proposing regulations that provide parity for certain of the exemptions from broker dealer registration under the Securities Exchange Act. ACB supports a legislative change. Such

a change will ensure that savings associations will have the same flexibility as banks to develop future products and offer services that meet customers' needs.

Easing Restrictions on Interstate Banking and Branching

ACB strongly supports removing unnecessary restrictions on the ability of national and state banks to engage in interstate branching. Currently, national and state banks may only engage in de novo interstate branching if state law expressly permits. ACB recommends eliminating this restriction. The law also should clearly provide that state-chartered Federal Reserve member banks may establish de novo interstate branches under the same terms and conditions applicable to national banks. ACB recommends that Congress eliminate states' authority to prohibit an out-of-state bank or bank holding company from acquiring an in-state bank that has not existed for at least five years. The new branching rights should not be available to newly acquired or chartered industrial loan companies with commercial parents (those that derive more than 15 percent of revenues from non-financial activities).

Other Important Issues

Streamlined CRA Examinations

ACB strongly supports amending the Community Reinvestment Act to allow community banks with less than $1 billion dollars in assets to participate in the CRA's small institution examination program. According to a report by the Congressional Research Service, a community bank participating in the streamlined CRA exam can save 40 percent in compliance costs. Expanding the small institution exam program will free up capital and other resources for almost 1,700 community banks across our nation that are in the $250 million to $1 billion asset-size range, allowing them to invest even more into their local communities.

Interest on Business Checking

Prohibiting banks from paying interest on business checking accounts is long outdated, unnecessary and anti-competitive. Restrictions on these accounts make community banks less competitive in their ability to serve the financial needs of many business customers. Permitting banks and savings institutions to pay interest directly on demand accounts would be simpler. Institutions would benefit by not having to spend time and resources trying to get around the existing prohibition. This would benefit many community depository institutions that cannot currently afford to set up complex sweep operations for their – mostly small – business customers.

In this Congress, ACB supported two pieces of legislation, adopted by the House of Representatives, that would repeal the Depression-era ban: H.R. 758, the Business Checking Freedom Act of 2003, and Title VII of H.R. 1375, the Business Checking Freedom Act of 2004. ACB urges the Senate to adopt this legislation either as part of a broader regulatory relief package or as a stand-alone bill.

Eliminating Unnecessary Branch Applications

A logical counterpart to proposals to streamline branching and merger procedures would be to eliminate unnecessary paperwork for well-capitalized banks seeking to open new branches. National banks, state-chartered banks, and savings associations are each required to apply and await regulatory approval before opening new branches. This process unnecessarily delays institutions' plans to increase competitive options and increase services to consumers, while serving no important public policy goal. In fact, these requirements are an outdated holdover from the times when regulatory agencies spent unnecessary time and effort to determine whether a new branch would serve the "convenience and needs" of the community.

Coordination of State Examination Authority

ACB supports the adoption of legislation clarifying the examination authority over state-chartered banks operating on an interstate basis. ACB recommends that Congress

clarify home- and host-state authority for state-chartered banks operating on an interstate basis. This would reduce the regulatory burden on those banks by making clear that a chartering state bank supervisor is the principal state point of contact for safety and soundness supervision and how supervisory fees may be assessed. These reforms will reduce regulatory costs for smaller institutions.

Limits on Commercial Real Estate Loans

ACB recommends increasing the limit on commercial real estate loans, which applies to savings associations, from 400 to 500 percent of capital, and giving the OTS flexibility to increase that limit. Institutions with expertise in non-residential real property lending and which have the ability to operate in a safe and sound manner should be granted increased flexibility. Congress could direct the OTS to establish practical guidelines for non-residential real property lending that exceeds 500 percent of capital.

Loans to One Borrower

ACB recommends eliminating the $500,000-per-unit limit in the residential housing development provision in the loans-to-one-borrower section of the Home Owners' Loan Act. This limit frustrates the goal of advancing residential development within the statute's overall limit – the lesser of $30 million or 30 percent of capital. This overall limit is sufficient to prevent concentrated lending to one borrower/housing developer.

The per-unit limit is an excessive regulatory detail that creates an artificial market restriction in high-cost areas.

Home Office Citizenship

ACB recommends that Congress amend the Home Owners' Loan Act to provide that for purposes of jurisdiction in federal courts, a federal savings association is deemed to be a citizen of the State in which it has its home office. Federal law already provides that all national banks are deemed citizens of the states in which they are located for jurisdictional purposes. (28 U.S.C. 1348) No similar provision exists for federal savings associations. For purposes of obtaining diversity jurisdiction in federal court, the courts have found that a federal savings association is considered a citizen of the state in which it is located only if the association's business is localized in one State. If a Federal savings association has interstate operations, a court may find that the federally chartered corporation is not a citizen of any state, and therefore no diversity of citizenship can exist. The amendment would provide certainty in designating the state of their citizenship.

Interstate Acquisitions

ACB supports the adoption of legislation to permit multiple savings and loan holding companies to acquire associations in other states under the same rules that apply to bank holding companies under the Riegle-Neal Interstate Banking and Branching

Efficiency Act of 1994. This would eliminate restrictions in current law that prohibit (with certain exceptions) a savings and loan holding company from acquiring a savings association if that would cause the holding company to become a multiple savings and loan holding company controlling savings associations in more than one state.

Application of QTL to Multi-State Operations

ACB supports legislation to eliminate state-by-state application of the QTL test. This better reflects the business operations of savings associations operating in more than one state.

Applying International Lending Supervision Act to OTS

ACB recommends that the ILSA be amended to clarify that the ILSA covers savings associations. Such a provision would benefit OTS-regulated savings associations operating in foreign countries by assisting the OTS in becoming recognized as a consolidated supervisor, and it would promote consistency among the federal banking regulators in supervising the foreign activities of insured depository institutions.

OTS Representation on Basel Committee on Banking Supervision

ACB recommends another amendment to the ILSA that would add OTS to the multi-agency committee that represents the United States before the Basel Committee on Banking Supervision. Savings associations and other housing lenders would benefit by having the perspective of the OTS represented during the Basel Committee's deliberation.

Parity for Savings Associations Acting as Agents for Affiliated Depository Institutions

ACB recommends that the Federal Deposit Insurance Act be amended to give savings associations parity with banks to act as agents for affiliated depository institutions. This change will allow more consumers to access banking services when they are away from home.

Inflation Adjustment under the Depository Institution Management Interlocks Act

ACB supports increasing the exemption for small depository institutions under the DIMA from $20 million to $100 million. This will make it easier for smaller institutions to recruit high quality directors. The original $20 million level was set a number of years ago and is overdue for an adjustment.

Reducing Debt Collection Burden

Under the Fair Debt Collection Practices Act, a debtor has 30 days in which to dispute a debt. ACB supports legislation that makes clear that a debt collector need not stop collection efforts for that 30-day period while the debtor decides whether or not to dispute the debt. This removes an ambiguity that has come up in some instances. If a collector has to cease action for 30 days, valuable assets, which may be sufficient to satisfy the debt, may vanish during the 30-day period.

Mortgage Servicing Clarification

The FDCPA requires a debt collector to issue a "mini-Miranda" warning when it begins to attempt to collect a debt. This alerts the borrower that his debt has been turned over to a debt collector. However, the requirement also applies in cases where a mortgage servicer purchases a pool of mortgages that include delinquent loans. While the mini-Miranda warnings are clearly appropriate for true third party debt collection activities, they are not appropriate for mortgage servicers who will have an ongoing relationship with the borrower.

ACB urges the adoption of legislation to exempt mortgage servicers from the mini-Miranda requirements. The proposed exemption (based on H.R. 314, the Mortgage Servicing Clarification Act) is narrowly drawn and would apply only to first lien mortgages acquired by a mortgage servicer for whom the collection of delinquent debts is

incidental to its primary function of servicing current mortgages. The exemption is narrower than one recommended by the FTC for mortgage servicers. The amendment would not exempt mortgage servicers from any other requirement of the FDCPA.

Repealing Overlapping Rules for Purchased Mortgage Servicing Rights

ACB supports eliminating the 90-percent-of-fair-value cap on valuation of purchased mortgage servicing rights. ACB's proposal would permit savings associations to value purchased mortgage servicing rights, for purposes of certain capital and leverage requirements, at more than 90 percent of fair market value – up to 100 percent – if the federal banking agencies jointly find that doing so would not have an adverse effect on the insurance funds or the safety and soundness of insured institutions.

Loans to Executive Officers

ACB recommends legislation that eliminates the special regulatory $100,000 lending limit on loans to executive officers. The limit applies only to executive officers for "other purpose" loans, i.e., those other than housing, education, and certain secured loans. This would conform the law to the current requirement for all other officers, i.e., directors and principal shareholders, who are simply subject to the loans-to-one-borrower limit. ACB believes that this limit is sufficient to maintain safety and soundness.

Decriminalizing RESPA

ACB recommends striking the imprisonment sanction for violations of RESPA. It is highly unusual for consumer protection statutes of this type to carry the possibility of imprisonment. Under the ACB's proposal, the possibility of a $10,000 fine would remain in the law, which would provide adequate deterrence.

Bank Service Company Investments

Present federal law stands as a barrier to a savings association customer of a Bank Service Company from becoming an investor in that BSC. A savings association cannot participate in the BSC on an equal footing with banks who are both customers and owners of the BSC. Likewise, present law blocks a bank customer of a thrift service corporation from investing in the savings association service corporation.

ACB proposes legislation that would provide parallel investment ability for banks and thrifts to participate in both BSCs and savings association service corporations. ACB's proposal preserves existing activity limits and maximum investment rules and makes no change in the roles of the federal regulatory agencies with respect to subsidiary activities of the institutions under their primary jurisdiction. Federal savings associations thus would need to apply only to OTS to invest.

Eliminating Savings Association Service Company Geographic Restrictions

Currently, savings associations may only invest in savings association service companies in their home state. ACB supports legislation that would permit savings associations to invest in those companies without regard to the current geographic restrictions.

Streamlining Subsidiary Notifications

ACB recommends that Congress eliminate the unnecessary requirement that a state savings association notify the FDIC before establishing or acquiring a subsidiary or engaging in a new activity through a subsidiary. Under ACB's proposal, a savings association would still be required to notify the OTS, providing sufficient regulatory oversight.

Authorizing Additional Community Development Activities

Federal savings associations cannot now invest directly in community development corporations, and must do so through a service corporation. National banks and state member banks are permitted to make these investments directly. Because many savings associations do not have a service corporation and choose for other business reasons not to establish one, they are not able to invest in CDCs.

ACB supports legislation to extend CDC investment authority to federal savings associations under the same terms as currently apply to national banks.

Eliminating Dividend Notice Requirement

Current law requires a savings association subsidiary of a savings and loan holding company to give the OTS 30 days' advance notice of the declaration of any dividend. ACB supports the elimination of the requirement for well-capitalized associations that would remain well capitalized after they pay the dividend. Under this approach, these institutions could conduct routine business without regularly conferring with the OTS. Those institutions that are not well capitalized would be required to pre-notify the OTS of dividend payments.

Reimbursement for the Production of Records

ACB's members have long supported the ability of law enforcement officials to obtain bank records for legitimate law enforcement purposes. In the Right to Financial Privacy Act of 1978, Congress recognized that it is appropriate for the government to reimburse financial institutions for the cost of producing those records. However, that act provided for reimbursement only for producing records of individuals and partnerships of five or fewer individuals. Given the increased demand for corporate records, such as records of organizations that are allegedly fronts for terrorist financing, ACB

recommends that Congress broaden the RFPA reimbursement language to cover corporate and other organization records.

ACB also recommends that Congress clarify that the RFPA reimbursement system applies to records provided under the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (title III of the USA PATRIOT Act). Because financial institutions will be providing additional records under the authority of this new act, it is important to clarify this issue.

Extending Divestiture Period

ACB recommends that unitary savings and loan holding companies that become multiple savings and loan holding companies be provided 10 years to divest non-conforming activities, rather than the current two-year period. This would be consistent with the time granted to new financial services holding companies for similar divestiture under the Gramm-Leach-Bliley Act. The longer time gives these companies time to conform to the law without forcing a fire-sale divestiture.

Restrictions on Auto Loan Investments

Federal savings associations are currently limited in making auto loans to 35 percent of total assets. ACB recommends eliminating this restriction. Removing this

limitation will expand consumer choice by allowing savings associations to allocate additional capacity to this important segment of the lending market.

Credit Card Savings Associations

Under current law, a savings and loan holding company cannot own a credit card savings association and still be exempt from the activity restrictions imposed on companies that control multiple savings associations. However, a savings and loan holding company could charter a credit card institution as a national or state bank and still be exempt from the activity restrictions imposed on multiple savings and loan holding companies. ACB proposes that the Home Owners' Loan Act be amended to permit a savings and loan holding company to charter a credit card savings association and still maintain its exempt status. Under this proposal, a company could take advantage of the efficiencies of having its regulator be the same as the credit card institution's regulator.

Protection of Information Provided to Banking Agencies

Recent court decisions have created ambiguity about the privileged status of information provided by depository institutions to bank supervisors. ACB recommends the adoption of legislation that makes clear that when a depository institution submits information to a bank regulator as part of the supervisory process, the depository institution has not waived any privilege it may claim with respect to that information. Such legislation would facilitate the free flow of information between banking regulators

and depository institutions that is needed to maintain the safety and soundness of our banking system.

Conclusion

I wish to again express ACB's appreciation for your invitation to testify on the importance of reducing regulatory burdens and costs for community banks. We strongly support the Committee's efforts in providing regulatory relief, and look forward to working with you and your staff in crafting legislation to accomplish this goal.

STATEMENT OF

EDWARD PINTO

LENDERS RESIDENTIAL ASSET COMPANY LLC

Subject:	Interest on Business Checking
Before:	Senate Banking Committee
Date:	June 22, 2004

Good Morning. I'm Ed Pinto, president of Lenders Residential Asset Company LLC in Bethesda, MD. Thank you, Chairman Shelby and Ranking Member Sarbanes, a fellow resident of the great state of Maryland, for giving me the opportunity to testify on behalf of the National Federation of Independent Business regarding interest bearing checking accounts for small businesses.

In preparing for this testimony I was reminded of a story. Many years ago a hallway was being painted in the Pentagon. After the fifth passerby could not resist checking to see if the paint was still wet, the captain posted an MP at either end to guard the hallway. Many years later, a professor of mine was teaching a class on management at the Pentagon. He asked each participant to go out and find an example of inefficiency. One lieutenant called the professor to say he could not find any example. The professor asked what was the closest object and he responded "the MP". "Well go ask him what he is doing." He did and got the response "I'm guarding the hall." "Why?" To make sure no one touches the wet paint.

Does anyone remember why Congress prohibited the payment of interest on business accounts?

I commend the Committee for conducting this hearing on Regulatory Reform. Eighty-six percent of NFIB members support allowing business owners to earn interest on their business checking account balances. During this Congress, the House has already passed legislation overturning the archaic law that prohibits interest on business checking accounts - once by voice vote and once by a vote of 418-0! S. 1967, introduced by Sen. Hagel and Sen. Snowe, repeals a law dating back to the Great Depression that prevents small-business owners from earning interest on their business accounts, but the bill continues to be stalled for reasons I can't

understand. The big banks have consistently opposed repealing the ban on interest checking, and have proposed compromise legislation that would delay implementation of the repeal by three or more years. Their efforts to insulate themselves from free-market competition have hurt small businesses, the job creation engines of this country. This consumer protection legislation is much needed, and every day it is delayed is an injustice to our members. The House-passed bill, as currently written with a two-year delay, is already a compromise, and NFIB strongly urges the Committee to resist efforts to further lengthen the phase-in period.

Lenders Residential Asset Company, which I founded in 1989, provides consulting services to the financial services industry.

When the company was started, I can recall my astonishment at being told that a business can't earn interest on a checking account. I was further astonished to find that my business account not only didn't pay interest, it came with a plethora of fees! My banker said not to worry, and introduced me to the spellbinding concept of compensating balances. Boy, was I in for an education, and one that had nothing to do with running my business. I remember thinking that all of this seemed quite foreign and not exactly consumer-friendly. I had been earning interest for years on my personal checking account, which had a much smaller balance. I recall asking my banker, "Why no interest?" I was told simply that it was against the law.

Later, as the business prospered, my banker suggested that I set up what my bank called a "sweep account" -- which, she told me, did not have the benefit of FDIC insurance, but did pay interest. And so, that's what we did. But, was it complicated. First, we analyzed my account history to determine how much to keep in my regular account (my second encounter with compensating balances) so as to "earn" enough to avoid incurring fees on my regular checking account. Next we had to project what would be earned in interest and compare that to the

additional fees incurred to administer my new sweep account. Then I had to authorize an amount to be swept each night. Here I had a choice: I could either call each afternoon to authorize the transfer or I could set a floor amount and automatically sweep all funds in excess of that amount. Not being a gluten for punishment, I selected the automatic option. After this exercise, I barely remembered what business I was in. But that was just the beginning.

As any new business owner will tell you, there are a lot better ways to spend your time than calling your banker everyday. But small business owners, by our nature, break out in hives at the thought of money sitting in a banking account not earning interest.

What I didn't know was that a sweep account is really designed for larger company with an in-house accounting and financial staff to keep up with the flow of money from account-to-account. For the small-business owner with a business to run, it can be a paperwork nightmare. We soon found that the sweep account, while addressing the non-interest bearing account issue, resulted in a flood of paper from the bank. Each day we receive a reconciliation statement letting us know how the money had been shifted around in the past 24 hours. And because this is done via the mail, there is always a two-to-three day delay in the information flow so we never have an accurate, up-to-the minute view of the flow of funds among our banking accounts. Of course, the mail piled up unopened at the rate of 250 letters per year. To add insult to injury, I now knew why the sweep account fees were so high.

Don't get me wrong. I am not arguing against sweep accounts. But they are a bookkeeping hassle for a small business that would rather have their bookkeeping and accounting staff focused on managing payables and receivables than in keeping up with a flood of paperwork pouring out of the bank.

For obvious reasons the make-work nature of the sweep account ended up significantly

reducing our interest earnings. And if you consider the allocation of staff time to handling the paperwork and the lack of oversight caused by the sweep solution, I could argue that we would have been much better off leaving the funds in a non-interest-bearing account - which is what many small-business owners do - a fact that restricts much-needed capital from those who need it most.

I know that there are many simpler non-bank alternatives to this crazy system. And so, while I have continued to work with a traditional banking institution (without a sweep account I might add), it makes little sense to me why it is continued. It would appear to me that even the banks who, on the surface, may seem to benefit from not paying interest, are running off some of their small-business customers by continuing to defend this archaic practice. I challenge anyone to present a justification for a result that can only be cited as prime example of the law of unintended consequences run amok. What we have today is an archaic law running headlong into the creativity of the free-market, with the inefficient result being to no one's liking.

I support giving banks at least the choice to offer interest-bearing accounts to small-business owners. I urge this Committee to consider this bipartisan effort and to resist efforts to further lengthen the phase-in period of this important legislation. The time is now for the Senate to act. Thank you for allowing me to express my views before the committee.

Competitive Analysis
Credit Unions
As of March 31, 2004

	SCU	PISCU	FCU
Member Growth*	.65%	1.63%	.43%
Share Growth*	2.68%	4.73%	3.03%
Loan Growth*	1.28%	1.73%	.90%
Delinquency	.69%	.66%	.68%
Loans/Shares	71.92%	65.43%	68.16%
Loans/Assets	62.40%	58.07%	59.01%
Return on Assets**	.87%	.95%	.93%
Net Worth	10.56%	10.66%	10.71%

* = First Quarter Only
** = Annualized Data

Testimony of

INDEPENDENT COMMUNITY BANKERS OF AMERICA

on

"Consideration of Regulatory Reform Proposals"

before

United States Senate
Committee on Banking, Housing and Urban Affairs

June 22, 2004

Dale Leighty
President and Chairman
First National Bank of Las Animas
Las Animas, Colorado

and

Chairman
Independent Community Bankers of America
Washington, D.C.

Mr. Chairman, Ranking member Sarbanes, and members of the Committee, my name is Dale Leighty. I am Chairman of the Independent Community Bankers of America (ICBA)[1] and President and Chairman of First National Bank of Las Animas, a $140 million-in-assets community bank located in Las Animas, Colorado.

I would like to thank you for examining the important issue of regulatory burden relief. This is one of ICBA's top priorities, and I am pleased to testify today on behalf of our nearly 5,000 community bank members to share with you their views and concerns.

Regulation Disproportionately Burdens Community Banks and Impacts Their Communities

ICBA supports a bank regulatory system that fosters the safety and soundness of our nation's banking system. However, statutory and regulatory changes continually increase the cumulative regulatory burden for community banks. In the last few years alone, community banks have been saddled with the privacy rules of the Gramm-Leach-Bliley Act; the customer identification rules and anti-money laundering/anti-terrorist financing provisions of the USA-PATRIOT Act; and the accounting, auditing and corporate governance reforms of the Sarbanes-Oxley Act.

Yet relief from any regulatory or compliance obligation comes all too infrequently. New ones just keep being added. There is not any one regulation that community banks are unable to comply with—it is the cumulative effect of all the regulations that is so burdensome. As ICBA President and CEO, Cam Fine recently stated, "Regulations are like snowflakes. Each one by itself may not be much but when you add it all up, it could crush the building."

Regulatory and paperwork requirements impose a disproportionate burden on community banks because of our small size and limited resources. We have had to devote so much of our resources and attention to regulatory compliance that our ability to serve our communities, attract capital and support the credit needs of our customers is diminished. Moreover, the time and resources community banks spend on regulatory compliance has also resulted in increased costs to our consumer and small business customers. Credit unions and other non-bank institutions that perform "bank-like" functions and offer comparable bank products

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[1] ICBA represents the largest constituency of community banks in the nation and is dedicated exclusively to protecting the interests of the community banking industry. We aggregate the power of our members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

and services are not subject to the same laws and regulations as community banks, thus placing community banks at a competitive disadvantage.

Perennial Problem. Regulatory burden is a perennial problem for community banks. In 1992, Grant Thornton, LLP conducted a study for ICBA on the cost of regulatory burden for community banks—the first to focus solely on compliance costs for community banks. At that time, the study showed the cost of complying with just 13 bank regulations (deemed the most burdensome in the eyes of community bankers), both in terms of time and money, was overwhelming. The annual cost for community for the 13 regulations—just a fraction of the rules that govern the industry—was $3.2 billion, which represented a whopping 24 percent of net income before taxes. In addition, 48 million staff hours were spent annually complying with the 13 regulatory areas.

Impact on Community Banks and Their Customers. Since that time, the market share of community banks with less than $1 billion in assets has dropped from about 20 percent of banking assets to 13 percent. And the share of large banks with more than $25 billion in assets has grown from about 50 percent to 70 percent. Community bank profitability also lags large banks.

At the same time credit unions, with an unfair tax-exempt advantage and favorable legislation loosening membership restrictions, have made inroads into small banks' market segments. Credit union assets have more than tripled since 1984, from $194 billion to $611 billion, whereas small bank (less than $1 billion) assets have decreased in value.

An analysis of these trends conducted by two economists at the Federal Reserve Bank of Dallas concluded that the competitive position and future viability of small banks is questionable.[2] The authors suggest the regulatory environment has evolved to the point placing small banks at an artificial disadvantage to the detriment of their primary customers—small business, consumers and farmers.[3]

ICBA Strongly Supports EGRPRA Review

ICBA is pleased that, at the direction of Congress, the federal bank regulators are currently reviewing all 129 federal bank regulations, with an eye to eliminating rules that are outdated, unnecessary or unduly burdensome. The review is required by the Economic Growth and Regulatory Paperwork Reduction

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[2] Gunther and Moore, "Small Banks' Competitors Loom Large," *Southwest Economy,* Federal Reserve Bank of Dallas, Jan./Feb. 2004.

[3] Community banks are responsible for a disproportionate amount of bank lending to small business, the primary job-creating engine of our economy. Banks with less than $1 billion in assets, make 37 percent of bank small business loans, though they account for only 13 percent of bank industry assets. And they account for 64 percent of total bank lending to farms.

Act of 1996 (EGRPRA). Community banks wholly applaud the EGRPRA effort and fervently hope that it bears fruit.

However, it is important for Congress to recognize there is only so much that the regulators can do to provide relief. Many regulatory requirements are hard-wired in federal statute. Therefore, effective reduction of regulatory burden will require congressional action.

ICBA strongly urges the Congress to be bold and open-minded when considering recommendations offered by the regulators or the industry for regulatory relief.

The Most Burdensome Regulations

The litany of burdensome regulations is long. Here is a partial list:

- A myriad of consumer disclosures—that unfortunately are rarely read by consumers: Truth in Savings, Truth in Lending, Real Estate Settlement Procedures Act, Electronic Funds Transfer, Fair Lending, privacy notices, insurance disclosures, Funds Availability notices;
- Many reporting requirements: Home Mortgage Disclosure Act, Currency Transaction Reports, Suspicious Activity Reports, Call Reports, Regulation O (insider lending) reports, Regulation D (reserve requirements) reports;
- Requirements for written policies and procedures, including annual staff training for: information security, customer identification programs, Bank Secrecy Act, Community Reinvestment Act, and all other aspects of banking including procedures for operations, lending, deposit-taking, investments, advertising, collection, etc. And examiners often ask banks to develop policies and procedures that do not apply to that bank's individual operations!

These regulations are overwhelming to the 37 employees of my bank who must grapple with them everyday.

Feedback from ICBA members indicates that consumer lending and disclosure regulations (including the Truth in Lending right of rescission) are among the most burdensome. Others include: Bank Secrecy Act and anti-money laundering compliance, Community Reinvestment Act, and privacy notices. Many of these concerns apply to banks of all sizes, while others may be of special concern to community banks.

Appendices Attached. Appended to this written statement are a number of specific legislative recommendations to help relieve regulatory burden (Appendix A). Also appended is a discussion of regulatory burden presented by a number of specific regulations that has been take from comments ICBA has provided to

regulators as part of the ongoing EGRPRA review and otherwise (Appendix B). The comments do not cover the full book of bank regulations.

Community Reinvestment Act. The Community Reinvestment Act deserves special mention since regulators have pending a proposal to reduce the regulatory and examination burden it poses on community banks. CRA is a clear example of regulatory overkill. At a time when banking monoliths stretch from coast-to-coast, evaluating the CRA performance of large complex banking organizations and small locally owned and operated community banks on the same examination standards simply does not make sense.

Increased Size Limit for Streamlined CRA Examination. ICBA strongly supports an increase in the asset size limit for eligibility for the small bank streamlined CRA examination process. Although we believe that a preferable threshold would be $2 billion in assets, we applaud the regulators' proposal to increase the limit to $500 million in assets and eliminate the separate holding company qualification.

ICBA also strongly supports legislation introduced in the House, H.R. 3952, calling for an increase in the CRA small bank size limit to $1 billion, although we would support amending the bill to raise the threshold to $2 billion. We also strongly support the inflation adjustment in the bill to ensure that inflation pressures do not diminish the bill's effect.

Under either the regulatory or legislative proposal, while community banks will still be subject to CRA, many will be free from the more onerous compliance burdens associated with the large bank CRA examination and able to concentrate efforts and resources on serving their communities. The bulk of CRA examination resources should be focused on truly large banks whose hundreds or thousands of local branches never see a CRA examiner, not on community banks that cannot survive unless they serve their communities.

Community activists have suggested that the proposal will "gut" the CRA. This is simply not so. All banks will still be subject to the requirements of the statute and continue to meet the credit needs of their communities. Increasing the small bank size limit will not undermine the purposes of CRA. Instead it will free community banks in the $250 million to $500 million asset range from unnecessary costs, improving their productivity and enhancing their ability to meet the credit needs of their communities.

CRA examination costs place an unfair burden on community banks. If the agencies' proposal is adopted, the regulatory paperwork and examination burden will be eased for 1,350 community banks between $250 million and $500 million of assets. These banks will no longer be subject to the investment and service tests, nor to CRA loan data collection and reporting requirements. Even so, the percentage of industry assets examined under the large bank tests will decrease only slightly from a little more than 90% to a little less than 90%.

In today's market, an institution with $500 million in assets is not a large bank. When the small bank streamlined examination was first considered, 17 percent of the banking industry's total assets were subject to the small bank exam using a $250 million asset limit. Due to consolidation and changes in industry demographics since then, if the asset limit were increased to $1 billion today, only slightly more than 15 percent of industry assets would be subject to the small bank exam—still less than the percentage of assets covered when the streamlined examination was first adopted nearly ten years ago.

ICBA/Grant Thornton CRA Cost Study. A 2002 ICBA/Grant Thornton study entitled *The High Cost of Community Bank CRA Compliance: Comparison of 'Large' and 'Small' Community Banks* reveals that CRA compliance costs can more than double when community banks exceed $250 million in assets and are no longer subject to streamlined examinations. A survey of community banks showed the mean employee cost attributable to CRA is 36.5 percent higher at large community banks than at small community banks. In each of two case studies—one contrasting costs for a bank that grew from "small" to "large" bank status, and one contrasting costs for a "small" and "large" bank owned by the same holding company—CRA compliance costs were four or more times greater for large community banks than for small ones.

The study further showed that the large bank CRA investment test also represents a cost burden for large community banks, with 92 percent finding the market for CRA investment opportunities "competitive" or "highly competitive" and 69 percent saying such investments are "not readily available." Half reported giving yield concessions to make CRA-qualified investments. Opponents of the proposal contend that community investments will disappear if smaller institutions are no longer subject to the investment test of the large bank CRA examination. We disagree. Community bankers report that they would be involved in the local community and make investments in community development because their success and survival depends on the success and the survival of the community and because they are integral parts of those communities.

It is ironic that community activists complain when larger institutions they consider less responsive to community needs merge with our-of-area banks. Yet the activists oppose critical steps to reduce the burden that is driving community banks to sell to their larger counterparts and, in fact, driving the community bank out of the community. Nevertheless, the cumulative effect of this one-size-fits-all regulation is driving away many of the small banks that have been serving their communities for decades. The ultimate result is that our local communities are losing not only their banks, but their community leaders.

Negative Cumulative Effect of Regulations on Community Banks

Even though each new requirement may be designed to address a particular problem, over time it all adds up to an unwieldy burden. A new rule is not just a new requirement for the bank. There's a lot more to it. First, the rule has to be understood and interpreted. Procedures have to be changed and adapted. Forms and software systems have to be updated to reflect the change. Bank employees have to be trained in the new requirement and given refresher courses from time to time. New audit programs have to be created and implemented to be sure that the new procedures for the new rule are properly followed.

How does the average community bank keep up? It's getting more and more difficult. The typical community bank has $75 million in assets and about 25 employees. During consumer compliance examinations alone, federal regulators review 26 separate consumer compliance rules. That's more rules than the average number of employees! And the time spent on compliance is time the bank is not using to serve its customers.

Moreover, the rules aren't segregated into product types. For example, a banker can't just look in one place for all the regulations applicable to a home equity loan. They have to consider a whole series of rules and regulations, such as Regulation B (Equal Credit Opportunity Act), Regulation C (HMDA), Fair Credit Reporting Act, RESPA, Truth-in-Lending. To make matters worse, the rules don't always match. If a customer wants to apply for a mortgage loan, RESPA and the Truth-in-Lending Act both require early disclosures to provide an applicant with information – but the requirements don't always mesh. After all, they're written by two different federal agencies.

Each rule has certain fixed costs associated with it. A mega bank with thousands of employees can more easily absorb those costs and devote the resources to addressing the new rule. For a small, community bank, the requirements are snowing them under. Unfortunately, many community bankers are seriously considering getting out of the business. When banks lose their local community focus, small businesses – the engines that help drive the economy – no longer have access to the kind of one-on-one relationship with a banker that can make or break the business.

State Law Also Adds Burden. Unfortunately, the Congress and federal regulators do not have a monopoly on regulatory burden. State laws and state regulations also can pose undue burden on community banks. ICBA strongly supports the dual banking system and the strengths it has brought to our economic and financial system. Many of our members are state-chartered and like it that way. But a growing number of state laws and regulations, including those that conflict with federal laws on the same topic, compound regulatory burden.

Tiered Regulation and Proper Allocation of Regulatory Resources

Community banks and large, national or regional banks pose different levels of risk to the banking system, and have different abilities to absorb the costs of regulatory burden For these reasons, the ICBA strongly urges Congress and the agencies to continue to refine a tiered regulatory and supervisory system that recognizes the differences between community banks and larger, more complex institutions.

Just as banks are urged to focus resources to address the greatest risks, regulators and examiners should reallocate resources to the largest banks that pose the greatest systemic risk. ICBA strongly supports better allocation of supervisory and regulatory resources away from community banks and towards larger institutions that present systemic risk.

A tiered regulatory system allocates the costs of regulatory/paperwork burden relative to the risk of the institution and helps restore equity in regulation, leveling the playing field and enhancing customer service. Less burdensome rules and/or appropriate exemptions for community banks are the hallmark of a tiered regulatory system.

From time to time, Congress and the agencies have instituted welcomed regulatory and supervisory policies that lighten the regulatory and paperwork burden for community banks. Examples include: less frequent safety and soundness exams for small, healthy banks; streamlined, risk-focused exam procedures for noncomplex banks; streamlined CRA exams for small banks; and less frequent CRA exams for small, well-rated banks.

Nonetheless, bank regulators devote disproportionate resources to examination and supervision of community banks. For example, one agency, the Federal Reserve, devotes 75% of supervision time to banks with less than $10 billion in assets, yet these banks only hold 30% of aggregate assets and are unlikely to pose systemic risk. Legislators and regulators should address these disparities to better allocate examiner resources and reduce unnecessary burden for community banks.

Maintain Separation of Banking and Commerce

The House-passed regulatory relief legislation, H.R. 1375, includes two provisions - de novo interstate branching and interest on business checking - that have serious implications for the long-standing doctrine providing for the separation of banking and commerce. Congress wisely reaffirmed this doctrine in the Gramm-Leach-Bliley Act of 1999.

The long tradition of keeping banking and commerce separate is based on solid grounds. First, it guards against the excessive concentration of economic power that would be created by the merger of corporate and financial conglomerates. Second, it insures the impartial allocation of credit, protecting our economy from conflicts of interest that might arise under the common ownership of a bank and commercial firm. And third, it safeguards against the improper extension of the Federal safety net, which could put taxpayer dollars at risk if a financial firm is weakened by the transfer of bank capital to a troubled corporate affiliate.

Industrial Loan Companies and Branching

The Financial Services Regulatory Relief Act, H.R. 1375, includes a crucial compromise authored by Representatives Paul Gillmor (R-OH) and Barney Frank (D-MA) limiting the ability of commercial companies to acquire and open new branches of banks by using a loophole in the Bank Holding Company Act. We urge the Senate to, at minimum, protect the Gillmor-Frank compromise, and ideally, to close the loophole in the law once and for all.

The loophole applies to industrial loan companies (ILCs). ILCs are special purpose charters available in only five states (CA, NV, UT, CO and MN) that operate under a special exemption from the Bank Holding Company Act (granted in 1987 because they were not considered "banks"). To maintain this exemption, ILCs must either remain under $100 million in assets, or not offer demand deposits.

This loophole creates significant risks to the banking system, competitive imbalances in the banking world, threatens small businesses, including community banks, and violates long-standing principles of U.S. banking law. The risks posed by ILCs are created because parent companies of ILCs (unlike any other banks) are not regulated at the holding company level by the Federal Reserve Board and are not subject to the same prudent ownership limitations and activities restrictions as bank holding companies.

Without the Gillmor-Frank compromise, H.R. 1375 would have allowed commercial conglomerates, including supercenter retail companies like Wal-Mart, to acquire an ILC charter and open new branches throughout the United States without any effective regulatory review of the process and the conglomerate's use of the ILC. In fact, states would have been powerless to stop these conglomerates from opening new branches of ILCs.

In testimony before the House, Federal Reserve Governor Mark Olson stated, "The bill as currently drafted would allow large retail companies to establish an ILC and then open a branch of the bank in each of the company's retail stores

nationwide." Gov. Olson added that this ". . . raises significant safety and soundness concerns and creates an unlevel competitive playing field. . . ."

The ICBA-backed Gillmor-Frank compromise:

- Defines "commercial firm" as any firm that derives at least 15% of its consolidated revenues form sources that are not financial in nature or incidental to a financial activity.
- Has a grandfather date of October 1, 2003, meaning any ILC owned by a commercial firm, or whose ownership application was pending, before that date would get the interstate de novo branching powers.
- Requires both the home state and host state bank supervisors to rule on the commercial basket test, giving either state a veto power.
- And includes a provision called "Prevention of Evasion Through Acquisition" that would require commercial companies that acquire ILCs in the future that have interstate branches to divest all branches located outside the ILC's home state.

Mr. Chairman, this compromise, which ICBA strongly supports, represents the minimum standard that the Senate Banking Committee should adopt if it includes liberalized interstate branching language in its regulatory relief bill. However, we would encourage you to go even farther and close the loophole entirely by bringing ILCs under the Bank Holding Company Act.

ILCs and Interest on Business Checking

H.R. 1375 also includes an amendment that incorporates the substance of H.R. 758, which allows banks – and ILCs – to pay interest on business checking accounts. ICBA has not taken a position on the underlying measure, advocating instead a compromise that would allow financial institutions to conduct daily sweeps into and out of interest-bearing accounts. ICBA-member banks are split on whether or not to allow banks to pay interest directly on commercial checking accounts.

The amendment to H.R. 1375 adopted by the House would allow ILCs to offer business NOW accounts and would make ILCs virtually indistinguishable from banks. Federal Reserve Board Chairman Alan Greenspan wrote to House Financial Services Committee Chairman Mike Oxley (R-OH) on March 11 that giving ILCs this new power ". . . would alter the structure of banking in the United States. . ." and bestow a ". . . significant competitive advantage for the corporate owners of ILCs, such as large retail and commercial firms. . . ."

Mr. Chairman, this provision – like the original language in H.R. 1375 dealing with interstate branching – would breach the wall separating banking and commerce, and violate a long-standing principle in U.S. law.

Again, we urge the Committee to apply a Gillmor-Frank standard if you include the business checking provisions in your regulatory relief bill, stipulating that ILCs owned by commercial firms would not be eligible for the new business NOW account powers under this legislation.

Conclusion

ICBA member banks are integral to their communities. Their close proximity to their customers and their communities enables them to provide a more responsive level of service. However, regulatory burden and compliance requirements are consuming more and more resources, especially for community banks. The time and effort taken by regulatory compliance divert resources away from customer service. Even more significant, the community banking industry is slowly being crushed under the cumulative weight of regulatory burden, causing many community bankers to seriously consider selling or merging with larger institutions, taking the community bank out of the community.

The ICBA urges the Congress and the regulatory agencies to address these issues before it is too late. This is especially true for consumer lending rules, which, though well intentioned, too often merely increase costs for consumers and prevent banks from serving customers. The fact that banks and thrifts are closely examined and supervised should be taken into account in the regulatory scheme, and depository institutions should be distinguished from non-depository lenders.

The ICBA strongly supports the current efforts of the agencies and Congress to reduce regulatory burden. We look forward to working to ameliorate these burdens and to the enactment of statutory changes to help ensure that the community banking industry in the United States remains vibrant and able to serve our customers and communities.

APPENDIX A

Recommendations for Legislative Action

Community Reinvestment Act

- Require bank regulators to apply streamlined CRA examinations to banks with up to $2 billion in assets (increase from current $250 million), with inflation adjustment.

Truth in Lending (Federal Reserve Regulation Z)

- To improve customer service, repeal the three-day right of rescission or give regularly examined depository institutions greater latitude to allow customers to waive the right, so they can receive their funds in a more timely manner.

- Eliminate the right of rescission for refinancing in which the lender holds the existing lien, refinancing with a new lender where no new money is advanced, and home equity lines of credit.

- Simplify and relax, or eliminate existing restrictions on what may be included and what must be included in advertisements if a certain trigger term is used.

- Simplify the definition of the finance charge so that all consumers can understand the Annual Percentage Rate.

- Synchronize and coordinate early Truth in Lending the RESPA disclosures. Timing of disclosures should allow consumers to make informed decisions. Disclosures should focus on the information consumers want most: the principal amount of the loan, the simple interest rate on the promissory note, the amount of the monthly payment and the costs to close the loan.

- Expand timeframes for resolution of billing errors to allow banks to investigate and resolve errors and avoid fraud. Increase penalties for frivolous error claims.

- Provide a de minimis level of $50 for which no restitution need be ordered for inadvertent errors. Allow flexibility so banks do not have to review large numbers of consumer files for inadvertent errors and possibly make restitution of nominal amounts where the costs far outweigh the minimal benefits to the individual consumer.

Home Mortgage Disclosure Act (HMDA) (Federal Reserve Regulation C)

- To recognize changing industry demographics, increase the asset threshold for the HMDA exemption from $33 million to at least $250 million, with inflation adjustment.

- Exempt banks that make fewer than 100 reportable loans per year per category.

- Allow the banking agencies to develop a definition of Metropolitan Statistical Area that applies to banks, instead of using Census Bureau definition created for entirely different reasons, to avoid covering certain rural banks.

- Limit reporting to purchase money mortgages and refinancing of such mortgages.

- Direct the Federal Reserve to streamline HMDA data collection and reporting and eliminate requirements that are not cost-justified. The volume of data that the Federal Reserve requires to be collected and reported under HMDA continues to grow and has been identified by bankers as one of the top ten regulatory burdens.

Bank Secrecy Act (BSA,) USA Patriot Act, Anti-Money Laundering (AML) compliance

- Increase the threshold for filing a Currency Transaction Report from $10,000 to $30,000, and adjust it for inflation. Increase other reporting thresholds as well.

- Allow banks filing fewer than 50 CTRs a month to file quarterly.

- Expand ability for banks to exempt from CTR filings certain regular, known customers and eliminate annual recertification for exempt customers.

- Change record retention requirement under USA Patriot Act for closed accounts from five to two years.

Flood Insurance

- Streamline and simplify flood insurance requirements.
- Allow exceptions to flood insurance requirements for agricultural real estate where the value of most of the collateral is represented by land, not permanent structures.

Privacy Notices

- Allow a bank that does not share customer information other than as permitted under one of the exceptions the option to forego delivery of the annual notice unless there has been a change in the bank's privacy policy.

- Allow banks that do not share information other than pursuant to the processing or service provider exceptions to provide a short statement to that effect printed on the customer's bank statement.

Call Report Streamlining

- Direct the agencies to streamline the Call Report and to conduct, in consultation with the industry, a review of Call Report requirements to determine (a) which data requirements are necessary for the agencies to carry out their supervisory responsibilities, (b) what information can be removed from the Call Report, (c) whether reporting can be reduced to once or twice a year for small highly-rated, well-capitalized banks and (d) if there is an easier method for the banks to retrieve and prepare the information and send it to the agencies in a format most compatible with existing bank data processing systems.

Sarbanes-Oxley Act

- Exempt banks with less than $10 billion in assets from internal control attestation and audit requirement, since banks with assets of more than $500 million are already subject to FDICIA attestation and audit requirements and are heavily supervised by bank regulators.

- Establish additional exemption levels under other sections of the Act for small banks/bank holding companies.

Credit to Insiders (Federal Reserve Regulation O)

- Direct agencies to expand overly restrictive executive officer borrowing authority, for example, by increasing dollar amounts officers may borrow for personal residence and children's education and for "other purpose."

- Repeal aggregate limit on loans to insiders or set in statute a two-times-capital aggregate limit for banks under $1 billion.

- Delete the requirement that loans to executive officers must become due and payable on demand.

- Streamline and reduce certain reporting requirements regarding loans to executive officers and loans from correspondent banks to executive officers and shareholders.

Examinations

- Give federal regulators more flexibility to determine the examination interval for well-rated, well-capitalized banks with less than $1 billion in assets.

Money Market Deposit Accounts (Federal Reserve Regulation D)

- Expand the number of permissible transfers from money market deposit accounts from 6 to 24 per month.

Expedited Funds Availability (Federal Reserve Regulation CC)

- Streamline and simplify the complex, operationally challenging requirements.

Electronic Funds Transfer Act

- Increase consumer liability from $50 to $500 for unauthorized transactions resulting from writing PIN on card or keeping PIN in the same location as the card.

- Extend notification requirement for a change in account terms or conditions contained in the initial Regulation E disclosure from 21 days to 30 days, consistent with Regulation DD.

Bank Holding Companies (Federal Reserve Regulation Y)

- Direct the Federal Reserve to increase the size limit for banks eligible for the Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors from $150 million to $1 billion. To qualify the holding company must (1) not be engaged in any non-banking activities involving significant leverage and (2) not have a significant amount of outstanding debt that is held by the general public.

- In an effort to further streamline certain bank holding company notices and applications, increase the size threshold for streamlined application and information requirements from $150 million threshold to $1 billion.

Dividends

- Eliminate dividend restriction requirements for banks that are well-capitalized and will continue to be well-capitalized following the declaration of the dividend.

Branch Applications/Notices

- Eliminate the newspaper publication requirement and eliminate the requirement to file a branch application for "eligible banks" (e.g., those with high CAMEL ratings and satisfactory CRA ratings and compliance ratings), if the branch that is acquired is less than a certain percentage of the total consolidated asset value of the bank or less than a certain dollar amount. Branch applications filed with the Federal Reserve or FDIC are often duplications of applications filed with the state banking authorities.

- Exempt ATMs, branch acquisitions in the acquirer's service area, branches moved in the same local market, and branches closed due to emergency acquisition or FDIC assistance.

SIPC Coverage:

- Provide community banks with the same protection afforded other investors and other depository institutions for their brokerage account assets when a broker dealer fails.

Sweep Accounts

- Amend the reporting requirements under the Government Securities Act so that banks don't need to send a statement whenever money is swept from a deposit account into a government repurchase agreement.

APPENDIX B
Regulatory Burden
Comments on Selected Regulations [1]

CONSUMER REGULATIONS

Truth in Lending (Federal Reserve Regulation Z)

Right of Rescission. Perhaps one of the most troublesome issues of current regulatory requirements is the three-day right of rescission under Regulation Z. Bankers have identified the right of rescission as one of the top ten regulatory complaints. Most of the problems this particular right is designed to rectify originate with non-depository creditors, not banks, a fact that should be considered. Moreover, banks and thrifts are closely examined and supervised to ensure compliance and fair practices, another key point to consider in addressing regulatory burden.

Bankers report that consumers rarely exercise the right of rescission. However, consumers do resent having to wait three additional days to receive loan proceeds after the loan is closed, and they often blame the bank for "withholding" their funds. Even though this is a statutory requirement, inflexibility in the application and interpretation of the requirement makes it difficult to waive the right of rescission and aggravates the problem. The restrictions should be rationalized to reflect consumer desires and modern-day realities. If the requirement is not repealed outright, depository institutions should at least be given much greater latitude to allow customers to waive the right.

Identification of the Creditor. In addition to the right of rescission, community bankers have identified other problems under Regulation Z. In many lending arrangements the bank is not the only party involved in making the loan, creating difficulty and confusion in determining which entity is actually responsible for making the requisite disclosures. For example, banks often enter arrangements with car dealers to offer loan products but do not control the dealer's actions. These arrangements take a variety of formats and involve the bank in the credit at different stages of the process. However, the bank is likely to be held responsible for what the car dealer does or does not disclose, no matter when the bank became involved in the loan. The responsibility for disclosures when more than one creditor is involved should be more clearly outlined and defined so that banks understand when and to what extent they are expected to control the actions of counter-parties to a loan transaction.

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[1] This appendix is a discussion of regulatory burden presented by a number of specific regulations that has been taken from comments ICBA has provided to regulators as part of the ongoing EGRPRA review and otherwise. It does not cover the full book of bank regulations.

Advertisements. Another problem under the Truth-in-Lending Act regulation involves how loan products may be advertised. From one perspective, advertisements help educate consumers about available loan products, but existing restrictions on what may be included and what must be included if a certain trigger term is used often limits the information actually included in advertising materials, meaning that consumers get less – not more – information. In some cases, the amount of information included can be virtually meaningless. While the intent is to encourage consumers to visit the bank to get more detailed information, the practical implications and market realities suggest that limiting information has the opposite effect. These restrictions should be greatly relaxed, if not eliminated. Banks are subject to the unfair and deceptive restrictions in section 5 of the Federal Trade Commission Act, and that standard should be more than sufficient for *all* bank advertising. Moreover, bankers question auto dealers' practice of advertising of zero percent financing for cars that fails to disclose all pertinent elements of the loan or that is not available to all but a very few – statements that would get bankers in trouble with their examiners but that place bank lenders at an unfair competitive disadvantage.

Finance Charges. The definition of the finance charge under Regulation Z is a primary example of an unclear regulatory requirement. Assessing what must be included – or excluded – is not easily determined, especially when fees and charges may be levied by third parties. And yet, the calculation of the finance charge is critical in properly calculating the annual percentage rate (APR). Even if that hurdle is overcome, actually calculating the APR and knowing when it is permissible to use estimates is also confusing to bankers that work with these issues every day. Explaining them to customers is not easy and may actually add to their confusion. This process desperately needs simplification so that *all* consumers can understand the APR. These calculations are especially frustrating in an increasingly competitive environment where non-depositories use sleight-of-hand to exclude certain items from the APR (bankers often point to auto dealers' advertisement of 0% APRs, as noted above). The regulation and disclosures ought to be tested against focus groups made up of average consumers and revised until easily understood by consumers.

New or Revised Disclosures. Once initial disclosures have been provided, there may be a lapse in time between loan approval and loan closing, especially for real estate loans. As a result, there can be changes in the structure of the final loan, and is not always clear when these changes mandate new disclosures. Similarly, it is not always clear when a change in an existing account relationship, as with a credit card account, requires a change-in-terms notice. Clearer rules or guidance on when new disclosures must be made is needed.

Real Estate Loans. Real estate loans create their own additional problems under Regulation Z. For example, the requirements for the early disclosures under Regulation Z are not in synch with the requirements under

HUD's RESPA requirements, and yet the banker should beware who does not get it right. The requirements should be coordinated.

Many consumers complain about the volume of documents required for real estate loan closings, and the volume and extent of disclosures has gotten so extensive as to provide little meaningful information. If a simplification process is to succeed, one set of coordinated rules for real estate loans is needed – not a variety of regulations issued by different agencies.

Real estate mortgage transaction disclosures should be simple and easy to understand, clearly specifying the obligations and responsibilities of all parties. Disclosures should focus on the information consumers want most: the principal amount of the loan, the simple interest rate on the promissory note, the amount of the monthly payment and the costs to close the loan. This would be similar to the "Schumer Box" required for credit card disclosures. Information should be provided to consumers at the appropriate stage of a transaction to allow them to make informed decisions. One set of rules should govern all mortgage lenders, and regulation, supervision and enforcement must be consistent across the industry. And much better supervision of non-depository lenders is needed.

Credit Card Loans. For credit card loans, the requirements under Regulation Z and Regulation E (Electronic Funds Transfers) should be reconciled. Instead of two different regulations, it would be easier if the Federal Reserve established one regulation for credit cards that covered all requirements. In addition, regulatory restrictions requiring resolution of billing-errors within the given and limited timeframes are not always practical. The timeframes should be expanded to allow banks to investigate and resolve errors. Moreover, the rules for resolving billing-errors are heavily weighted in favor of the consumer, making banks increasingly subject to fraud as individuals learn how to game the system, even going so far as to do so to avoid legitimate bills at the expense of the bank. There should be increased penalties for frivolous claims and more responsibility expected of consumers.

Restitution. Recognizing the complexity of the disclosure requirements, if there have been inadvertent errors by the bank in making disclosures, greater flexibility should be allowed so banks do not have to review large numbers of consumer files and possibly make restitution of only a few cents: the costs for such actions certainly far outweigh the minimal benefits to the individual consumer.

Equal Credit Opportunity Act (Federal Reserve Regulation B)

Regulation B creates a number of compliance problems and burdens for banks. Knowing when an application has taken place is often difficult because the line between an inquiry and an application is not clearly defined. To answer customer questions about loan products, bankers must have sufficient

information to respond correctly, and yet having too much information can lead to an "application" that triggers additional responsibilities on the part of the bank. While bankers want to provide customer service, the regulations make it difficult, and almost mandate a written application in all instances. This should be rationalized to reflect modern technologies and to prevent barriers to customer service.

Spousal Signature. A related issue that creates problems for all creditors is the issue of when to require the signature of a spouse. This can be especially problematic for small business loans when the principal of the business and his or her spouse guarantee the loan. Instead of allowing banks to accommodate customer needs and provide customer service, the requirements make it difficult and almost require that all parties – and their spouses – come into the bank personally to fill out the application documents. This makes little sense as the world moves toward new technologies that do not require physical presence to apply for a loan.

Adverse Action Notices. Adverse action notices present another problem—one that promises to be aggravated by new requirements under the Fair and Accurate Credit Transactions (FACT) Act. It would be preferable if banks could work with customers and offer them alternative loan products if they do not qualify for the type of loan for which they originally applied. However, doing so may trigger requirements to supply adverse action notices. And knowing when to send an adverse action notice is not always readily determined. For example, it may be difficult to decide whether an application is truly incomplete or whether it can be considered "withdrawn."

Moreover, the requirements for adverse action notices under Regulation B are not always in synch with the requirements under the Fair Credit Reporting Act (FCRA). And, while there may be more than one reason that the loan was denied, determining what reason to provide on the adverse action notice form may not be simple. A simple straightforward rule on when an adverse action notice must be sent – that can easily be understood – should be developed.

The real danger is that regulatory complications could make it much easier for banks to deny an application instead of working with customers to find a suitable loan product. In such cases, it will be low- and middle-income loan applicants or those that are marginal or have problem credit histories that will be most negatively affected.

Other Issues. Regulation B's requirements also complicate other aspects of customer relations. For example, to offer special accounts for seniors, a bank is limited by restrictions in the regulation. And, most important, reconciling the regulation's requirements not to maintain information on the gender or race of a borrower and the need to maintain sufficient information to identify a customer

under section 326 of the USA PATRIOT Act is difficult and needs better regulatory guidance.

Home Mortgage Disclosure Act (HMDA) (Federal Reserve Regulation C)

Exemptions. The HMDA requirements are the one area under Part 2 of the current EGRPRA regulatory review (consumer lending regulations) that does not provide specific protections for individual consumers. Rather, HMDA is primarily a data-collection and reporting requirement and therefore lends itself to a tiered regulatory requirement that places fewer burdens on smaller institutions. The current exemption for banks with less than $33 million in assets is far too low and does not make sense in today's banking environment, especially when there are banks with $1 *trillion* in assets. The HMDA exemption should be increased to at least $250 million, if not higher.

A second problem is the definition of an MSA (metropolitan statistical area). Since the definition of an MSA also determines which banks must report under HMDA, the banking agencies should develop a definition that applies to banks. Instead, banks are subject to a definition created by the Census Bureau for entirely different reasons. As a result, banks in rural areas and that should not be covered by HMDA reporting requirements may be captured by rules that do not reflect the reality of banking. Although the ICBA has often been a proponent of consistency in regulatory definitions, HMDA reporting requirements should be developed by the banking agencies and not subject to rules developed by other agencies that are establishing definitions for completely different purposes.

Volume of Data Required. For banks that are subject to HMDA requirements, the volume of the data that must be collected and reported is clearly burdensome, and has been identified by bankers as one of the top ten regulatory burdens. Consumer activists are constantly clamoring for additional data, and the recent regulatory changes requiring collection and reporting of yet more data succumb to their demands without a clear cost-benefit analysis. All consumers ultimately pay for the data collection and reporting. Moreover, collecting some of the information, such as data on race and ethnicity, can be offensive to some customers who hold the bank responsible. Clearly, better cost-benefit analysis is needed in assessing the volume of data required under HMDA, with clear demonstration of the utility that justifies the costs involved.

Specific data collection requirements are difficult to apply in practice and therefore add to regulatory burden and the potential for error. Bankers report expending precious resources to constantly review and revise the HMDA data to ensure accurate reporting. Some of these problems are:

- Knowing which loans are refinancings

- Assessing loans against HOEPA (the Home Ownership and Equity Protection Act)
- Determining the date the interest rate on a loan was set
- Comparing Treasury yields against loan rates when maturity of loan does not match existing Treasury securities
- Determining physical property address or census tract information in rural areas
- Determining lien status (first, second, third)
- Coordinating reasons for denial with requirements for Reg B adverse action notice
- Constant review and updating of information collected for reporting

These problems should be addressed, whenever possible by eliminating the data requirement, and regulatory guidance in this area should be clear and easily applied. The current complexity and difficulty in applying existing guidance to daily operations merely adds to the level of burden and cost.

Finally, bankers report encountering conflicts between the data required under HMDA and the data that must be collected and reported under ECOA. The two data collection requirements should be reconciled and coordinated so that there is only one set of data-collection rules that apply to the race, age, ethnicity and gender of borrowers.

Privacy Notices

Many community bankers view the annual privacy notice as ineffective. Banks that do not share information other than as permitted under one of the exceptions should have the option not to deliver the annual notice unless there has been a change in their privacy policy, a step that would make it more likely consumers would pay attention to the notices. For banks that do not share information, a short statement to that effect printed on a customer's bank statement should be sufficient. As a general rule, a privacy notice should only be required at account opening and when a bank's privacy policy or practices change. The current requirement that banks furnish all customers with an annual privacy notice actually has a very serious unintended consequence: it encourages customers to disregard the information that is provided, making them increasingly less likely to pay heed to notices.

Flood Insurance

Flood insurance is another one of the top ten regulatory problems identified by bankers. The current flood insurance regulations create difficulties with customers, who often do not understand why flood insurance is required and that the federal government – not the bank - imposes the requirement. The government needs to do a better job of educating consumers to the reasons and requirements of flood hazard insurance.

For bankers, it is often difficult to assess whether a particular property is located in a flood hazard zone since flood maps are not easily accessible and are not always current. Even once a property has been identified as subject to flood insurance requirements, the regulations make it difficult to determine the proper amount, and customers do not understand the relationship between property value, loan amount and flood insurance level. Once flood insurance is in place, it can be difficult and costly to ensure that the coverage is kept current and at proper levels. As a result, many banks rely on third party vendors to assist in this process, but that adds costs to the loan. Flood insurance requirements should be streamlined and simplified to be understandable.

SAFETY AND SOUNDNESS REGULATIONS

Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) compliance

Of special concern to ICBA member banks are the requirements and costs associated with filing currency transaction reports (CTRs), especially when weighed against the lack of evidence that they provide useful information. Bankers believe that law enforcement has a tendency to shift costs and burdens to the banking industry and therefore ignores the costs. Bankers are concerned with potential conflicts between anti-discrimination laws and customer identification requirements under the USA PATRIOT Act. And, although guidance has begun to appear, bankers are concerned with the overall lack of regulatory guidance, especially on practical issues such as retention of copies of a customer's driver's license.

Another problem with Patriot Act compliance is the data-match program that requires banks to search records for possible matches to lists furnished by the government every two weeks. And, related to BSA, bankers complain about the difficulty of using lists issued by the Office of Foreign Asset Control (OFAC).

Bankers are willing to take the necessary steps to do their part to combat money laundering and terrorist financing. However, there is a critical need for better communication from law enforcement about the success of existing bank efforts and guidance on what to look for to help detect illicit activities. There is a need for a true partnership between law enforcement and banks – but so far, banks feel that all the effort has been on the bank side. Perhaps more important, though, is the need to recognize that banks have limited resources. For example, the time and effort expended in filing currency transaction reports consumes resources not available to combat other types of fraud or to serve customers. These requirements must be balanced, and law enforcement should not view banks as having limitless resources to comply with these demands.

There is another important point that must be recognized. As the costs associated with compliance increase, the costs for offering simple checking and

savings accounts also increase. These fees are ultimately passed along to consumers. This point is especially important in the anti-money laundering context because as these fees increase, they drive more and more potential customers away from banks. The Treasury Department has stressed the need to bring the nearly 10 million "unbanked" customers into the banking system. However, by increasing costs and driving customers away, it creates a fertile environment for underground banking systems. If a transaction is conducted through a regulated and highly supervised depository, law enforcement has access to the information. But driving consumers away from banks increases use of systems where that information may not be as readily accessible.

Sarbanes-Oxley

The corporate governance, auditing and accounting reforms of the Sarbanes-Oxley Act have greatly increased regulatory burden and costs for community banks that are public companies. Many expect accounting and auditing fees to double as a result of the Act, with little additional benefit for shareholders or customers. The costs of D&O insurance and director compensation will also increase significantly. Particularly burdensome and costly are Section 404, Management Report on Internal Controls; independent board, nominating and compensation committees; independent audit committee with financial expert; and separation of audit and non-audit services. For community banks that are heavily regulated and supervised, the rules add little benefit and makes it more difficult to attract competent persons to serve as directors.

Credit to Insiders (Federal Reserve Regulation O)

Bankers feel that the many disclosures required for loans to insiders, especially board members, invades privacy. More important, it drives good customers away by forcing insiders to go elsewhere for loans. The restrictions also make it difficult for bankers to attract qualified individuals to the board of directors.

Examinations

The need for consistency among agencies, coordination of examinations and better training for examiners are critical. Bankers also stress the need to distinguish between different banks in different markets in the examination process.

DEPOSIT REGULATIONS

Money Market Deposit Accounts (Federal Reserve Regulation D)

ICBA members have suggested that the current limit on transfers from MMDAs is an anachronism in today's environment that puts banks at a competitive disadvantage to brokerage firms and credit unions. This is especially true for smaller banks that cannot afford the costs that would allow them to offer sweep services. ICBA supports expanding the number of transfers for money market deposit accounts.

Expedited Funds Availability (Federal Reserve Regulation CC)

The current funds availability schedule increases the potential for fraud loss for banks. Bankers also report that the costs and burdens associated with placing extended holds reduce their usefulness. Especially problematic is next-day availability for cashier's checks that are becoming increasingly subject to counterfeiting.

APPLICATIONS AND REPORTING

The ICBA believes that there are a number of steps that could be taken to reduce the burden in the area of applications and reporting. Following are specific comments pertaining to individual regulations identified in Part 1 of the EGRPRA regulatory review (applications and reporting).

Bank Holding Companies (Federal Reserve Regulation Y)

Small Bank Holding Company Policy Statement. Appendix C of Federal Reserve Regulation Y includes the Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors (Policy Statement). This Policy Statement applies only to bank holding companies with pro forma consolidated assets of less than $150 million that (1) are not engaged in any non-banking activities involving significant leverage and (2) do not have a significant amount of outstanding debt that is held by the general public.

ICBA submitted a petition to the Federal Reserve in 1989 and a comment letter in 1996 urging the Board to revise the Policy Statement to define small bank holding companies as those whose assets totaled $500 million or more, rather than the outdated $150 million. In addition, we recommended the debt-to-equity ratio threshold of 1:1 be increased to 3:1.

In light of the fact that the $150 million exemption level has remained a static figure since 1972, the ICBA continues to urge that the limit be raised given the average asset growth in the banking industry and inflationary pressures. In order to truly represent the asset size of a small BHC today, the exemption should be raised to $1 billion. The lack of indexing for the $150 million over the

past 31 years has hindered the ability of small banks to facilitate the transfer of ownership and remain independent, rather than selling out to a larger regional BHC. Increasing the exemption to $1 billion would improve the ability of small local institutions to sell their stock locally, keeping the financial decisions affecting the community in the local area.

Small banks and small bank purchasers frequently borrow all or a substantial portion of the purchase price in an acquisition. Therefore, the debt-to-equity ratio for small BHCs should be raised to 3:1. It does not require a significant amount of debt to increase the debt-to-equity ratio to 3:1, nor does it cause any significant systemic risk. The difference in a small BHC as opposed to a large BHC is that the large BHCs cannot cut their dividends without adversely affecting their ability to raise equity capital. Dividends are essential if a large BHC is to main an acceptable market price for its stock. The dividends for a small BHC, however, can be reduced, in most instances, without significantly impacting the ability of the small BHC to raise equity capital. Restriction of dividends is easier for institutions that are closely held and where the decision involves a limited number of owners.

Applications by Small Bank Holding Companies. Throughout Federal Reserve Regulation Y, there are instances where the application or notice requirements for bank holding companies with consolidated assets of less than $150 million are different from the requirements for bank holding companies with consolidated assets greater than $150 million. For instance, when a bank holding company files a notice to the Federal Reserve for the purchase or redemption of more than ten percent of its stock as required by Section 225.4 of Regulation Y, bank holding companies with assets more than $150 million must disclose consolidated pro forma risk-based capital and leverage ratio calculations and if the redemption is to be debt funded, a parent-only pro forma balance sheet. By contrast, bank holding companies with assets less than $150 million have to submit only a parent-only balance sheet and if the redemption is to be debt funded, one year income statement and cash-flow projections. In an effort to further streamline the application process, ICBA urges the Federal Reserve to increase the $150 million threshold to $1 billion, particularly if the definition of a small bank holding company in Appendix C is changed to $1 billion.

BHC Public Notice Requirements. Also throughout Regulation Y, including the change in bank control provisions, bank holding companies are required to publish notices in newspapers of general circulation whenever applications or notices are filed with the Federal Reserve. (The Federal Reserve also publishes the notices in the Federal Register.) Bankers complain that the newspaper notices are often expensive and that few people read them. Often these notices must be published in weekly newspapers, particularly if the bank's main office is located in a rural community. The inconvenience of publishing in a weekly newspaper can often delay the acceptance of an application by the Federal Reserve. Bankers also report delays with their applications because the Federal Reserve Banks require bankers to submit "tear sheets" from the

newspaper indicating that the notice has been published. ICBA urges the Federal Reserve to eliminate the newspaper publication requirement for applications and notices under Regulation Y. In lieu of publishing in a newspaper of general circulation, ICBA suggests that notices be posted online on the Federal Reserve's website or on a separate website set up by all the bank agencies which would be devoted to financial institution notices and applications.

State Member Banks (Federal Reserve Regulation H)

Dividends. Section 208.5 of Federal Reserve Regulation H prohibit a member bank from declaring or paying a dividend if the total of all dividends declared during the calendar year, including the proposed dividend, exceeds the sum of the bank's net income during the current calendar year and the retained net income of the prior two calendar years, unless the dividend has been approved by the Board. ICBA suggests that he Federal Reserve eliminate this requirement for banks that are well-capitalized and will continue to be well-capitalized following the declaration of the dividend. Banks with excess capital often find it difficult to reduce their capital because of this restriction. Once they declare an extraordinary dividend that exceeds their income for the current year and their income for the prior two years, they must wait several years before they can declare another extraordinary dividend that exceeds their current year's income. Elimination of this requirement will ease the regulatory burden on banks that have excess capital.

Branch Applications. Section 208.6 of Federal Reserve Regulation H requires a state member bank wishing to establish a branch to file an application with the Federal Reserve and to publish notice of the filing in a newspaper of general circulation. As noted above, ICBA urges the Federal Reserve to eliminate the newspaper publication requirement for all Federal Reserve applications and notices. Bankers report that few people read the notices and that they are expensive. ICBA also recommends that the Federal Reserve consider eliminating the requirement of filing a branch application for "eligible banks" (e.g., those with high CAMEL ratings and satisfactory CRA ratings and compliance ratings) particularly if the branch that is being acquired is less than a certain percentage of the total consolidated asset value of the bank or less than a certain dollar amount. Banks do not need to file an application with the Federal Reserve every time they acquire a branch. Furthermore, branch applications that are filed with the Federal Reserve are often duplications of applications filed with the state banking authorities. Both the state banking authorities and the Federal Reserve consider the same factors for approving branch applications such as capital adequacy, convenience and needs, etc. It is unnecessary and duplicative for member banks to file branch applications with both the state banking authorities and the Federal Reserve.

Call Reports

The volume and extent of information that must be reported for the call report is extensive and very time consuming for banks to prepare. Bankers feel that the information requested by these reports is far more than the regulatory agencies need and that it is hard to complete the numerous schedules to the reports. Although software programs are helpful, many community banks report they must make manual adjustments to provide information in the format requested. Unfortunately, it seems that once any particular bit of data is requested on the call report, it never goes away, even though the need or rationale for the information may have long expired.

ICBA applauds the goal of the banking agencies to automate the Call Report system and to build a central data repository. However, we recommend that the agencies convene an industry-wide task force to review all the information that is required by the Call Report to determine (a) if such information is necessary for the agencies to carry out their supervisory responsibilities, (b) whether any information can be removed from the Call Report, and (c) if there is an easier method for the banks to retrieve and prepare the information and send it to the agencies in a format most compatible with existing bank data processing systems. Such a task force of bankers could assist in streamlining the requirements of the Call Report and provide recommendations for facilitating the retrieval of Call Report data.

Testimony of Bradley E. Rock
On Behalf of the American Bankers Association
Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

June 22, 2004

Mr. Chairman and members of the Committee, my name is Bradley Rock. I am Chairman, President and CEO of Bank of Smithtown, a 95-year old, $630 million community bank located in Smithtown, New York. I am also the Vice Chairman of the Government Relations Council and a member of the Community Bankers Council of the American Bankers Association (ABA). The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

I am glad to be here today to present the views of the ABA on the need to reduce the burden of red tape and paperwork. This is an important issue for ***all*** businesses, including banking. In my testimony, I would like to make three key points:

- The regulatory burden is not just a minor nuisance for banks – it has a significant impact on bank customers and local economies.

- The regulatory burden is significant for banks of all sizes, but pound for pound, small banks carry the heaviest regulatory load. The community bank, which has been the cornerstone of economic growth in this country, is in great danger of being regulated right out of business.

- The review of regulatory costs by the federal bank regulators is very positive; results are what counts, however, and many bankers are skeptical that significant relief from the regulators is possible. It will take Congressional action to make a difference.

I will touch on each of these in the remainder of my statement.

I. The Regulatory Burden Has a Significant Impact on Bank Customers and Local Economies

Reviewing regulations and their impact on our businesses and communities should be an ongoing process, as the marketplace continues to change rapidly. Outdated laws and regulations only squander scarce resources of banks that could otherwise be used to provide financial services demanded by our customers. New laws, however well intentioned, have added yet more layers of responsibilities on businesses like ours. While no single regulation by itself is overwhelming to most businesses, the cumulative weight of all the requirements is overwhelming. It is like playing football against a defensive line that weighs 70 pounds more per player. New laws add heft to the regulatory burden like additional pounds increase the weight of an already massive defensive line. There is simply no way to advance the ball against such a barrier.

The burden of regulation has a significant impact on bank customers and local economies. Compliance costs are a significant drain on bank resources, taking precious resources away from meeting the needs of our customers. And every new law, regulation or rule added means two things: more expensive bank credit and less of it. This is likely to hurt small businesses the most, as they cannot go directly to the capital markets, yet need low-cost financing. The result is slower economic growth.

Over the past 25 years, the compliance burden has grown so large and is so pervasive throughout all levels of bank management that it is extremely difficult to measure. Research done by the ABA and the Federal Reserve[1] in the 1990s indicates that the total cost of compliance ***today*** for banks would range from $26 billion to $40 billion per year. And these costs do not include the cost related to major legislation enacted in the last five years, such as the Gramm-Leach-Bliley Act, the Sarbanes-Oxley Act, the USA Patriot Act, and the FACT Act. Nor do these costs include the cumbersome layering of additional rules, issued by the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board

[1] "Survey of Regulatory Burden", American Bankers Association, June 1992; Elliehausen, "The Cost of Banking Regulation: A Review of the Evidence," Staff Study, Board of Governors of the Federal Reserve System, April 1998.

(PCAOB), and the American Institute of Certified Public Accountants (AICPA), which are often focused on financial instruments and financial institutions. Nor do these costs include changes in existing regulations either (such as the recently effective changes for HMDA reporting) that inevitably arise every year.

Compliance costs are expected to grow at an even faster pace in the coming years. As the table below illustrates, bank compliance officers are bracing for large increases in spending for document development and generation, consultants, outside attorneys, software and offsite record storage.

Projections for 2003 compliance spending over 2002 spending
(Figures in Percentages)

	UP	DOWN	EVEN
Consultants	29.3	13.0	57.7
Outside attorneys	22.2	12.2	65.6
Mystery shoppers	6.9	13.8	79.3
Software	26.4	9.3	64.3
Offsite record storage	22.0	4.9	73.2
Document development & generation	34.5	3.6	61.9

Source: *ABA Banking Journal*, June 2003

Certainly, some of the regulatory cost is appropriate for safety and soundness reasons. But consider the direct impact on bank lending and economic growth if this burden could be reduced by 20 percent and redirected to bank capital; it would support additional bank lending of $52 billion to $78 billion. This would clearly have a big impact on our economies. In fact, it represents nearly 10 percent of all consumer loans or 15 percent of all small business loans.

II. Community Banks Are In Danger of Being Regulated Right Out of Business

Regulatory costs are significant for banks of all sizes, but pound for pound, small banks carry the heaviest regulatory load. In 1996, Congress found that "small businesses bear a disproportionate share of regulatory costs and burdens."[2] For the typical small bank, about one out of every four dollars of operating expense goes to pay the costs of government regulation. For large banks as a group, total compliance costs run into the billions of dollars annually.

The cumulative effect of new rules and regulations will ultimately force many community banks to look for merger partners to help spread the costs; some will go out of business altogether. At a recent meeting of ABA's Community Bankers Council, we had a long discussion on the future of banking. Consistently, every banker mentioned regulatory burden as the first or second critical factor threatening the viability of his or her community bank over the next five years. In fact, many bankers and bank consultants believe that half of the banks in the U.S. will disappear in the next five years because of the regulatory burden and that only banks greater than $500 million in assets will have the capacity to meet their regulatory obligations. These are quite shocking comments as there are 8,000 banks with less than $500 million in assets and only 1,100 above this level. As my bank is just above that asset size, I can tell you, Mr. Chairman, the pressures to comply with all the regulations and still meet the demands of our customers are enormous. We feel that we must grow the bank rapidly to generate more revenues simply to pay for the ever-increasing regulatory cost. The sad part is that too much time and effort is now devoted to compliance and not to serving our customers.

Bankers at all levels, from bank directors and CEOs to compliance managers and tellers, spend endless hours on compliance paperwork. In fact, much of the burden of regulatory paperwork – for example, filling out hundreds of forms, providing reams of disclosure statements to loan customers and documenting virtually every community lending activity – falls heavily on tellers and loan officers. For example, HMDA alone requires the bank to complete 25 specific items on the Loan Application Register for every routine mortgage refinancing. Considering that more than 10 million mortgages were refinanced over the last three years and it is obvious that this is a huge reporting burden.

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[2] Small Business Regulatory Enforcement Fairness Act of 1996

Considering the very high turnover for tellers and other business-line staff and the complexity of the regulations (particularly for mortgage lending), the training costs required to assure compliance with the many regulations is large and growing. In fact, compliance-related training and development and compliance conferences and schools, taken together, make up the second-largest portion of total compliance spending, after salaries and benefits.[3]

Compliance issues are discussed at virtually every meeting of the Board of Directors. I personally spend about one and a half days per week just on compliance issues. Some CEOs tell me that they are now spending nearly half of their time on regulatory issues. This means that for banking alone, CEOs spend over 5.5 million hours per year on compliance – time that could have been better spent on ways to expanding their businesses and to meet the changing needs of their customers.

Thus, compliance puts a big strain on manpower, especially at small banks. Large banks typically have many full-time employees devoted just to compliance. Many community banks cannot afford to have full-time staff for compliance. At Bank of Smithtown, every person in every department has major compliance responsibilities. Because of the complexities involved, my bank pays tens of thousands of dollars each year to an outside firm to help us with the big compliance issues. On top of this, one person on my staff has a full-time job just to coordinate all the activities throughout the bank related to regulatory compliance. Of course, labor costs are a small part of the entire cost required to meet all the compliance obligations that we have. In addition, banks spend billions annually on compliance training, outside compliance support (including accounting firms, consultants and attorneys), compliance related hardware and software, printing, postage, and telephone connections.

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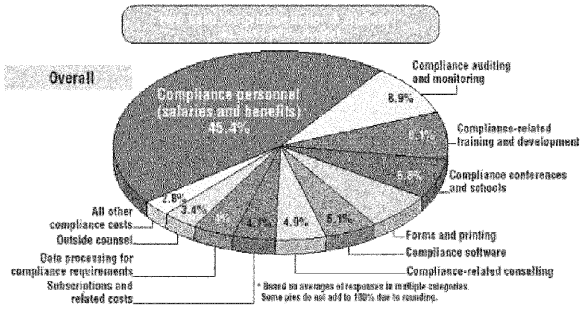
[3] *Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey.* ABA Banking Journal, June 2003. Sponsored by the ABA Banking Journal, ABA Compliance Executive Committee and Bankers Systems, Inc.



Source: *Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey.* ABA Banking Journal, June 2003.

I was shocked to learn from a banker recently that his bank – with only 20 employees – has had to add a full time person to complete reports related to the Bank Secrecy Act. Not only is this a huge expenditure of time and money, he and other bankers wonder if these reports are even being read. The cost vs. benefit analysis fails to make the case for many of the rules and regulations banks must follow, and the reports that we generate.

This banker is not alone. In fact, there are more than ***3,350 banks and thrifts with fewer than 25 employees; more than 1,000 banks and thrifts have fewer than 10 employees***. These banks simply do not have the human resources to run the bank *and* to read, understand and implement the thousands of pages of new and revised regulations, policy statements, directives, and reporting modifications they receive every year. In fact, according to the Small Business Administration's Office of Advocacy, the total cost of regulation is 60 percent higher per employee for firms with fewer than 20 employees compared to firms with more than 500 employees due to the fixed costs associated with regulations.[4]

To illustrate the magnitude of this burden on small banks, consider this: Each year the ABA publishes a book called the "Reference Guide to Regulatory Compliance." This ***600-page reference*** guide attempts to ***summarize and outline*** the requirements embodied in thousands and thousands of pages of regulations promulgated from more than 50 statutory requirements. It covers 26 key

[4] Crain and Hopkins, "Impact of Regulatory Costs for Small Firms," Small Business Administration, Office of Advocacy, 2001

requirements for consumer protection, ten for safety and soundness, eight on information reporting, seven on bank operations, and four on "social responsibilities" (such as CRA). The upcoming edition will no doubt have even more pages outlining the new responsibilities under the USA Patriot Act, the expanded HMDA reporting requirements, HIPAA requirements, additions under the Sarbanes-Oxley Act and the inevitable changes in regulations that occur every year.

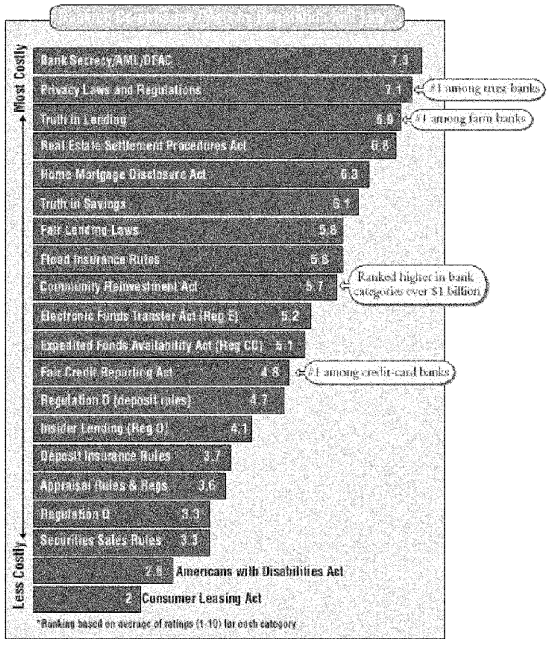
Moreover, this reference guide covers the primary compliance obligations, but bankers face other call report and disclosure requirements by the banking regulators, and other new requirements from the SEC, FASB, PCAOB and AICPA.

In 2003, several Texas banks quantified the burden they face every day due to regulatory issues. One of those institutions, Austin Bank, a $600 million bank based in Jacksonville, Texas, calculated that its employees spend almost 31,500 hours annually on compliance issues. Almost 27,000, or over 85 percent of these hours are spent on Bank Secrecy Act or USA Patriot Act responsibilities at the bank. In excess of 14,000 of these hours alone are spent on currency transaction reporting.

Another institution, Southside Bank, Tyler, Texas, with $1.5 billion in assets, found that its employees spend over 13,000 hours annually on HUD, HMDA, CRA, and Truth in Lending Act compliance. The bank has found that while some regulations have real merit and do help the consumer, most consumers largely ignore the flood of disclosures they are presented with as part of a banking transaction. In addition, in the age of fast computers and quick decisions, the bank finds a real contradiction between meeting the technical requirements of regulatory disclosures and what their customers really are concerned about or interested in knowing, which is getting an account opened or a loan approved.

The experiences of these two banks are illustrative of a theme repeated consistently in the outreach meetings hosted by the regulatory agencies regarding the Congressionally-mandated review of existing regulations. It is clear from the comments of bankers at these meetings that the overwhelming burden is in statutes and regulations classified by the agencies as Consumer Protection and Anti-terrorism/Anti-money laundering. This corresponds with the most recent increases in regulatory burden, including massive new HMDA reporting requirements, annual privacy notices, and

extensive new USA Patriot Act requirements, including customer identification programs, and mandated responses to urgent law enforcement information requests. In fact, it appears that the great bulk of comments from bankers to the regulators about how to reduce the regulatory burden will fall into the two categories of consumer protection and anti-terrorism/anti-money laundering. The Chart below provides a ranking of the regulations based on their relative compliance cost.



Source: Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey. ABA Banking Journal, June 2003.

Banks that are regulated by more than one bank regulatory agency have a particular challenge, in that opinions about what is correct or adequate with regard to certain regulatory requirements differ between agencies. Such banks currently lack one definitive answer about what is required and necessary to comply with any specific aspect of a regulation. Another challenge facing institutions is the fact that compliance regulations can come from a variety of sources, including HUD and FTC

for instance, that are not familiar with the banking industry and how it functions, and are not sensitive to the cumulative costs and burdens of compliance.

Sensitivity to the overall regulatory burden further needs to consider what new changes are being required of the industry from other standard setters, such as the SEC, FASB, PCAOB, and AICPA. The system lacks monitoring of the overall increasing regulatory and reporting burden on financial institutions. Just over the last few years, numerous accounting changes have been issued and have cost the industry an enormous amount of valuable staff time and money to implement. A few of the most recognizable rules include: fair value disclosures, accounting for derivatives, accounting for guarantees, accounting for loan loss reserves, accounting for special purpose entities, and accounting for purchased loans. These rules are being issued at a very rapid speed with an extraordinarily short amount of time given to implement them; this presents a significant challenge to all banking institutions. Moreover, we are concerned that a significant amount of time, effort and expense has been directed to rules that have not been demanded by investors and will not be used or even understood by them.

While we recognize the positive benefits of the Sarbanes-Oxley Act, this year banks are experiencing large increases in annual auditing fees as a result of it and new rules developed by the PCAOB. Like many other community banks, my bank's accounting fees will double this year. Not only have outside auditing fees increased tremendously, but so too have attorneys' fees and insurance costs. Many publicly traded community banks are exploring whether to de-register under the Securities Exchange Act of 1934 because the huge regulatory expenses and the doubling – and even tripling – of accounting and legal costs that result directly from Section 404, Management Assessment Of Internal Controls, and other provisions of the Sarbanes-Oxley Act. We would suggest that the Committee look at the costs versus benefits in the application of some of the Act's provisions to community banks.

Another rule maker that I am compelled to mention is the International Accounting Standards Board (IASB). Although I am a community banker, and currently do not have to follow rules issued by the IASB, there is a rapid movement in the U.S. to converge accounting and reporting required by the FASB with those of the IASB. As the convergence continues, more and more demands will be

placed on the industry that will require systems changes, process changes, and an increase in reporting requirements – and at what cost?

ABA believes there is a serious need to look periodically at the total picture of all new rules and requirements placed on the industry, prioritize those requirements, and assess what is immediate and what can be implemented over time.

The bottom line is that too much time and too many resources are consumed by compliance paperwork, leaving too little time and resources for providing actual banking services. I'm sure I speak for all bankers when I say that I would much rather be spending my time talking with our customers about their financial needs and how my bank will fulfill them than poring over piles of government regulations. The losers in this scenario are bank customers and the communities that banks serve.

III. Federal Banking Agency Review of Regulations Must Show Results; Congressional Support for Reduction is Critical

Congressional initiatives to roll back unnecessary regulation have created an environment within the bank regulatory community that has encouraged review, streamlining and even elimination of some unnecessary regulations. In fact, the agencies have made considerable progress in the last five years in improving some of their regulations. Nonetheless, not all of the agencies' regulations have been so revised, although we certainly recognize that, in many cases, the agencies are constrained by the language of statutes in reducing the burdens in a meaningful fashion.

We are hopeful that the current review of bank regulations, required under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), will provide meaningful relief. We applaud the openness of the banking regulators to the concerns of the industry as they conduct this review. Attachment 1 provides some of the key concerns communicated to the regulators in this process from ABA.

Doubt exists as to whether this effort will be – or even can be – successful in achieving a meaningful reduction in the burden. Most bankers have seen previous efforts at regulatory relief come and go without noticeable effect, while the overall level of regulatory burden has kept rising. Results are what matters.

There is a dilemma here: at the same time that the regulatory agencies are undertaking a review of all regulations with an eye toward reducing the overall compliance burden, they must promulgate new rules for the new laws that Congress has enacted. Simply put, any reduction in existing compliance obligations is likely to be obliterated by compliance requirements of new regulations implementing new laws. The hours that Austin Bank has devoted to compliance with the Bank Secrecy and USA Patriot Act shows how overwhelming new obligations can be.

We expect similar compliance energy to be expended when the numerous FACT Act provisions become effective. While ABA strongly supported that Act and commends Congress for its passage, some provisions of that act will impose additional new burdens. We strongly urge Congress to emphasize to the various agencies responsible for implementing the FACT Act regulations that those agencies be sensitive to compliance burdens when promulgating the regulations.

It should be noted that even when Congress has acted to reduce a burden, the agencies have at times not followed through. For example, in 1996, Congress amended RESPA so as to reduce the amount of information that must be provided to mortgage customers relating to a lender's sale, transfer or retention of mortgage loan servicing. This change eliminated the requirement that lenders provide historical data on the likelihood of this transfer and that customers acknowledge receipt of this information in writing. ***HUD has never implemented this statutory change to RESPA.*** Thus, since 1996 HUD's regulation continues to require language in the disclosure form, which Congress struck from the statute. This creates an unnecessary burden on banks.

Bankers continue to be concerned about "the uneven playing field" in compliance between depository institutions and other financial institutions. While bankers spend increasing amounts of time and money dealing with regulatory red tape, non-bank competitors, including money market funds and mutual funds, are selling savings and investment products to bank customers. The same is true of the local credit union and the Farm Credit System, both of which are free from much of the

red tape and expenses imposed on banks. Even when the regulatory requirement is the same on paper, such as the case with the Truth in Lending requirements, non-bank competitors are not subject to the frequent, in-depth, on-site examination that banks are subject to. The result is slower growth for banks, leaving fewer community resources available for meeting local credit needs.

Bankers know that their loans will be examined for consumer compliance at least once every two years. They also know that nonbank lenders will not have their loans examined, probably ever, because the Federal Trade Commission and the state agencies that have jurisdiction over them do not have the examination and supervision infrastructure to do so. One solution is to fund, by assessment of the nonbank lenders, if necessary, a real supervisory examination program to stop some of the consumer abuse and predatory lending that we hear about constantly. Congress should ensure that the FTC has the resources to actually enforce against nonbank lenders the consumer protection laws currently in effect.

Importantly, the EGRPRA mandate encompasses more than just regulatory action: it calls for the agencies to advise the Congress on unnecessary burdens imposed by statute, which the agencies cannot change but the Congress can. As noted, in many cases, meaningful compliance burden reduction cannot be achieved absent statutory changes. Mr. Chairman, we hope this Committee will seriously consider the recommendations made under this effort.

Conclusion

In conclusion, the cost of unnecessary paperwork and red tape is a serious long-term problem that will continue to erode the ability of banks to serve our customers and support the economic growth of our communities. We thank you for continuing to look for ways to reduce the regulatory burden on banks and thrifts, and to restore balance to the regulatory process. Mr. Chairman, the ABA is committed to working with you and the members of this committee to achieve this goal.

Attachment 1
Some Specific Regulatory Concerns

ABA has raised several broad concerns with the bank regulators in comment letters on the EGRPRA review. First, the agencies need to consider the overall bank regulatory burden in making any new regulatory proposals, whether they are changes to existing regulations or implementation of new ones. Consider, for example, the major changes to the Home Mortgage Disclosure Act data collection and reporting requirements of Regulation C adopted by the Fed in December of 2001. Originally, the Fed would have required that the new data be collected in 2003, but the number of changes and the complexity involved were so great that the Fed subsequently amended the rule to require most data to be collected beginning in 2004.

The changes include a new census tract reporting system that uses five rather than four identifiers; a complex new reporting of whether applicants are of Hispanic ethnicity and of reporting from which races from a multiple racial designation system is the applicant; whether the loan is for a manufactured home; whether the loan is a HOEPA loan; whether the loan is secured by a first lien, junior lien or no lien; the rate gap on loans secured by a first mortgage that are more than three percent higher than similar term Treasuries, if a first lien, or five percent higher, if a junior lien; a change in the definition of home improvement loans; a major change in the definition of refinance that captures for the first time significant numbers of commercial loan refinancings; newly requiring government monitoring information on ethnicity, race, and gender on telephone applications; a requirement making preapprovals of loans subject to HMDA reporting; and a new identifier for a purchaser of the loan. ***Almost all home mortgage applications had to be revised and reprinted, every telephone and electronic application system had to be revised, every automated computer system for HMDA data collection had to be extensively reprogrammed, and virtually every mortgage lending officer had to be retrained in order to implement these changes.*** The industry is still staggering under the burden of adjusting to the burden of these changes.

Agencies should also always take into account regulatory burden arising from those other regulators and rule makers. There are examples where this has not occurred. For example, the Department of Housing and Urban Affairs recently proposed a significant revision of Regulation X

which implements the Real Estate Settlement Procedures Act that was inconsistent with the closely related existing Truth in Lending Act regulations, promulgated by the Federal Reserve Board. If adopted, it would have created much new burden and great confusion. Thus, we believe that it is not enough just to review banking regulations. The agencies and the industry need to review the entire burden of regulation on banking.

Second, bankers are concerned that some regulatory proposals from the agencies suggest that the staff members writing the proposals are not as familiar with banking practice and the current level of regulatory burden, as they might need to be. For example, the existing HUD requirement that hazard insurance and property taxes for junior liens and home equity loans be disclosed on the Good Faith Estimate and HUD-1 creates regulatory burden for banks and confusion for their customers. Frequently a bank does not have access to this information and must ask the customer for such information in order to provide disclosures back to the customer. At the same time, the customer is confused because the hazard insurance and property taxes disclosed are already paid as escrowed in servicing the first lien. Eliminating this redundancy will benefit lenders and their customers.

ABA believes that familiarity is crucial to reducing the regulatory burden, to minimize ***changes*** to existing regulations as much as possible and to avoid new regulations. ABA is concerned that the cost and burden of regulatory changes and new requirements are often underestimated. It is assumed that a new disclosure or revision to an existing disclosure means simply purchasing the new forms and software. But it usually involves much more. Banks must always look for changes to existing regulations and new requirements, review them, make necessary modifications, order new forms and programs, revise websites and advertisements, educate staff, prepare staff for customer inquiries, and implement auditing measures. As one banker put it, "Just hold still!"

The agencies also could be more sensitive to regulatory burdens and costs when proposing changes to regulations. A good example is the Federal Reserve Board's (Fed) proposal in late 2003 to alter the meaning of "clear and conspicuous" for virtually all required consumer protection disclosures. While well intentioned, the Fed's staff seemed unaware that all forms, all documents, all software programs, all advertisements, websites, education materials, etc., would have to be reviewed, revised, and redistributed and that staff would have to be reeducated. The Fed's staff also seemed to equally underestimate the costs associated with potential litigation, both the actual costs as well as the

costs associated with litigation avoidance, all well-documented costs. And yet, there is little if any evidence that the existing disclosures are inadequate so as to justify enormous new compliance costs.

The March 2003 amendments to Regulation B and its Commentary involving joint applications provides another example of how regulatory changes, which appear to be minor, can create confusion and compliance burdens. The Fed modified the regulation to clarify the need for creditors to document that co-applicants have applied for a loan. The Fed also added language to the model forms so that applicants could specifically indicate whether they were applying jointly or individually.

While the Fed stated that written applications are not necessary (except where otherwise required) and that model forms are optional, some institutions and examiners incorrectly concluded that the changes required written applications and that the language added to the model forms is mandatory. Some agency examiners also asserted that certain common secondary mortgage forms no longer complied. On this basis, some creditors altered their forms.

The bottom line is that even though an Agency may issue an advisory that revisions or procedures are optional, compliance officers see a significant risk in not adopting what seems to be sanctioned forms or language. Retaining current forms along with new language would reinforce the concept of flexibility and choice.

Third, we believe that the Paperwork Reduction Act has outlived its usefulness as a mechanism to achieve meaningful reductions in regulatory burden. Amendments to the law in 1995 removed from judicial review approvals of paperwork collections by the Director of OMB. This essentially eliminated any effective challenge to new paperwork burden by banks and their trade associations. Since then, the filings by the agencies and the review of them by the OMB have become just routine. Moreover, responses to OMB requests for comment on the paperwork burden have apparently dropped to almost nothing, since virtually every request for maintenance or additional paperwork is approved under the current process. Thus, commenting would be a waste of precious time. Simply put, the Paperwork Reduction Act is not effective in reducing or preventing additional paperwork and may just be serving to increase agency paperwork.

TESTIMONY OF

EUGENE F. MALONEY

**BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS**

"CONSIDERATION OF REGULATORY REFORM PROPOSALS"

**June 22, 2004
10:00 a.m.
Dirksen Senate Office Building, Room 538**

My name is Eugene F. Maloney. I am Executive Vice President and Corporate Counsel with Federated Investors, Inc. Federated is a Pittsburgh-based financial services holding company whose shares are listed on the New York Stock Exchange. Through a family of mutual funds used by or in behalf of financial intermediaries and other institutional investors, we manage approximately $200 billion. For the past 16 years I have been a member of the faculty of Boston University School of Law, where I teach a course on the securities activities of banks. Our mutual funds are used by over 1,000 community banks either within their own portfolios or in behalf of clients of their trust departments. These institutions are not our customers – they are our friends.

In connection with the proposed removal of Regulation Q, thereby permitting banks and thrifts to pay interest on business checking, my firm's position is that we are strongly in favor of any rule, regulation or legislation which results in our community bank friends becoming more competitive, more profitable or being able to operate their business more efficiently. We are concerned that the current initiative to repeal Regulation Q will result in the exact opposite. This conclusion is based on my personal experience with the introduction of ceilingless deposit accounts in 1982 and the impact it had on our client base. Friends of long standing lost their jobs, their pensions and their self esteem because of the failure by governmental officials and members of Congress to fully think through the economic impact of ceilingless deposit accounts to our banking system and its profitability. This failure cost every man, woman and child in the United States $1,500.

In researching the history of ceilingless deposit accounts which were to be "competitive with and equivalent to money market mutual funds," we found some fascinating information. At the meeting chaired by the

Secretary of the Treasury to consider the features of the new account, the members were advised that if they set the minimum account size below $5,000, massive internal disintermediation would occur, and it would result in pure cost to the banks. The account size was set at $2,500. We have been to the national archives and declassified the minutes of subsequent meetings. They make for astonishing reading. The members were fully briefed on the excesses committed by banks and thrifts and elected to do nothing to stop them. I brought some examples with me *(see Exhibits A-1, A-2)*.

We have seen nothing in the present record to suggest any effort has been made to prevent a repeat of the past mistakes.

The legislative record indicates that only slight attention has been given to the cost to banks of paying interest on business checking accounts or the resulting impact on bank earnings. The record does not include the type of detailed analysis such as was performed by the staff of the Depository Institutions Deregulation Committee ("DIDC") during the DIDC's deliberations on whether to allow the payment of interest on business checking accounts in the early 1980's. The record also does not indicate that any significant attention has been given to the relationship between interest rate deregulation in the early 1980's and the subsequent thrift crisis.

The House committee report on the pending legislation includes a detailed estimate of the implications for federal tax revenues and the budgetary impact of paying interest on required reserve balances,[1] but not of the impact on bank earnings or assets.

During the House committee hearings, in response to questioning as to whether the legislation would "weaken any player in the market,"

Governor Meyer of the Federal Reserve Board replied, "No."[2] In response to a question as to whether the Board had any estimate as to the amount of deposits that are lost by banks due to the current prohibition against the payment of interest on business checking accounts, Governor Meyer replied, "No, I don't have any numbers to share with you."[3]

The witness representing the Independent Community Bankers of America testified that there are differences of opinion as to the cost impact of the legislation:

> There are wide differences of opinion regarding the anticipated effects of repealing the prohibition. For example, one analysis prepared by a banker who is opposed to repealing the prohibition on paying interest on business checking accounts indicated that if the bank's customers moved $20 million into interest bearing accounts at 5-1/2 percent, the interest cost would be the equivalent of 17 cents per share, affecting the price of the institution's stock by $2.38. Under this scenario, the bank would have to raise $21,509,304 in additional deposits to offset the cost of moving the $20 million in interest-free deposits to interest bearing accounts. This banker determined that such a cost would be prohibitive.
>
> By contrast, another banker supporting the repeal of the prohibition argued that the current prohibition has been

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[1] H. Rep. No. 107-38 at 10-18 (Congressional Budget Office report).

[2] "Proposals to Permit Payment of Interest on Business Checking Accounts and Sterile Reserves Maintained at Federal Reserve Banks," Hearing before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, 107th Cong., 1st Sess. (March 13, 2001) ("House Hearing") at 18 (Testimony of Laurence H. Meyer, Member, Board of Governors of the Federal Reserve System).

> competitively damaging to the banking industry, especially community banking. He said many brokerage firms and other non-bank competitors have and will more aggressively continue to compete directly with commercial banks to develop and expand small business relationships. If the banking industry is not allowed to be competitive in offering interest-bearing commercial checking accounts, community banks may become more vulnerable to losing their most important business deposit and loan customers to non-bank and money center financial services providers that are not constrained by banking prohibitions.[4]

This witness also testified that the payment of interest on required reserves offered little benefit to smaller banks:

> So you can see, Mr. Chairman, the interest on reserves proposal would have little, if any, direct monetary benefit for most community banks. Indeed, it is the larger depository institutions that would benefit most from such a proposal.

I have not found any senior official at a community bank that is in favor of this initiative. Let me share with you why I think this is true. Since the record to date lacks any analysis of the economic impact of the repeal, we commissioned our own study which was conducted by Treasury Strategies of Chicago *(see Exhibit B)*. These are some of their key findings:

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[3] *Id.* at 24.

[4] House Hearing at 81(testimony of Robert I. Gulledge, Chairman/CEO of Citizens Bank, Inc., Robertsdale, Alabama, on behalf of the Independent Community Bankers of America).

1. On the basis of our in-depth consulting work in this arena, we estimate the profit at risk as a result of interest on business checking will be $7-$9 billion for the banking industry. We compute a specific exposure index for each of our client's business segments. The highest index value (exposure) is generally found in banks with a large concentration of small business customers. Banks serving the middle market also have high index values. Banks with concentrations of state and municipal deposits have below average risk and banks serving the largest corporations have the least risk.
2. For the banks studied by Treasury Strategies, we have determined that in order to break even on their small customer base, commercial banking segments will need to grow deposits or raise service charges by the following:

   Small Business:

   (a) grow deposits by 80%; or

   (b) raise service charges by 34%

   Mid-size Companies:

   (a) grow deposits by 35%; or

   (b) raise service charges by 16%

The reason I am here today is to make a fact-based attempt to prevent history from repeating itself.

I appreciate being given the opportunity to share my thoughts with the Committee. I would be pleased to take questions.

CUNA & Affiliates

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WRITTEN TESTIMONY
OF
MARILYN JAMES
PRESIDENT & CEO, NEPCO FEDERAL CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
"CONSIDERATION OF REGULATORY REFORM PROPOSALS"
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JUNE 22, 2004

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JUNE 22, 2004

Chairman Shelby, Ranking Member Sarbanes, Senators Crapo, Allard and other members of the Committee, on behalf of the Credit Union National Association (CUNA), I appreciate this opportunity to come before you and express the association's views on legislation to help alleviate the regulatory burden under which all insured financial institutions operate today.

CUNA is the largest credit union advocacy organization, representing over 90% of our nation's approximately 9,400 state and federal credit unions and their 85 million members.

I am Marilyn James, President and CEO of NEPCO Federal Credit Union in Pueblo, Colorado. NEPCO, a relatively small credit union with $20 million is assets, is an acronym for Northeast Pueblo County. We have a geographic field of membership that incorporates approximately 1/5th of the city and 1/4th (inclusive of each other) of the county and was designed in 1976 so that it included our original FOM, the Pueblo Army Depot (now the Pueblo Chemical Depot). We serve anyone who lives or works in the area or has a relative who is eligible.

The Pueblo City/County population is approx. 124,000 and is 36% Latino or Hispanic, 61% White and 3% other (according to the most recent census). 25% are under age 18, 15% are over age 65

with the remaining 60% between 18-64. Two trends seem to be the future of our area: Increasing elderly and increasing Latino/Hispanic. The median income has shown a slight decline in comparison to both the State of Colorado and the U.S. This is counterbalanced by a low cost of living compared to both the State and the U.S. The average annual wage is $27,100.

While we do not track our membership specifically by ethnic origin, I would say that NEPCO's membership somewhat reflects the local community with a slightly larger percentage of Latino/Hispanic members, probably closer to 45%. The age breakdown of our members also deviates from the City/County: 6% are under age 18, 22% are over age 65 and 72% are between the ages of 18 and 65.

NEPCO offers the usual services: All types of secured and unsecured consumer loans including line of credit, VISA credit cards and overdraft protection and mortgage loans; regular share accounts (including Life Savings Insurance), money market shares, vacation & Christmas savings, share drafts with VISA debit/ATM cards, IRAs and CDs. We are one of the few institutions in town where you can still open a savings account with $5.00 and a checking account with as little as $50.00. There is no monthly service charge on our checking accounts and the only fees incurred by our members are the cost of check forms and fees for such things as NSF, stop payment, etc. These fees are approximately 35% lower than corresponding fees at local banks. We also offer free instruction to members opening a draft account (at the member's request) as well as free consultation for members who have trouble balancing their accounts.

While we do not have "Life Line Checking" per se, we have many members who have opened a $5.00 share account for the specific purpose of receiving direct deposit of social security and/or

other recurring payments. There is no fee attached to these transactions. In addition, we offer members check cashing services either for free (requires a savings balance of more than $100, or a loan account) or at a nominal fee of $1.00 per $100. This fee is 50% less than the cheapest check cashing service in town and 100% or more less costly than most. This is one service that could be provided to the underserved in our community and give us the opportunity to educate consumers eligible for membership regarding other services beneficial to consumers of modest means.

CUNA is especially pleased that the Committee is considering a new effort to provide regulatory relief of unneeded and costly burdens, since the last two regulatory relief bills that Congress passed did not include provisions specific to credit unions. Some might suggest that the Credit Union Membership Access Act (CUMAA) was the credit union version of regulatory relief. While that law did provide relief from an onerous Supreme Court decision, it also imposed several new, stringent regulations on credit unions, which, in spite of assertions to the contrary, are the most stringently regulated of insured financial institutions.

Credit Unions Are Distinct Financial Institutions

Among its numerous provisions, the Credit Union Membership Access of 1998[1] (CUMAA) required the U. S. Department of the Treasury to evaluate the differences between credit unions and other types of federally insured financial institutions, including any differences in the regulation of credit unions and banks.

The study, "Comparing Credit Unions with Other Depository Institutions," found that while "credit unions have certain characteristics in common with banks and thrifts, (e.g., the intermediation

[1] Pub. L. No. 105-219 Sec. 401; 112 Stat. 913 (1998); 12 USC 1752a note and 1757a note

function), they are clearly distinguishable from these other depository institutions in their structure and operational characteristics."

These qualities, catalogued by the U.S. Treasury in its 2001 study, had been previously incorporated into the congressional findings of the Federal Credit Union Act[2] when CUMAA was adopted in 1998.

Recognition and appreciation of such attributes is critical to the understanding of credit unions, as Congress made it clear when it amended the FCU Act in 1998 that it is these characteristics that form the foundation on which the federal tax exemption for credit unions rests. As Congress determined when it passed CUMAA:

"Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are:

1. member-owned,
2. democratically operated,
3. not-for profit organizations,
4. generally managed by volunteer boards of directors, and
5. because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means."

While other institutions, such as mutual thrifts, may meet one or two of these standards or display some of these differences, other credit union distinctions listed here do not necessarily apply. As

[2] P. L. 105-219, Sec. 2, 112 Stat. 913

Treasury noted in its study, "Many banks or thrifts exhibit one or more of …(these) characteristics, but only credit unions exhibit all five together." [3]

Other 1998 congressional findings in the FCU Act also emphasize the unique nature of credit unions:

(1) "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means.

(2) "Credit unions continue to fulfill this public purpose and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action.

Since their inception, credit unions continue to share these unique attributes, separating them from other depository institutions. Despite the frequent attempts of detractors to present credit unions in a false light and label them as other types of institutions, the distinct characteristics of credit unions have been recognized in statute and in analytical reports from the U.S. Treasury and others. Further, despite repeated attempts, legal challenges brought by banking groups against NCUA's field of membership policies under the Credit Union Membership Access Act have not proved fruitful.

As distinct institutions, credit unions today stand distinctly in need of regulatory relief.

[3] U.S. Dept. of the Treasury, *Comparing Credit Unions with Other Depository Institutions, (Wash. DC: 2001.)*

Credit Unions' Regulatory Burden Is *Real* And Relief Is Imperative

As cooperative financial institutions, credit unions have not been shielded from the mounting regulatory responsibilities facing insured depositories in this country.

Last month, Federal Deposit Insurance Corporation (FDIC) Vice Chairman John M. Reich said in testimony before the House Subcommittee on Financial Institutions and Consumer Credit, "regulatory burden is a problem for all banks." His statement is accurate as far as it goes.

Regulatory burden is an issue for all financial institutions generally, and credit unions in particular. Indeed, credit unions **are the most heavily regulated of all financial institutions.** This dubious distinction is the result of several factors, which include:

- Credit unions operate under virtually the same consumer protection rules, such as Truth-Lending, Equal Credit Opportunity, Home Mortgage Disclosure, Real Estate Settlement Procedures Act, Truth-in-Savings, Expedited Funds Availability Act, USA Patriot Act, Bank Secrecy, safety and soundness including prompt corrective action regulations reviewed by Treasury, and other rules that apply to banks. Credit unions will also have to comply with developing rules under the Fair and Accurate Credit Transactions (FACT) Act and the Check 21 statutory requirements. A list of the 137 rules that federal credit unions must follow is attached.

  (1) Credit unions are the only type of financial institution that have restrictions on whom they may serve;

  (2) Credit unions are the only group of financial institutions that must comply with a federal usury ceiling;

(3) Credit unions may not raise capital in the marketplace but must rely on retained earnings to build equity;

(4) Credit unions are the only group of financial institutions that must meet statutory net worth requirements;

(5) Credit unions face severe limitations on member business lending;

(6) Credit unions have limitations on loan maturities;

(7) Credit unions have stringent limitations on investments;

(8) Credit unions have not been granted new statutory powers, as banks have under Gramm-Leach Bliley; and

(9) Credit unions' operations and governance are inflexible because many aspects are fixed in statute.

Most importantly for credit unions, time and other resources spent on meeting regulatory requirements are resources that would otherwise be devoted to serving their members – which is, after all, their primary objective.

With Few Exceptions, Credit Unions Must Comply with Virtually All Bank Rules

Despite unfounded banker chargers to the contrary, federally insured credit unions bear an extraordinary regulatory burden that is comparable to that of banks in most areas and much more restrictive in others.

As the Treasury's 2001 study comparing credit unions with other institutions concluded, "Significant differences (in the general safety and soundness regulation of banks and credit unions, parenthesis added) have existed in the past, but have been gradually disappearing." The Treasury

study cited prompt corrective action and net worth requirements for credit unions as a major regulatory difference that was removed in 1998.

Treasury further noted that their "relative small size and restricted fields of membership" notwithstanding, "federally insured credit unions operate under bank statutes and rules virtually identical to those applicable to banks and thrifts."

Credit Unions Must Comply With Substantial Requirements Banks Don't Have to Follow

In addition to following rules applicable to the banking industry, credit unions operate under considerable statutory and regulatory requirements that do not apply to other types of financial institutions.

As Treasury's study pointed out, credit union statutory net worth requirements direct federally insured credit unions to maintain a minimum of 6% net worth to total assets in order to meet the definition of an adequately capitalized credit union. Well-capitalized credit unions must meet a 7% net worth ratio. "(T)his exceeds the 4% Tier 1 level ratio applicable for banks and thrifts (and is statutory as opposed to regulatory)," Treasury stated. Complex credit unions have additional net worth requirements.

Treasury's analysis also pointed to the fact that **"federal credit unions have more limited powers than national banks and federal saving associations. Most notably, federal credit unions face stricter limitations on their (member business)** …lending and securities activities. In addition, a usury ceiling prevents them from charging more than 18% on any loan, and the term of many types of loans may not extend beyond twelve years."

Credit unions also have statutory and regulatory restrictions as to whom they may serve. Federal credit unions' fields of membership must meet the common bond requirements that apply to an associational, occupational, multi-group or community credit union. Thus, unlike banks and thrifts, which may serve anyone regardless of where they live or work, a credit union may only offer its services to individuals within its field of membership.

Credit unions operate under heavily constrained investment authority as well. A federal credit union may invest in government securities and other investments only as provided under the Federal Credit Union Act and authorized by NCUA.

Credit unions also must comply with limitations on lending, including member business lending. A federal credit unions' member business loans may not exceed the lesser of 1.75 times its net worth or 12.25 percent of total assets, unless the credit union is chartered to make such loans, has a history of making such loans or has been designated as a community development credit union. By comparison, banks have no specific limits on commercial lending and thrifts may place up to 20% of their total assets in commercial loans.

It is useful to note that there are other limitations on credit unions' member business lending that do not apply to commercial banks. A credit union's MBLs must generally meet 12-year maturity limits and can only be made to members. Credit union MBLs have significant collateral and while not required, often carry the personal guarantee of the borrower.

Commercial banks have a variety of mechanisms through which they can raise funds, including through deposit-taking or borrowing funds in the capital markets. In marked contrast, credit unions

may only build equity by retaining earnings. A credit union's retained earnings are collectively owned by all of the credit unions' members, as opposed to a bank that is owned by a limited number of stockholders or in some cases, by a finite number of individuals or family members.

Thus, a major distinction between credit unions and commercial banks is that credit unions operate under a number of specific, operational regulations that do not apply to banks. Bank trade associations attempt to mislead Congress when they erroneously argue that credit unions have evolved into banks. The restrictions on credit union operations and the limitations on their activities drive a stake into the heart of that argument.

Unlike Banks, Credit Unions Have Not Received New Statutory Powers

Not only have credit unions not received new statutory powers as banks have, severe regulatory constraints on member business lending and under prompt corrective action have been imposed on credit unions for the last several years.

An important study regarding the regulation of credit unions was published last year under the auspices of the Filene Research Institute and addresses the regulatory advantages banks have over credit unions.

Authored by Associate Professor of Economics William E. Jackson, III, Kenan-Flagler Business School, University of North Carolina at Chapel Hill and entitled, "The Future of Credit Unions: Public Policy Issues,"[4] the study looked at the efforts of Congress over the last two decades to

[4] Jackson, III, William E., University of North Carolina-Chapel Hill. ***The Future of Credit Unions: Public Policy Issues, 2003.***

provide regulatory relief for traditional depository institutions and whether more relief for credit unions is reasonable and appropriate.

The study reviewed sources of funding, investments, and the ownership structure of banks, thrifts and credit unions and found that the operational differences among these types of institutions are "distinctive." It observed that since 1980, Congress has enacted a number of statutory provisions that have noticeably changed the regulatory environment in which banks and thrifts conduct business, such as by deregulating liabilities; removing restrictions on interstate branching; and expanding the list of activities permissible for financial holding companies.

For example, the Gramm-Leach-Bliley Act of 1999 expanded the statutory definition of the kinds of products and services in which banks may engage. Under the Act, banking institutions may engage in activities that are merely "financial in nature" as opposed to those that are "closely related to banking." The bank regulators have the authority to determine what is permissible as "financial in nature." Credit unions were not included in this sweeping, statutory expansion of bank powers. However, while they received neither benefits nor new powers under the Gramm-Leach-Bliley Act, credit unions were included in the substantial requirements under the Act regarding privacy, including requirements to communicate their member privacy protection policies to members on an annual basis.

The credit union study noted, "Credit unions face stricter limitations on their lending and investing activities" than other institutions bear. "In general, credit unions have received less deregulation than either banks or thrifts," the study concluded.

Pending Credit Union Regulatory Relief Legislation That CUNA Supports

CUNA strongly supports H.R. 3579, the Credit Union Regulatory Improvements Act (CURIA), which currently has over fifty co-sponsors and is awaiting a hearing before the House Financial Services Committee. CUNA has also endorsed of H.R. 1375, the House-passed Regulatory Relief Act, which was approved by the House of Representatives on March 18, 2004, by a vote of 392-25. In our view, these bills provide an excellent starting point for the Senate Banking Committee as it considers real reforms that will provide regulatory relief to credit unions and other institutions.

While CUNA also supports other statutory changes, we first want to focus on amendments to the Federal Credit Union Act that are contained in H.R. 3579 and Title III of H.R. 1375.

H.R. 3579—The Credit Union Regulatory Improvements Act (CURIA)

Although a comparable bill has not been introduced in the Senate, it nevertheless provides a sound foundation for this Committee's consideration of some fundamental problems facing credit unions today and we ask you to take a close look at these proposed changes as incorporated in CURIA.

H.R. 3579, THE CREDIT UNION REGULATORY IMPROVEMENTS ACT OF 2003--SECTION-BY-SECTION DESCRIPTION

TITLE I: Regulatory Flexibility

Section 102. Leases of land on federal facilities for credit unions

This provision would permit military and civilian authorities responsible for buildings on federal property the discretion to extend to credit unions that finance the construction of credit union facilities on federal land real estate leases at minimal charge. Credit unions provide important

financial benefits to military and civilian personnel, including those who live or work on federal property. This amendment would authorize an affected credit union, with the approval of the appropriate authorities, to structure lease arrangements to enable the credit union to channel more funds into lending programs and favorable savings rates for its members.

Section 103. Investments in securities by federal credit unions

The Federal Credit Union Act limitations on the investment authority of federal credit unions are anachronistic and curtail the ability of a credit union to respond to the needs of its members. The amendment provides additional investment authority to purchase for the credit union's own account certain investment securities. The total amount of the investment securities of any one obligor or maker could not exceed 10 percent of the credit union's unimpaired capital and surplus. The NCUA Board would have the authority to define appropriate investments under this provision, thus ensuring that new investment vehicles would meet high standards of safety and soundness and be consistent with credit union activities.

Section 104. Increase in general 12-year limitation of term of federal credit union loans

Currently, federal credit unions are authorized to make loans to members, to other credit unions, and to credit union service organizations. The Federal Credit Union Act imposes various restrictions on these authorities, including a 12-year maturity limit that is subject to limited exceptions. This section would allow loan maturities up to 15 years, or longer terms as permitted by the National Credit Union Administration (NCUA) Board.

As a Federal credit union, my institution must comply with this limitation. We are very concerned that members seeking to purchase certain consumer items, such as a mobile home, may seek

financing elsewhere in which they could repay the loan over a longer period of time than 12 years. While we would prefer for NCUA to have authority to determine the maturity on loans, consistent with safety and soundness, a 15-year maturity is preferable to the current limit. Such an increase in the loan limit would help lower monthly payments for credit union borrowers and benefit credit unions as well as their members.

Section 105. Increase in one-percent investment limit in credit union service organizations

The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than 1% of its shares and undivided earnings in these organizations, commonly known as credit union service organizations or CUSOs. The amendment raises the limit to 3% percent.

CUSOs provide a range of services to credit unions and allow them to offer products to their members that they might not otherwise be able to do, such as check clearing, financial planning and retirement planning. Utilizing services provided through a CUSO reduces risk to a credit union and allows it to take advantage of economies of scale and other efficiencies that help contain costs to the credit union's members. Further, as federal credit union participation in CUSOs is fully regulated by NCUA, the agency has access to the books and records of the CUSO in addition to its extensive supervisory role over credit unions.

The current limit on CUSO investments by federal credit unions is out-dated and limits the ability of credit unions to participate with these organizations to meet the range of members' needs for financial services. It requires credit unions to arbitrarily forego certain activities that would benefit

members or use outside vendors in which the credit union has no institutional stake. While we feel the 1% limit should be eliminated or set by NCUA through the regulatory process, we appreciate that the increase to 3% will provide credit unions more options to investment in CUSOs to enhance their ability to serve their members.

CUNA also would support raising the borrowing limitation that currently restricts loans from credit unions to CUSOs to 1 percent. We believe the limit should be on par with the investment limit, which under this bill would be raised to 3 percent.

Section 106. Member business loan exclusion for loans to non-profit religious organizations

This section excludes loans or loan participations by federal credit unions to non-profit religious organizations from the member business loan limit contained in the Federal Credit Union Act, which is 12.25% of the credit union's total assets. This amendment would offer some relief in this area by allowing federal credit unions to make member business loans to religious-based organizations without concern about the statutory limit that now covers such loans. While the limit would be eliminated, such loans would still be subject to other regulatory requirements, such as those relating to safety and soundness.

We believe that this is really a technical amendment designed to correct an oversight during passage of the Credit Union Membership Access Act. The law currently provides exceptions to the member business loan caps for credit unions with a history of primarily making such loans. Congress simply overlooked other credit unions that purchase parts of these loans, or participate in them. This provision would clarify that oversight and ensure that these organizations can continue meeting the needs of their members and the greater community at large and ensuring that loans are available for religious buildings as well as their relief efforts.

Section 107. Check-cashing and money-transfer services offered within the field of membership

Federal credit unions are currently authorized to provide check cashing services to members and have limited authority to provide wire transfer services to individuals in the field of membership under certain conditions. The amendment would allow federal credit unions to provide check cashing services to anyone eligible to become a member.

This amendment is fully consistent with President Bush's and Congressional initiatives to reach out to other underserved communities in this country, such as some Hispanic neighborhoods. Many of these individuals live from pay check to pay check and do not have established accounts, for a variety of reasons, including the fact that they do not have extra money to keep on deposit. We have had members join one day, deposit their necessary share balance and come in the very next day and withdraw because they need the money. This is not mismanagement on their part. They just do not have another source of funds. And sometimes, a $5.00 withdrawal means the difference between eating or not.

If we are able to cash checks and sell negotiable checks such as travelers checks, we could accomplish two things: save our staff time and effort opening new accounts for short term cash purposes which are soon closed and gain the loyalty and respect of the potential member so that when they are financially capable of establishing an account, they will look to the credit union, which will also provide financial education and other support services. This is especially so in Pueblo, which attracts migrant workers who live in our area for several months each year, many who return year after year. It has been our experience that this particular group is taken advantage of because of the language barrier. We have developed a group of bi-lingual members who are

willing to act as translators when needed and several successful membership relationships have resulted.

Legislation that includes similar provisions is pending in the Senate on this issue: S. 1359, the "International Remittance Services Enhancement and Protection Act;" and S. 1344, the "Money Wire Improvement and Remittance Enhancement Act," or the "Money WIRE Act." The latter, introduced by Senator Corzine, is cosponsored by several other members of the Committee, including Sens. Bayh and Schumer.

Section 108. Voluntary mergers involving multiple common bond credit unions

In voluntary mergers of multiple bond credit unions, NCUA has determined that the Federal Credit Union Act requires it to consider whether any employee group of over 3,000 in the merging credit union could sustain a separate credit union. This provision is unreasonable and arbitrarily limits the ability of two healthy multiple common bond federal credit unions from honing their financial resources to serve their members better.

The amendment is a big step forward in facilitating voluntary mergers, as other financial institutions are permitted to do. It provides that the numerical limitation does not apply in voluntary mergers.

Section 109. Conversions involving common bond credit unions

This section allows a multiple common bond credit union converting to or merging with a community charter credit union to retain all groups in its membership field prior to the conversion or merger. Currently, when a multiple group credit union converts to or merges with a community charter, a limited number of groups previously served may be outside of the boundaries set for the community credit union. Thus, new members within those groups would be ineligible for service

from that credit union. The amendment would allow the new or continuing community credit union to provide service to all members of groups previously served.

Section 110. Credit union governance

This section gives federal credit union boards flexibility to expel a member who is disruptive to the operations of the credit union, including harassing personnel and creating safety concerns, without the need for a two-thirds vote of the membership present at a special meeting as required by current law. Federal credit unions are authorized to limit the length of service of their boards of directors to ensure broader representation from the membership. Finally, this section allows federal credit unions to reimburse board of director volunteers for wages they would otherwise forfeit by participating in credit union affairs.

There has been more than one occasion when we would have liked to have had the ability to expel a member for just cause. It is relatively rare that things occur that would cause us to use such a provision. However, the safety of our personnel may be at stake. One instance involves a member who seems to have a fixation on one of our employees and who has made inappropriate comments. Another involves an older member who refuses to take no for an answer from one of our young tellers whom he persistently asks to date. We have heard an example at another credit union when one member actually told one of the tellers he would punch her if he ever saw her out in public. Most cases are not quite that extreme; however, we have had our share of unruly members who seem to enjoy causing a ruckus.

Credit unions should have the right to limit the length of service of their boards of directors as a means to ensure broader representation from the membership. Credit unions, rather than the federal government, should determine term limits for board members. Providing credit unions with this

right does not raise supervisory concerns and should not, therefore, be denied by the federal government.

Credit unions are directed and operated by committed volunteers. Given the pressures of today's economy on many workers and the legal liability attendant to governing positions at credit unions, it is increasingly difficult to attract and maintain such individuals. Rather than needlessly discourage volunteer participation through artificial constraints, the Federal Credit Union Act should encourage such involvement by allowing volunteers to recoup wages they would otherwise forfeit by participating in credit union affairs.

Whether or not a volunteer attends a training session or conference is sometimes determined by whether or not that volunteer will have to miss work and not be paid. I've seen it happen in my own credit union, and my board is comprised of GM employees and retirees. I can imagine this would have an even more substantial impact on boards where the volunteers are not making the income my volunteers do.

Section 111. Providing NCUA with greater flexibility in responding to market conditions

Under this section, in determining whether to lift the usury ceiling for federal credit unions, NCUA will consider rising interest rates or whether prevailing interest rate levels threaten the safety and soundness of individual credit unions.

Section 112. Leasing Space in Buildings with Credit Union Offices in Underserved Areas

This section enhances the ability of credit unions to assist distressed communities with their economic revitalization efforts. It would allow a credit union to lease space in a building or on

property in an underserved area on which it maintains a physical presence to other parties on a more permanent basis. It would permit a federal credit union to acquire, construct, or refurbish a building in an underserved community, then lease out excess space in that building.

Section 113. Credit Union Conversion Voting Requirements

This section would change the Federal Credit Union Act from permitting conversions after only after a majority of those members voting approve a conversion, to requiring a majority vote of at least 20 percent of the membership to approve a conversion.

Time and time again, Congress has made clear its support for credit unions, in order to assure consumers have viable choices in the financial marketplace. Yet, banking trade groups and other credit union detractors have indicated they would like to encourage credit union conversions, particularly those involving larger credit unions, in order that they may control the market, thereby limiting consumers' financial options.

In February, the National Credit Union Administration adopted new regulatory provisions to require credit unions seeking to change their ownership structure to provide additional disclosures to their members to insure they are adequately informed regarding the potential change and are fully aware of the consequences of such action. CUNA strongly supported this action because we feel members should know that their rights and ownership interests will change, particularly if the institution converts to a bank. In such a situation the institution would "morph" from one in which the members own and control its operations to an institution owned by a limited number of stockholders.

CUNA likewise supports the agency's ongoing efforts to ensure members are provided sufficient disclosures and opportunities to present opposing views in relation to a possible conversion.

Congress addressed conversions in the Credit Union Membership Access Act and reinforced that a credit union board which desires to convert must allow its members to vote on its conversion plan. CURIA would require a minimum level of participation in the vote -- at least 20% of the members -- for a conversion election to be valid. Currently, there is a requirement that only a majority of those voting approve the conversion. The legislation would prevent situations in which only a very small number of an institution's membership could successfully authorize such a conversion.

Earlier this year, CUNA's Governmental Affairs Committee developed a resolution that was adopted by our Board relating to credit union ownership, and we want to share its provisions with the Committee.

- The credit union charter presents the best vehicle for serving the financial needs of consumers;
- Credit unions considering changing ownership structure to a bank or thrift charter should decide solely on the basis of what is best for the members of the credit union--not for the management or directors;
- The credit union system should identify and recommend ways to keep the credit union's net worth in the hands of its members;
- Credit unions should provide plain language, full disclosure of all relevant information--including the pros and cons--of a change in the ownership and governance of the credit unions;

- Ensure that credit union senior management and directors are not unjustly enriched, and that appropriate penalties will be imposed for noncompliance with disclosure and other requirements designed to protect the interests of the members; and
- CUNA is rededicated to the improvement of the credit union charter.
- CUNA will continue to look for ways, working with Congress and regulators, to insure a credit union's membership is fully aware of the consequences of a conversion prior to any membership vote.

Section 114. Exemption from pre-merger notification requirement of the Clayton Act

This section gives all federally insured credit unions the same exemption as banks and thrift institutions already have from pre-merger notification requirements and fees of the Federal Trade Commission.

Section 115. Treatment of credit unions as depository institutions under securities laws

This section gives federally insured credit unions exceptions, similar to those provided to banks, from broker-dealer and investment adviser registration requirements.

Title II: Member Business Lending

Section 201. Limits on Member Business Loans

This section eliminates the current asset limit on member business loans at a credit union from the lesser of 1.75 times actual net worth or 1.75% times net worth required for a well-capitalized credit union and replaces it with a flat rate of 20 percent of the total assets of a credit union. This provision therefore facilitates member business lending without jeopardizing safety and soundness at participating credit unions.

Section 202. Definition of Member Business Loans

This section would amend the current definition of a member business loan to facilitate such loans by giving the NCUA the authority to exclude loans of $100,000 or less as de minimus, rather than the current limit of $50,000.

Section 203. Restrictions on Member Business Loans

This section would modify language in the Federal Credit Union Act that currently prohibits a credit union from making any new member business loans if its net worth falls below 6 percent. This change will permit the NCUA to determine if such a policy is appropriate and to oversee all member business loans granted by an undercapitalized institution.

Having described briefly how CURIA would address this issue, I would like to provide the Committee with a detailed rationale for these needed changes.

HELPING SMALL BUSINESS

Title II, Section 203 of the Credit Union Membership Access Act of 1998 (CUMAA) established limits on credit union member business loan (MBL) activity. There were no statutory limits on credit union member business lending prior to1998. The CUMAA-imposed limits are expressed as a 1.75 multiple of net worth, but only net worth up to the amount required to be classified as well capitalized (i.e., 7%) can be counted. Hence the limit is (1.75 x .07) or 12.25% of assets.

NEED FOR REFORM OF CREDIT UNION MBL LIMITS

Small businesses are the engine of economic growth – accounting for about one-half of private non-farm economic activity in the U.S. annually. Their ability to access capital is paramount. But this access is seriously constrained by the double-whammy of banking industry consolidation and the CUMAA-imposed limitations on credit union MBLs. Recent research published by the Small Business Administration reveals that small businesses receive less credit on average in regions with a large share of deposits held by the largest banks. Federal Deposit Insurance Corporation statistics show that the largest 100 banking institutions now control nearly two-thirds of banking industry assets nationally. In 1992 the largest 100 banking institutions held just 45% of banking industry assets. Thus, CUMAA severely restricts small business access to credit outside the banking industry at a time when small firms are finding increasing difficulty in accessing credit within the banking industry.

Basic problems with the current MBL limits are:

- **THE LIMITS ARE ARBITRARY AND UNNECESSARILY RESTRICTIVE.** Insured commercial banks have no comparable business lending portfolio concentration limitations. Other financial institutions, savings and loans, for example, have portfolio concentration limitations, but those limitations are substantially less restrictive than the limits placed on credit unions in CUMAA.

- **THE 12.25% LIMIT DISCOURAGES ENTRY INTO THE MBL BUSINESS.** Even though very few credit unions are approaching the 12.25% ceiling, the very existence of that ceiling discourages credit unions from entering the field of member business lending. Credit unions must meet strict regulatory requirements before implementing an MBL program, including the addition of experienced staff. Many are concerned that the costs of meeting these requirements cannot be recovered with a limit of only 12.25% of assets. For example, in today's market, a typical

experienced mid-level commercial loan officer would receive total compensation of approximately $100,000. The substantial costs associated with hiring an experienced lender, combined with funding costs and overhead and startup costs (e.g., data processing systems, furniture and equipment, printing, postage, telephone, occupancy, credit reports and other operating expenses) make member business lending unviable at most credit unions given the current 12.25% limitation. In fact, assuming credit unions could carry salary expense of 2% of portfolio, 76% of CUs couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25% of asset maximum. Alternatively, assuming credit unions could carry salary expense of 4% of portfolio, 63% of CUs couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25% of asset maximum.

- **THE LIMITS ARE NOT BASED ON SAFETY AND SOUNDENSS CONSIDERATIONS.** There is no safety and soundness reason that net worth above 7% cannot also support business lending. If all net worth could be counted, the actual limit would average between 18% and 19% of total assets rather than 12.25% of total assets.

- **THE MBL DEFINITIONS CREATE DISINCENTIVES THAT HURT SMALL BUSINESSES.** The current $50,000 cutoff for defining an MBL is too low and creates a disincentive for credit unions to make loans to smaller businesses. Permitting the cutoff to rise to $100,000 would open up a significant source of credit to small businesses. These "small" business purpose loans are so small as to be unattractive to many larger lenders. Simply inflation adjusting the $50,000 cutoff, which was initially established in 1993 and hasn't been adjusted since that time, would result in an approximate 33% increase in the cutoff to over $65,000.

While some bankers call credit union member business lending "mission creep" this is simply a preposterous fiction. Credit union member business lending is not new -- since their inception credit unions have offered business-related loans to their members. Moreover, credit union member business lending shows a record of safety. According to a U.S. Treasury Department study , credit union business lending is more regulated than commercial lending at other financial institutions. In addition, the Treasury found that "member business loans are generally less risky than commercial loans made by banks and thrifts because they generally require the personal guarantee of the borrower and the loans generally must be fully collateralized. Ongoing delinquencies – for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due – are lower for credit unions than for banks and thrifts. Credit unions' mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent)."

Not surprisingly, the Treasury also concluded that MBL "does not pose material risk to the" National Credit Union Share Insurance Fund.

Updated statistics from full-year 2000 through 2003 indicate that the favorable relative performance of MBLs reported in the Treasury study has continued in recent years. Credit union MBL net chargeoffs have averaged just 0.08% over the four-year period since the Treasury study, while the comparable average net chargeoff rate at commercial banks was 1.28% and at savings institutions it was 1.11%. MBLs have even lower loss rates than other types of credit union lending, which themselves have relatively low loss experience.

Credit union member business lending represents a small fraction of total commercial loan activity in the United States. At year-end 2003, the dollar amount of MBLs was less than one-half of one

percent of the total commercial loans held by U.S. depositories. Credit union MBLs represent just 2.5% of the total of credit union loans outstanding and only 17.5% of U.S. credit unions offer MBLs. According to credit union call report data collected by the National Credit Union Administration the median size of credit union MBLs granted in 2003 was $81,125.

An almost two-thirds increase in credit union MBL limits (from 12.25% to 20% of assets, equivalent to the business lending limit for savings institutions) would not cause these numbers to change dramatically.

Raising the current MBL limits would help small business. As noted earlier, small businesses are the backbone of the US economy. The vast majority of employment growth occurs at small businesses. And small businesses account for roughly half of private non-farm gross domestic product in the U.S. each year.

Small businesses are in need of loans of all sizes, including those of less than $100,000, which many have said banks are less willing to make.

Moreover, large banks tend to devote a smaller portion of their assets to loans to small businesses. The continuing consolidation of the banking industry is leaving fewer smaller banks in many markets. In fact, the largest 100 banking institutions accounted for 42% of banking industry assets in 1992. By year-end 2003, the largest 100 banking institutions accounted for 65% of banking industry assets – a 23-percentage point increase in market share in just eleven years.

This trend and its implications for small business credit availability are detailed in a recently released Small Business Administration paper. The findings reveal "credit access has been significantly reduced by banking consolidation…we believe this suggests that small businesses,

especially those to which relationship lending is important, have a lower likelihood of using banks as a source of credit."

In reforming credit union MBL limits Congress will help to ensure a greater number of available sources of credit to small business. This will make it easier for small businesses to secure credit at lower prices, in turn making it easier for them to survive and thrive.

Title III: Capital Levels

Section 301. Amendment to Net Worth Categories

This section modernizes credit union capital requirements by redefining the net worth ratio to include risk assets, thereby instituting a new measurement to determine the relative risk of a credit union's assets and improving the safety and soundness of credit unions and the safety of the National Credit Union Share Insurance Fund.

The following is a detailed discussion of the problem and the need for such reform.

REFORMING PCA

The Prompt Corrective Action (PCA) section of the Credit Union Membership Access Act of 1998 (CUMAA) established for the first time "capital" or "net worth" requirements for credit unions. Prior to that time, credit unions were subject only to a requirement to increase their regular reserves depending on the ratio of these reserves to "risk-assets" (then defined as loans and long-term investments). The purpose of Section 1790d. (Prompt Corrective Action) of the Act is "to resolve the problems of insured credit unions at the least possible long-term loss to the Fund." The

CUMAA instructs the National Credit Union Administration (NCUA) to implement regulations that establish a system of prompt corrective action for credit unions that is consistent with the PCA regime for banks and thrifts under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) but that takes into account the unique cooperative nature of credit unions.

NEED FOR REFORM OF CREDIT UNION PCA

The legislative creation of credit union Prompt Corrective Action in 1998 was a significant first step in establishing capital requirements for credit unions. Indeed, during the first two full years of PCA's existence, the number of seriously undercapitalized credit unions has declined substantially, while the costs of resolving failed credit unions have remained modest. However, capital requirements were not the original purpose of the CUMAA. The genesis of the Act was the Supreme Court's field of membership decision of 1998 that prohibited the NCUA from approving credit union fields of membership comprising more than one group. Most of Congress' attention at the time was necessarily devoted to resolving the field of membership issue. Therefore, it is not surprising that there should be a need for some modifications to PCA now that the NCUA and the credit union movement have some experience with it.

Basic problems with the current PCA system are:

- **HIGH BASIC CREDIT UNION CAPITAL REQUIREMENTS.** Credit unions have higher capital requirements than do banks, even though the credit union share insurance fund has an enviable record compared to other federal deposit insurance funds. Indeed, because credit unions' cooperative structure creates a systemic incentive against excessive risk taking, it has been argued that credit unions actually require less capital to meet potential losses than to other depository institutions.

- **NET WORTH REQUIREMENT HARD CODED INTO LAW.** Bank and thrift regulatory agencies are empowered to establish the capital ratios that place institutions into the various capitalization categories: well capitalized, adequately capitalized, inadequately capitalized, etc. In the case of credit unions, the actual numerical values for these ratios are specified in the law. This denies the NCUA the opportunity to establish net worth ratios based on its informed understanding of potential threats to the National Credit Union Share Insurance Fund.

- **LACK OF ACCESS TO CAPITAL MARKETS.** Credit unions may only use retained earnings to build net worth. They are currently not permitted any form of secondary capital, which could be used to augment retained earnings in protecting the share insurance fund and meeting capital requirements.

- **RISK BASED SYSTEM COULD BE IMPROVED.** In one way, the risk-based net worth requirements for credit unions under PCA represent an improvement over banks' Basel-type risk based capital requirements. The credit union system explicitly accounts for both interest-rate and credit risk. The current Basel system considers only credit risk. However, the Basel system's method of applying different risk weights to assets permits a more precise accounting for risk than does the credit union system, which focuses on concentrations of assets in the balance sheet.

Taken together, these problems have created an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that those credit unions with net worth ratios well below those required to be adequately capitalized should be subject to prompt and stringent corrective action. There is no desire to shield such credit unions from PCA. They are indeed the appropriate targets of PCA. However, the pernicious effects of PCA have been on those credit unions that have more than enough capital to operate in a safe and sound manner, but that feel constrained by potential future

reductions in their net worth ratios that can result from growth in member deposits. The law stipulates that a credit union with a 6% net worth ratio is "adequately" capitalized. Considering the risk exposure of the vast majority of credit unions, 6% is indeed a completely adequate level of net worth. However, because of PCA, a very well run, very healthy, very safe and sound credit union cannot feel comfortable operating with just a 6% net worth ratio. This is because of the effect of potential growth on a credit union's net worth ratio. Without access to capital markets, a spurt of growth brought on by members' desire to save more at their credit union can quickly lower a credit union's net worth ratio, even if the credit union maintains a healthy net income rate.

This effect goes far beyond those credit unions that are close to the 6% cutoff for being considered adequately capitalized. Again because of the conservative management style that is the product of their cooperative structure, most credit unions wish to be always classified as "well" rather than "adequately" capitalized. In order to do that, they must maintain a significant cushion above the 7% level required to be "well" capitalized so as not to fall below 7% during a period of rapid growth. A typical target is to have a 200 basis point cushion above the 7% standard. Thus, in effect, the PCA regulation, which was intended to ensure that credit unions maintain a 6% capital ratio, has created powerful incentives to induce credit unions to hold net worth ratios roughly 50% higher than that level. The PCA regulation in its present form thus incents credit unions to operate at "overcapitalized" levels. This reduces the ability of credit unions to provide benefits to members and to grow.

There are two ways to resolve these problems. One would be to permit credit unions to issue some form of secondary capital in a way that both provides additional protection to the share insurance fund and does not upset the unique cooperative ownership structure of credit unions. Secondary capital could come either from members in the form of uninsured shares, or from nonmembers in

the form of subordinated debt or trust preferred securities. There would likely be limits on the extent to which a credit union could rely on secondary capital to meet net worth requirements. For example, secondary capital might be limited to no more than 50% of total capital for purposes of meeting net worth requirements. That said, the rest of this section of the testimony deals with reforming basic PCA requirements rather than with secondary capital.

The other solution would be a reform of PCA requirements themselves. Reform of prompt corrective action should have two primary goals. First, it should preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized. This will maintain the very strong incentives for credit unions to avoid becoming seriously undercapitalized. This is essential to achieving the purpose of minimizing losses to the share insurance fund. Second, a reformed PCA should not induce well-capitalized credit unions to feel the need to establish such a large buffer over minimum net worth requirements that they feel required to become overcapitalized.

CUNA believes that the best way to reform PCA consistent with these two requirements would be to transform the system into one which is much more explicitly based on risk measurement. Because of the variety of risk exposures a credit union could come under for a given level of assets, the riskiness of those assets should be given greater consideration in determining capital adequacy.

Such a reform could be achieved by modifying the definition of the "net worth ratio" for PCA as contained in the Act. Specifically, the current definition "the ratio of the net worth of the credit union to the total assets of the credit union" would be changed by inserting "risk" between "total" and "assets." The Act would further authorize NCUA to establish a system for determining risk

assets based on its knowledge of credit union balance sheets and in a fashion designed to minimize losses to the share insurance fund.

A conversion to a risk based system would also need to incorporate a minimum core leverage requirement to ensure that an undercapitalized credit union that held primarily non-risk assets would not be inappropriately shielded from PCA. To that end, in addition to maintaining the stipulated level of net worth to total risk assets, a credit could be required to maintain a ratio of net worth to total assets of at least 4% to be considered adequately capitalized. Further, any credit union with a ratio of net worth to total assets of less than 3% or 2% would be considered significantly or critically undercapitalized respectively, regardless of its net worth ratio.

Under this proposal, a credit union's PCA capitalization classification would be determined as follows:

	Ratio of Net WorthTo Risk Assets*		Ratio of Net WorthTo Total Assets*
Well Capitalized	Over 7%	&	5% and above
Adequately Capitalized	6% and above	&	4% and above
Undercapitalized	4% and above	&	3% and above
Significantly Undercapitalized	2% and above	&	2% and above
Critically Undercapitalized	Under 2%	or	Under 2%

*If a credit union's net worth ratio falls into different categories by risk and total assets, the lower classification would apply.

This reform proposal involves improving the risk-based components of PCA and placing greater emphasis on the risk-based measures, while lowering the pure net worth ratio requirements to be classified as adequately capitalized. It also maintains a basic 4% net worth requirement regardless of risk (compared to the current 6% requirement) to be classified as adequately capitalized. CUNA believes that in addition to relying on improved risk measurements, a reduction of the net worth levels to be classified as well- or adequately-capitalized is justified for the following reasons:

1. One of the original justifications for higher credit union net worth requirements (higher than for banks) is the 1% NCUSIF deposit. However, the 1% NCUSIF deposit is a systemic, as opposed to an individual credit union issue. The purpose of PCA is to minimize losses to the Share Insurance Fund. It does this in two ways. First, it creates a powerful incentive for individual credit unions to maintain net worth ratios above those required by the regulation. Second, it requires the NCUSIF to take mandatory supervisory corrective action whenever an individual credit union's net worth ratio falls below certain levels. These corrective actions are designed to restore the credit union to an adequately capitalized level, or to force liquidation before that individual credit union's net worth is completely depleted, reducing losses to the Share Insurance Fund. The systemic issue of the 1% deposit really has nothing to do with the level of net worth at which NCUSIF might need to take corrective action with respect to any individual credit union, or to the level of net worth that an individual credit union should aspire to so as to comply with the rule. The only time the 1% issue would come into play in the context of PCA is if huge numbers of credit unions failed concurrently, so that individual credit unions were required to write-down part of their 1% deposits. Given the strong capitalization of credit unions that PCA itself incents, and the existence of PCA to

force corrective action at individual credit unions before failure, such a systemic meltdown is extremely unlikely. Therefore, one might ask why does each credit union have to be overcapitalized compared to a similarly situated bank, to guard against the extremely unlikely event that huge numbers of credit unions fail simultaneously? The answer is they should not be. Establishing credit union PCA with a higher net worth requirement than for banks because of this systemic issue is tantamount to solving the same problem twice.

2. Another reason given for credit unions' higher net worth requirements is their lack of access to capital markets. Credit unions' only source of net worth is the retention of earnings, which is a time consuming process. The idea is that since credit unions cannot access capital markets, they should hold more capital to begin with so that they have it available in time of need. There is some merit to this notion, but a problem with this logic is that is suggests that a poorly capitalized institution can easily access the capital markets. However, if an institution's net worth ratio falls substantially due to losses, investors are likely to be wary of providing additional capital. Thus lack of effective access to outside capital in times of financial stress might not really distinguish credit unions from other depository institutions as much as it might appear. Other institutions similarly have limited access to capital markets when they have experienced substantial losses. The other reason that a credit union's net worth ratio might fall – rapid asset growth – also should not require a higher net worth requirement for credit unions. Asset growth (which comes from savings deposits) can be substantially influenced by a credit union's dividend policies. Lowering dividend rates creates the dual effects of retarding growth and boosting net income, both of which raise net worth ratios compared to not lowering dividend rates. A credit union should be allowed to protect a reasonable net worth ratio with aggressive dividend rate cutting rather than being required to hold additional capital. Also, a credit union could maintain a 4% net worth ratio earning 1% of assets

(an earnings level consistent with the highest CAMEL rating of 1 and close to the credit union average net income ratio over the past two decades) and still grow by as much as 30% per year. Therefore, lack of access to net worth from sources other than retained earnings does not justify a higher net worth requirement for credit unions.

3. There is substantial evidence that credit unions require **less** net worth than do for-profit financial institutions for purposes of providing protection to the deposit insurance system. Credit unions, because of their very cooperative nature, take on less risk than do for-profit financial institutions. Because credit union boards and management are not incented by stock ownership and options, the moral hazard problem of deposit insurance has much less room for play in credit unions than in other insured depository institutions. Evidence of the effects of this conservative financial management by credit unions is found in the fact that average credit union ratios for net worth, net income and credit quality have shown dramatically less volatility over that past two decades than comparable statistics for banks and thrifts. Similarly, the equity ratio of the NCUSIF has been remarkably stable between 1.2% and 1.3% while other federal deposit funds have seen huge swings and even insolvency. This is hardly evidence supporting the need of more capital in credit unions than in banks and thrifts.

Reforming PCA along the lines of the risk-based approach suggested here would preserve and strengthen the essential share-insurance fund protection of PCA. It would more closely tie a credit union's net worth requirements to exposure to risk – the reason for holding net worth in the first place. It would also permit adequately and well-capitalized credit unions to operate in a manner devoted more to member service and less to unnecessary capital accumulation.

H.R. 1375—Financial Services Regulatory Relief Act (Credit Union Provisions)

Most of the provisions of this bill are also included in H.R. 1375. The single exception is the following section.

Section 301. Privately insured credit unions authorized to become members of a Federal Home Loan Bank

This section permits privately insured credit unions to apply to become members of a Federal Home Loan Bank. Currently, only federally insured credit unions may become members. The state regulator of a privately insured credit union applying for Federal Home Loan Bank membership would have to certify that the credit union meets the eligibility requirements for federal deposit insurance before it would qualify for membership in the Federal Home Loan Bank system.

Additional Legislative Amendments CUNA Supports

- **Allow credit unions to make MBLs unless they are significantly undercapitalized at 4% or less**

Under prompt corrective action, credit unions are not allowed to continue making member business loans if they are undercapitalized, that is have net worth of less than 6%. When this provision was included in the FCU Act, the Treasury had not yet conducted its study of MBLs for credit unions. That study concluded that MBLs within the credit union system are subject to more safeguards and are less risky than such lending at banks. The small business community is in great need of these kinds of business loans, generally for amounts of less than $100,000, which banks are often not willing to make. This change would facilitate the continuation of MBL lending while a credit union works to bring its net worth back to the adequate level of 6%.

- **Allow community credit unions to continue adding members from groups that were part of the field of membership (FOM) before the credit union converted to a community charter but are now outside the community**

Prior to the adoption of amendments to the Federal Credit Union Act in 1998, community credit unions were able to add new members from groups that they had previously served but are outside of the community area the credit union serves. Currently, the credit union may serve members of record but not include additional members from those groups. CUNA supports legislation that would restore that capacity to credit unions.

- **Allow credit unions to serve underserved areas with an ATM**

The legislative history to the Credit Union Membership Access Act indicates that federal credit unions should establish a brick and mortar branch or other facility rather than establishing an ATM to serve an underserved area. This directive makes it far less affordable for a number of credit unions to reach out even more to underserved areas. While credit unions serving underserved areas through an ATM should be as committed to the area as a credit union with another type of facility, this change would facilitate increased service to underserved areas.

- **Eliminate the requirement that only one NCUA Board member can have credit union experience**

Currently, only one member of the NCUA Board may have credit union experience. Such a limit does not apply to any of the other federal regulatory agencies and denies the NCUA Board and

credit unions the experience that can greatly enhance their regulation. At a minimum, the law should be changed to permit **at least one** person with credit union experience on the NCUA Board.

Financial Accounting Standards Board Issues

Two pending issues from the Financial Accounting Standards Board have raised serious concerns for credit unions. One involves the issue of the accounting treatment of credit union mergers. Currently, credit unions may use the pooling method under which the retained earnings of the merging credit union are included in the retained earnings of the continuing credit union. FASB permits this treatment under a delay in the effective date of its Statement of Financial Accounting Standards No. 141, Business Combinations, which requires the acquisition method of accounting for mergers and acquisitions. Under the acquisition method, the retained earnings of the merging credit union must be reflected as "acquired equity" and, although included in GAAP net worth, would not be included in net worth under prompt corrective action of the continuing credit unions. That is because, for purposes of prompt corrective action, net worth is statutorily defined as "retained earnings" as determined under GAAP and does not include "acquired equity," which will be included in GAAP net worth. In other words, regulatory net worth would be more strictly defined than GAAP net worth. It is our understanding that FASB intends to apply the standard to credit unions beginning in early 2006, following a comment period beginning later this year.

Such a change, we believe will have the unintended consequence of discouraging, if not eliminating, voluntary mergers that, absent FASB's policy, would be advantageous to credit union members involved. In addition, FASB's application of SFAS No. 141 to credit unions will mean that a credit union's net worth would typically be understated by the amount of the fair value of the merging credit union's retained earnings.

This result is not in the public interest. That is why CUNA, along with the National Credit Union Administration and others, supports a technical correction that would amend the Federal Credit Union Act to make it clear that net worth is equity, including acquired earnings of a merged credit union as determined under GAAP, and as authorized by the National Credit Union Administration Board. Senior legal staff at FASB has indicated support for a legislative approach, and we urge the Committee to likewise support such an effort, well in advance of the effective date of SFAS 141 so credit unions will have certainty regarding the accounting treatment of mergers.

FASB's business combinations proposal is equally problematic for other types of cooperatives, such as farmer-owned and electric cooperatives, which also tend toward mergers of equals rather than acquisitions. CUNA is working with other cooperatives on this issue, all of which oppose the purchase method for member-owned cooperatives.

The other issue relates to the accounting treatment of loan participations. Many of our members currently engage in loan participations, either as the originating institution or as an investor, and FASB's project to review FASB Statement (FAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, is of great concern to us. Other financial institution groups, as well as federal financial regulators, have likewise raised serious questions about the need for and advisability of the proposed guidance.

For a variety of reasons, participations can be important financial and asset liability management tools. They are used increasingly by credit unions, as well as by other institutions, to control interest rate risk, credit risk, balance sheet growth, and maintain net worth ratios. Participations

enable credit unions to utilize assets to make more credit available to their membership than they would be able to do without the use of loan participations.

FASB states that it is concerned that in a loan participation, in which the borrower has shares or deposits at the originating institution, if that institution is liquidated, the participating institution would not be able to recover its pro rata portion of the members' shares/deposits within the originating institution that are "claimed" by the originating institution to setoff the portion of the debt owed to it. This outcome is highly unlikely and we are not aware that it has ever occurred in a credit union.

Nonetheless, FASB is considering amendments to Statement of Financial Accounting Standard 140 that would expressly state that because the right of setoff between the originating institution and the member/depositor/borrower exists (setting up the potential that the participating institution would not have any claim against the member/depositors' funds in the originating institution) the loan transaction does not meet the isolation requirements of FAS 140. Because of this concern, instead of transferring the portion of the loan participated off of its books as a sale, the transaction would be reflected on the originating credit union's financial statements and records as a secured borrowing.

In order for participations to continue being treated as sales for accounting purposes, the amendments would further change the existing accounting standards by requiring an institution to transfer participations through a qualified special purpose entity (QSPE). This is a needless and costly expense that would make it difficult for credit unions to use participation loans as a management tool. Further, it would drastically limit the ability of credit unions to provide low-cost, economical financing for their membership through loan participations.

There are sufficient safeguards already in place that address FASB's concerns about isolating the loan participation asset from the reach of the originating credit union and its creditors in liquidation, without the need for changes to FAS 140 of the nature FASB is contemplating.

CUNA strongly opposes the changes FASB has signaled it is considering because they are unnecessary and would render the use of loan participations impracticable. While we commend FASB for requesting comments on this issue and holding roundtable discussions in which CUNA, the CUA, and the FDIC participated last week, we remain concerned about the scope of the problems its contemplated guidance could create if adopted. We urge the Committee to communicate with FASB and encourage the Board to withdraw this unnecessary, potentially devastating guidance.

CREDIT UNION TAX EXEMPTION

While we recognize that the topic of this hearing is on regulatory relief proposals, we feel compelled to use this opportunity to respond to attacks on the credit union tax-exempt status by the banking industry.

Bankers claim that credit unions are no longer the same types of organizations they were in 1917 and 1937 when the federal income tax exemptions were granted to state and federal credit unions respectively, and because of this credit unions should now be taxed. They point to the evolution and expansion of credit union fields of membership and the addition of a wider range of financial services as evidence that the tax exemption is no longer warranted.

Interestingly, the original justification for credit unions' tax exemption had absolutely nothing to do with either field of membership restrictions or the extent to which credit union service offerings were limited. Field of membership restrictions were included in the original Federal Credit Union Act as a device to support the operations of small, volunteer-run credit unions. Since lending was to be crucial to credit union operations, the idea was to ensure that credit unions knew to whom they were lending in the days before comprehensive credit reports. Second, when credit unions were first established, the range of financial services to consumers was very limited. It's true that credit unions did not then offer their members credit cards, money market accounts, and a wide range of share certificates in the 1930's. But, of course neither did banks. These services had not yet been invented. Today they are part of the normal portfolio of consumer financial services. Both credit unions and banks have expanded their service offerings over the past seven decades as consumer demand and technological advances have combined to create new products and services.

Rather, the original reason for the tax exemption had everything to do with the cooperative structure of credit unions. As the Treasury Department describes in its January 2001 report, *Comparing Credit Unions and Other Depository Institutions,* the rationale for the 1937 granting of the tax exemption for federal credit unions:

Two reasons were given for granting this exemption (in 1937):

> (1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and (2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members . . ." Thus, the tax

> exemption was based primarily on the organizational form of credit unions..." (Quotes within this excerpt are from H.R. REP. NO. 1579, 75th Cong., 1st Sess. P. 2.)

Credit unions continue to operate as democratically controlled mutual institutions, serving only their members, on a non-profit basis, meeting the main rationale for the tax exemption. The net income of a credit union is not distributed among stockholders. Instead, that portion not returned to members in lower loan rates and fees, or higher yields on savings, is retained by the credit union to ensure safety and soundness. These retained earnings are not accumulated for the benefit of management or stockholders. They exist only for the benefit of members in the future by providing for the stability of the credit union.

Congress recently reaffirmed the logic behind the tax treatment of credit unions in the findings to the Credit Union Membership Act of 1998:

> The Congress finds the following: . . .
>
> (4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

Despite what bankers say, the reasons for the credit union tax exemption today are the same as they were 70 years ago. Credit unions remain true cooperatives, operating for the benefit of their

members. Credit unions also take seriously their role to serve all their members, including those of modest means.

Credit unions have a proven record of serving those of modest means who fall within their fields of membership. A recently published report on *Who Uses Credit Unions (Third Edition)* by the Filene Research Institute found that: "Households that use a bank only have higher median incomes than those who use a credit union only." And, "Among households that use both a bank and a credit union, those that use a bank primarily have higher median incomes than those that use a credit union primarily." (page 15). The source for this analysis was the Federal Reserve's *Survey of Consumer Finances*.

Credit unions are not as present in the financial lives of those at the very lowest end of the income distribution as they are for those in the middle-income and lower-middle-income groups. Credit union membership is highest in the $30,000 to $80,000 range of household income. At higher and lower income levels, credit union membership is lower. Upper income households are more likely to be bank customers; lower income households are more likely to be unbanked.

The lower membership rates in the very lowest income groups do not mean credit unions have avoided their responsibilities. Credit unions in the U.S. have a 70-year history of serving primarily occupational fields of membership. There have always been a few community credit unions in some parts of the country, but the overwhelming character of credit union fields of membership has been occupational. As such, credit unions have developed into powerful forces of financial betterment in the lives of working people all over the country. The move to serve select employee groups (SEGs)

over the past two decades has extended the availability of credit union service to more Americans, but this membership expansion has been largely restricted to occupational fields.

Those at the very lowest end of the income distribution are less likely to be employed, particularly at the larger employers where credit unions have historically had the greatest presence. Indeed, research shows that "unbanked" households tend to be headed by a person who isn't working. Therefore, the reason credit unions might not show up in statistics as heavily serving the lowest end of the income distribution is because those households are least likely to have in the past been eligible to join traditional, occupationally based credit unions.

It's important to note that credit unions didn't choose the occupational field of membership model as a way of excluding potential members. In fact, just the opposite has been the case. Many credit unions have for much of their history, especially in the past two decades, been doing what they can to expand fields of membership. Yet the bankers attack credit unions when we try to branch out in this way as well.

In summary, restricted by law and regulation that defined fields of memberships on occupational grounds, credit unions have performed very well in serving those of modest means who fell within those fields. With recent field of membership expansions, especially the move to more community based fields of membership, we expect the provision of credit union service to those at the lower end of the income distribution to increase in the coming several years. Evidence of credit union interest in this area is found to the extent to which credit unions have added underserved areas to their fields of membership under the NCUA's Access Across America program. Since the beginning of 2003, almost 65 million potential members from underserved areas have been added to

credit union fields of membership. Although it will take some time for credit unions to reach out to and serve members in these communities, it is instructive to note that in the three years ending December 2003, credit unions that added such underserved areas experienced membership growth of over three times that of other credit unions (17.4% vs. 5.2% over the three year period).

There are other good public policy reasons to retain the credit union tax exemption. Substantial, tangible benefits accrue to members because of the cooperative operation of the credit union. Precisely because of their cooperative structure, credit unions produce benefits to members that far exceed the amount of the tax exemption. These benefits are realized in the form of lower fees, lower loan rates, and higher yields on savings. CUNA has estimated that these benefits total over $6 billion a year. That is the additional amount that credit union members would pay if they were to conduct all the business they do with credit unions at banks instead. That is about four times the roughly $1.5 billion that credit unions would pay in federal income tax.

The reason the tax exemption is so leveraged for the benefit of credit union members is directly due to the cooperative structure of credit unions. When comparing banks to credit unions, more important than the tax exemption is the fact that banks must pay dividends to stockholders. In addition, credit unions pay very little in the form of compensation to directors, with the savings passed on to members. Finally, credit unions expense ratios compare very favorably to banks of similar size. Their efficiency of operations, supported by lower compensation for senior staff and lower loan losses, also benefits members.

The tax exemption plays an important role in maintaining the cooperative structure of credit unions. As is pointed out elsewhere in this testimony, credit unions are more heavily regulated than are

other financial institutions. The restrictions on the operations of a credit union are severe: limits on who the credit union can serve, limits on business lending, lack of access to capital markets, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than throwing off the restrictions by converting to a bank charter. Continuing as credit unions maintains the source of cooperative benefits to 85 million credit union members.

The credit union tax exemption is also a very important element in the structure that supports the safety and soundness of the credit union share insurance fund, thus protecting the general taxpayer from obligation. In it's history, the U.S. has had three federal deposit insurance systems: the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the National Credit Union Share Insurance Fund (NCUSIF). A decade and a half ago, FSLIC failed at a cost of almost $200 billion, borne by the taxpayer. At the same time, FDIC teetered on the brink of insolvency, which could have cost the taxpayer plenty. At the same time, NCUSIF easily maintained its ratio of insurance fund balance to insured shares in the normal operating range of 1.2% to 1.3%.

There are two important connections between the stability of NCUSIF and credit unions' tax exemption. First, the primary buffer for a deposit insurance system is the capital or net worth maintained in insured institutions. Indeed, the whole purpose of prompt corrective action is to minimize losses to the deposit insurance funds by ensuring there is sufficient capital in insured depositories. Because credit unions have no access to the capital markets, their only source of capital is the retention of earnings. A tax on net income, the only source of credit union capital, would thus disincent credit unions from retaining earnings, weakening protection for NCUSIF. It is

worth noting that the cost to the taxpayer of FSLIC's losses far exceeded the total of of all federal income taxes paid by FSLIC insured institutions prior to FSLIC's failure.

Second, as described in more detail in the section on reforming PCA, as cooperatives credit unions have a systemic inclination to avoid risky activities. This is an especially useful trait for federally insured depository institutions. Again, to the extent the tax exemption is an important part of the reason credit unions remain cooperatives, it serves to protect taxpayers from losses to the share insurance fund.

Finally, the bankers have suggested that large credit unions should be subjected to income taxation. There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Large credit unions are democratically controlled, not-for-profit cooperatives in every way that smaller credit unions are. The boards of directors of large credit unions are volunteers just as they are at small credit unions. Because of its size a large credit union is likely offer a broader array of services, and be a greater presence in a local market, but that makes it no less a cooperative than a smaller credit union. No one suggests that as soon as the congregation of a church, synagogue or mosque exceeds a certain size, it should no longer be tax exempt. Likewise, it would be ludicrous to say that the American Heart Association should lose its tax exemption simply because of its size while a local health clinic that serves the indigent should not.

Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs geared to and benefiting low- and

moderate-income households. In the February 2003 CUNA study Serving Members of Modest Means, when asked how many of up to 18 services geared to low/moderate income households were offered, only 6% of credit unions with assets below $20 million offered at least half of the services. Fully 42% of credit unions with assets over $500 million offered 9 or more of the services. Large credit unions are also more likely than small credit unions to participate in outreach activities to attract low/moderate income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program. Finally, many small credit unions benefit from the assistance they receive from larger credit unions, whether it be from donated equipment or donated training. This is the cooperative spirit in its purest form.

The significance of the credit union tax exemption is well understood by public officials. Both President Bush and Senator Kerry, as well as you, Chairman Shelby, and many other Members of Congress, have written letters or issued statements affirming their appreciation for the important service that credit unions provide to their 85 million members, and indicating their support for the continuation of credit unions' tax exemption.

COMMERCIAL BANK TAX STATUS

Subchapter S Elections and Other Considerations

The commercial banking industry has increasingly attacked the current credit union tax status. Historically, these attacks generally focused on credit union size and/or breadth of service offerings. As explained earlier, the credit union tax status has nothing to do with size or types of services offered.

More recently, as state and federal government budgets have come under pressure, banker attacks have focused on the revenue implications of the credit union tax status.

However, the hypocrisy of the banking industry's new-found concern for government tax receipts is clearly seen in the industry's zealous pursuit of Subchapter S status.

Subchapter S status was originally created to provide federal tax relief to small business owners, and to allow small businesses to incorporate without incurring a tax penalty. Before 1997, banks were prohibited from organizing as S corporations, and therefore were organized and taxed as C corporations. The Small Business Job Protection Act of 1996 allowed certain banks to elect Subchapter S status, beginning January 1, 1997.

An annual average of nearly 300 commercial banking firms (banks and savings & loans) have elected Subchapter S status since that time. According to Federal Deposit Insurance Corporation statistics, a total of 2,020 active Subchapter S banking institutions existed at year-end 2003 and an additional 117 have been added to that total in the first quarter of 2004. This brings the March 2004 total number of Subchapter S banking institutions to 2,137. Overall, 24% of commercial banking firms now hold Subchapter S status.

These Subchapter S banking institutions have $306 billion in total assets – an amount that is equal to 47% of the total assets in the credit union movement. The two largest Subchapter S institutions each has more than $9 billion in total assets, and the third largest has more than $7 billion in total assets.

Subchapter S banking institutions recorded $6.3 billion in annualized net income in the first three months of 2004. This amount is roughly equal to the annualized dollar amount of net income recorded by all U.S. credit unions in the same period.

While Subchapter S status is not the same as the credit union tax status, it results in significant loss of both state and federal government revenue. Collectively, Subchapter S election is estimated to have totaled $626 million in foregone revenue to the U.S. Treasury in 2003 and a total of $3.5 billion in foregone revenue since 1997. These estimates are based upon the fact that Subchapter S shareholders pay tax on their banking institutions income whether it is distributed in the form of dividends or not.

Moreover, the banking industry has lobbied tirelessly for Subchapter S expansion. If successful, such an expansion will add millions to the foregone Treasury revenue totals cited above. While the exact costs are difficult to measure (in part because there is no convenient way of identifying the number of shareholders individual banks have), conservative estimates put Subchapter S expansion costs at roughly $1.2 billion over ten years. Overall, 54% of this total foregone revenue would likely arise from raising the shareholder threshold from 75 to 100, 31% from allowing IRA shareholders, 12% form allowing director-qualifying stock, and 5% from counting family members as one shareholder.

The credit union movement does not oppose Subchapter S status for banking institutions, nor the expansion of Subchapter S status. Yet banking industry attacks on the credit union tax status continue at a torrid pace.

OTHER BANK TAX ISSUES

The use of other tax breaks and tax shelters within the banking industry are well known and widely documented. Like Subchapter S status, these too, result in substantial revenue losses to the Treasury.

One particularly egregious example of this activity was reported on the February 2004 PBS Frontline broadcast "Tax Me if You Can". In this program, Bob McIntyre, Director, Institute on Taxation and Economic Policy, cited the case of one large bank. McIntyre said: "…amazingly, in 2002, even though it reported $4 billion in profits, <the bank> reported that it didn't pay any taxes, and in fact, got a tax rebate from the government of about $160 million."

Of course, the IRS filings of individual corporations are confidential and unavailable to investors, so there is no way to know how widespread this activity is in banking circles. However, the Frontline report suggests it is more prevalent than commonly believed.

Regardless of the exact magnitude of banking industry tax avoidance, it is worth reiterating that the single banking institution cited in the Frontline broadcast earned $4 billion in 2002 profits but paid no taxes. The entire U.S. credit union movement earned $5.9 billion in 2002.

At the state level, in a number of states, banks have set up shell subsidiaries to avoid paying state taxes. For example, a recent study found that 80% of banks in Wisconsin commonly set up subsidiaries in Nevada and transfer their income-earning securities to the Nevada companies to avoid paying Wisconsin taxes. Since Nevada has no corporate income tax, the banks don't pay taxes. Eleven of the 15 largest banks in the state paid no corporate income tax.

While the banking industry professes deep concern about government tax revenue, it is directly responsible for revenue losses that total many times the value of the credit union tax exemption. Increasing government tax revenues would thus be best accomplished by closing banking industry tax loopholes rather than by imposing new taxes on credit unions and their 85 million member-owners.

Facts and Fallacies

Finally, as an additional appendix, I am attaching a report by CUNA entitled *Commercial Banks and Credit Unions: Facts, Fallacies, and Recent Trends*. This report addresses many of the inaccurate statements made by the banking industry and provides evidence that credit unions deserve their place in the market and consumers and small businesses deserve to have them as a choice for their financial needs.

Conclusion

In summary, Mr. Chairman, we are grateful to the Committee for holding this important hearing. We strongly urge the Committee to act on this very important issue this year. All financial institutions, including credit unions, would benefit greatly from reducing unnecessary and costly regulatory burdens. And so would American consumers benefit from the savings that credit unions would pass along to their 85 million members.

Testimony

to the

Senate Committee on

BANKING, HOUSING AND URBAN AFFAIRS

June 22, 2004

regarding

All Current Proposals for Legislation on Financial Services Reform

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Consumers Union
National Association of Consumer Advocates
National Community Reinvestment Coalition

Mr. Chairman, Senator Sarbanes, and Members of the Committee, this written testimony accompanies the verbal comments provided to you today by both Ed Mierzwinski of the **U.S. Public Interest Research Group,**[1] and Margot Saunders of the **National Consumer Law Center**[2] on behalf of our low income clients. We both thank you for the opportunity to provide comments on the many issues which may arise as you consider proposals for financial services reform. This testimony is also provided to you on behalf of the **Consumer Federation of America**[3], **Consumers Union**[4], the **National Association of Consumer Advocates**[5], **and the National Community Reinvestment Coalition.**[6]

There are many proposals for changes to the laws governing financial services currently under consideration in the Congress. We support some of these proposals, we have no positions on others, and we have grave concerns regarding a few. In this testimony, we will first address those proposals which pose the greatest threat to the low and moderate income consumers that we represent. Next we will describe our support for a number of important changes that are needed to update federal law to protect consumers. *Given the huge potential number of proposals that could be considered under the rubric of financial services reform, if we do not address a particular proposal, it should* not *be assumed that we support it. We have endeavored to identify those proposals which we believe you may consider and address those, but we may*

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[1]The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

[2]The **National Consumer Law Center** is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues. As a result of our daily contact with these advocates, we have seen examples of predatory practices against low-income people in almost every state in the union. It is from this vantage point--many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities--that we supply these comments. We have led the effort to ensure that electronic transactions subject to both federal and state laws provide an appropriate level of consumer protections. We publish and annually supplement fifteen practice treatises which describe the law currently applicable to all types of consumer transactions.

[3]The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[4]**Consumers Union** is the nonprofit publisher of Consumer Reports magazine, is an organization created to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. Consumers Union's publications carry no advertising and receive no commercial support.

[5]**The National Association of Consumer Advocates** is a non-profit corporation whose members are private, and public sector attorneys, legal services, law professors and law students , whose primary focus involves the protection and representation of consumers.

[6]**National Community Reinvestment Coalition** is a national trade association representing more than 600 community based organizations and local public agencies who work daily to promote economic justice and increase fair and equal access to credit, capital and banking services to traditionally underserved populations in both urban and rural areas.

have missed some.

I. Harmful Proposals to Consumers

A. Expansion of **industrial loan companies** is dangerous to the banking system and to taxpayers.

B. Preemption of the voter mandated Constitutional **interest rate ceilings in the state of Arkansas** is bad policy and unfair to Arkansas voters.

C. S. 884 is *NOT* a consumer protection bill--it is solely designed to protect the **rent to own** industry from meaningful consumer protections.

D. Allowing virtually unlimited **diversity jurisdiction** in federal courts for national banks and federal thrifts is a bad idea.

E. Exemption of **mid-size banks from some CRA** requirements would be damaging to communities.

F. Consumer protections from unfair, deceptive and over-reaching **debt collectors** should not be reduced.

II. Important Proposals to Update Federal Laws to Protect Consumers

G. Make sure the **EGRPRA** process is fair to consumers.

H. Clarify the application of the Truth in Lending Act to **bounce loans.**

I. All banks, including state chartered banks, should be prohibited from providing exorbitantly priced **pay day loans** in violation of state laws.

J. The jurisdiction limits and statutory penalties of the **Truth in Lending Act** and the Consumer Leasing Act need to be brought up to the 21st Century standard.

K. **Credit unions** should be permitted to provide check cashing and remittance services to anyone in their field of membership.

L. Expand the **Electronic Fund Transfer Act** to apply to all forms of electronically processed payments

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I. Harmful Proposals to Consumers

A. Expansion of industrial loan companies is dangerous to the banking system and taxpayers.

H.R. 1375 takes the very dangerous step of allowing financial firms and some commercial entities to set up a new, nationwide commercial banking system through industrial loan companies (ILCs) that is subject to much less rigorous oversight than under the current structure. This has enormous negative implications for the safety and soundness of these banks and thus for taxpayers who, of course, support the deposit insurance system. Our organizations agree with the Federal Reserve Board that the establishment of such a parallel, poorly regulated banking scheme would be very harmful. ILCs were intended to be limited purpose institutions; yet now seek to emulate the powers of commercial banks without the oversight. Allowing them to offer business checking or branch nationwide would be a mistake.

The House bill would allow many existing and new ILCs to branch into all 50 states, whether these states approve or not, and to offer business checking services. (Presently, ILCs are chartered and operate in only five states, although 17 states would permit ILCs to branch.) Business checking can only be provided by very small ILCs with less than $100 million in deposits.) Huge financial firms like Merrill Lynch, American Express, and Morgan Stanley--all of which currently own ILCs--would soon be able to offer federally insured commercial banking services indistinguishable from those offered by real banks at hundreds of their offices throughout the country. Commercial firms that currently own ILCs, like General Motors and BMW, would also be permitted to expand.

Additionally, banks and securities companies would be allowed to set up new ILCs, an option many would likely take advantage of because of the decreased regulatory burden and the prospect of a national market. This risk may pose even greater threats to the financial system. If large financial firms were to place their commercial banks under ILC oversight rather than Federal Reserve oversight, this could rapidly increase the number of ILCs and dilute the number of large financial systems that are subject to the important safety and soundness rules that the current system requires. Although one requirement of the bill could prevent some large commercial firms from branching de novo into some states in the future, this minor limitation is overwhelmed by the fact that the overall number of ILCs and the amount deposited in them would likely escalate without a corresponding increase in the oversight of safety and soundness at these institutions. Even worse, while the Federal Reserve Board has the power to examine the parent of a commercial bank and impose capital standards, in an industrial loan company structure only the bank can be examined and regulators can not impose capital requirements on the parent companies.

Specifically, Section 401 of the bill, which broadens the ability of banks to engage in "de novo" branch banking in all 50 states, would permit existing ILCs, including those owned by some commercial and all financial entities, to expand nationally. Regarding ILCs established in the future, the states would be permitted to deny the establishment, acquisition or operation of an ILC branch if they determine that the ILC is directly or indirectly controlled by a commercial

firm receiving more than 15 percent of its annual revenue from non-financial sources. Title VII of the bill allows all ILCs to offer checking services to businesses.

We should also note that a Senate bill, S. 1967, would allow industrial loan companies to offer interest bearing checking accounts to businesses. The bill provides that the authority would take effect two years after the date of enactment. There is a requirement that the Secretary of the Treasury and the Federal banking agencies issue joint regulations within 2 years after the date of enactment, but the authority goes into effect after 2 years whether the joint regulations are issued or not. This bill is a straightforward expansion of the authorities of industrial loans companies which we strongly oppose.

Our organizations have several specific concerns with both bills:

1. The ILC loophole to the Bank Holding Company Act is being abused and should be closed, not expanded. ILCs were never intended to be large, nationwide banks that offered services indistinguishable from commercial banks. In 1987, Congress granted an exception to the BHCA for ILCs because there were few of them, they were only sporadically chartered in a small number of states, they held very few assets and were limited in the lending and services they offered. In fact, this exception specifically applied only to ILCs chartered in five states (Utah, California, Colorado, Nevada and Minnesota) that have either assets of $100 million or do not offer checking services. Since that time, however, everything about ILCs has grown: the number that exist, the amount of assets and federally insured deposits in them and the services and lending products that they can offer.

According to the Federal Reserve, the majority of ILCs had less than $50 million in assets in 1987, with assets at the largest ILC at less than $400 million. As of 2003, one ILC owned by Merrill Lynch had more than $60 billion in assets (and more than $50 billion in federally insured deposits) while eight other large ILCs had at least $1 billion in assets and a collective total of more than $13 billion in insured deposits. Moreover, the five states cited in the law are aggressively chartering new ILCs, allowing them to call themselves "banks" and giving them almost all of the powers of their state chartered commercial banks. These states, especially Utah, are also promoting their oversight as a less rigorous alternative to those pesky regulators at the Federal Reserve. For example, the web site of the Utah Department of Financial Institutions trumpets its "positive regulatory environment" and states that "ILCs offer a versatile depository charter for companies that are not permitted to, or that choose not to, become subject to the limitations of the Bank Holding Company Act ...."

2. Large financial firms should not be permitted to establish a parallel banking system that is not subject to the rigorous oversight required for real banks. This represents an enormous and unacceptable risk to taxpayers. Securities firms that own ILCs have taken the lead in promoting the ILC expansions in this bill. They have not been shy about stating that they want to expand ILC powers because they do not want to deal with the regulatory oversight they would face from the Federal Reserve if they purchased a bank, as allowed under the Gramm Leach Bliley Act. Instead, they prefer to set up a "shadow" banking system through ILCs. They want to be able to offer the same services and loans as commercial banks without the same regulatory oversight.

According to the Federal Reserve, however, the deposits in ILC accounts are not as secure as those in real banks. As mentioned above, ILCs are exempt from BHCA, which allows the Federal Reserve to conduct examinations of the safety and soundness not just of banks, but of the parent or holding company of these banks. The BHCA also grants the Federal Reserve the power to place capital requirements and impose sanctions on these holding companies. The Federal Deposit Insurance Corporation (FDIC), which regulates ILCs, does not have these powers.

Oversight of the holding company is the key to protecting the safety and soundness of the banking system. It is immaterial whether the owner of the bank is a financial or a commercial entity. Holding company regulation is essential to ensuring that financial weaknesses, conflicts of interest, malfeasance or incompetent leadership at the parent company will not endanger the taxpayer-insured deposits at the bank. Years of experience and bank failures have shown this to be true.

Moreover, the involvement of investment banking firms in recent corporate scandals has provided plenty of evidence of the need for rigorous scrutiny of these companies as they get more involved in the banking industry. In particular, the participation of some securities firms in the Enron and Wall Street analyst scandals has shown that these firms were rife with conflicts-of-interest that caused them to take actions that ultimately harmed their investors. Given this track record, it would be a serious dereliction of duty on the part of Congress to tie the hands of regulators in looking at bank holding companies.

3. The bill violates long-standing principles of banking law that commerce and banking should not mix. Although the "15 percent rule" in the House bill may in some limited situations make it more difficult for some large commercial companies that do not presently own ILCs to acquire, establish or operate an ILC branch in states that move to block this action, it allows a large number of existing commercial ILC parent organizations to expand ILCs nationwide and to offer business checking services without limits. This includes firms such as General Motors, Pitney Bowes, BMW, Volkswagen and Volvo. Moreover, the determination of whether ownership of an ILC is commercial in nature, thus preventing the branching of that ILC into particular states, would be made individually by each state. These are the very states that would likely seek to have ILC branches locate within their borders for economic reasons. The states have a clear conflict-of-interest in making this determination in an accurate manner.

Recent corporate scandals show the serious risks involved in allowing any commercial entity to own a bank without significant regulatory scrutiny at the holding company level. Accounting scandals at Sunbeam, Enron, Worldcom, Tyco, Adelphia and many others involved deliberate deception about the financial health of the companies involved. If these companies had owned banks, not only would employees, investors and the economy have suffered, but taxpayers as well.

4. ILCs should not be allowed to skirt state restrictions by getting a charter in one of only five states and then branching to other states without their permission. Right now, only 17 states have agreed under the Riegle-Neal Act's "opt in" provision to a reciprocal arrangement

that allows banks chartered in each state to compete in all of them. This means that, under this bill, Congress would be forcing 33 states to allow the entry of under-regulated banks that clearly represent a risk to the companies that might do business with these banks. Congress should not be typing the hands of states that wish to protect their residents from under-regulated ILCs.

B. Preemption of the voter mandated Constitutional interest rate ceilings in the state of Arkansas is bad policy and unfair to Arkansas voters.

S. 904 would amend the Federal Deposit Insurance Act to remove usury limits currently applicable to Arkansas lenders under the state's constitution. This amendment not only undermines states' rights, it also will mean that Arkansas consumers will pay far more than necessary for credit and risk exposure to discriminatory lending practices. This bill is opposed by a broad coalition of national civil rights, labor and consumer rights organizations (*see* attached letter regarding S. 904 listing these organizations).

The people of Arkansas have determined that there should be a usury limit and have passed one in their state Constitution. Nevertheless, S. 904 deliberately exempts state lenders from this constitutional provision and the express wishes of the people of Arkansas. Despite the clear intent of the majority of voters in Arkansas that they be protected from high interest rates, S. 904 would allow "any other lender" doing business in the state to avoid the interest caps set by the people and the legislature of the state of Arkansas.

The proponents of S. 904 argue that the bill is necessary to remove the Arkansas interest rates caps to make credit more available in the state. Conversely, they argue that as many out-of-state lenders are already permitted to ignore the state usury limits, the bill is needed to bring more jobs to the state from credit facilities that cannot now operate under state law. Opponents of the bill argue that adequate credit is fully available to consumers in Arkansas, that lifting the usury ceiling would simply result in higher priced credit and abusive lending, and that the people of Arkansas should be permitted to determine their own fate on this issue.

Status of Interest Rate Caps in Arkansas. Like *most* states, Arkansas has a general usury ceiling that limits the amount of interest that can be charged on loans.[7] Unlike most states, Arkansas has not enacted a series of *exceptions* to the general usury law, allowing for either higher rates of interest, or unregulated interest rates on different kinds of loans. Arkansas is also unusual in that its usury ceiling is set by its state Constitution, rather than by statute, so that change must be agreed to by the voters of the state, rather than simply by the state legislature.

Despite the difficulties in changing the Constitutional provision on usury caps, the voters of Arkansas did change it in 1982, establishing a floating cap of 5% over the Federal Discount Rate.[8] The courts of the state of Arkansas have upheld both the constitutionality and the

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[7] For a general review of the usury laws in the states, their importance, and the exceptions to them, *see* National Consumer Law Center *The Cost of Credit: Regulation and Legal Challenges* (2d ed. 2000) § 2.4.

[8] Const. Art. 19, § 13(a).

enforcement of this provision repeatedly since its enactment.[9]

Exceptions to the Usury Ceiling. There are two ways that loans can be made in Arkansas insured depository institution. As a result of the Gramm-Leach-Bliley Act, banks operating in Arkansas can charge the same rates as out-of-state banks which have branches within the state[10] The second way is for a loan to be made by an out-of-state lender using a loan contract, which includes a *choice of law* provision naming the lender's state as the governing law, so long as the other state has a *reasonable relationship* with the loan transaction.[11]

Availability of Credit in Arkansas. Proponents of S. 904 have argued that because depository institutions can charge unlimited rates of interest, and other lenders cannot, that local lenders have a competitive disadvantage.[12] It has also been intimated that because of the usury cap in Arkansas, many consumers are turned down for car loans, when-- presumably-- they would have qualified for them if higher interest rates were permitted.[13]

However, if there is real competition for interest rates, then a *ceiling* on interest rates should pose no problem, because lenders would be competing with each other to offer the *lowest* interest rates.

Secondly, all indications are that there is no lack of available credit to Arkansas consumers. Conversations with the leading consumer lawyers in the state indicate that there are no complaints from consumers about lack of access to credit. In fact, just the opposite is evident to these long-time consumer advocates-- **recent decreases in interest rates have led to the increased availability of low priced car financing, enabling many more consumers to afford car loans than in recent history.**[14]

Effect of Interest Rate Ceilings on Jobs In Arkansas. Some jobs in the credit industry might be gained in Arkansas if the usury ceiling were lifted. Creditors located outside of the state could relocate in the state and make the loans directly, without having to invoke the legal fiction of the *choice of law* provision in the contract. However, the question is--how many jobs? And, at what cost to Arkansas consumers?

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[9] *See, e.g., Luebbers v. Money Store, Inc.* 344 Ark. 232, 40 S.W. 3d 745 (2001).

[10] Pub. L. No. 106-102 (199), Section 731, *amending* 12 U.S.C. § 1831u(f).

[11] *Evans v. Harry Robinson Pontiac-Buick, Inc.* 336 Ark. 155, 983 S.W.2d 946 (1999).

[12] *See* Letter to Senators Shelby and Sarbanes from Senator Blanche Lincoln, September 16, 2003.

[13] *See* Letter to Senators Lincoln and Pryor from Jeb Joyce, representing the Arkansas Fair Credit Coalition, October 20, 2003.

[14] Conversation with Susan Purtle, consumer attorney with Legal Aid of Arkansas, October 21, 2003; conversation with Mona Teague, Executive Director of Legal Aid of Arkansas, October 16, 2003; conversation with Jean Turner Carter, Executive Director, Center for Arkansas Legal Services, October 10, 2003. This sentiment was expressed by other consumer attorneys in Arkansas as well.

First, the cost to Arkansas consumers. If S. 904 passes, Arkansas would be at the complete opposite end of the spectrum for consumer protections compared to its current position. Instead of having the most protective of state statutes, it would have the least. If S. 904 passes, **unlike every other state in the union, Arkansas will have absolutely no usury ceiling, and no legal way of ever imposing any limits on interest rates.**

The number of jobs that would be gained in Arkansas if S. 904 passes is speculative, at best. However, even if creditors make a firm promise to move a specific number of jobs to the state, the people of Arkansas--not Congress--should have the opportunity to determine whether a gain in jobs is an appropriate trade for a dramatic decrease in consumer protections.

Effect of Interest Rate Ceilings on Discriminatory Lending. Currently, there is a practice in automobile financing which is the subject of significant litigation. It is alleged in a variety of lawsuits around the nation that car dealers routinely obtain higher referral fees from lenders for loans made to African American borrowers, than occurs on loans made to white borrowers.[15] These kickbacks to the car dealers are then recouped by lenders in the form of higher interest rates on the loans used to finance the cars. However, studies show that in states that have interest rates caps on auto financing, there is less discrimination between borrowers of different races, because there is less room to increase the loan rates to cloak these referral fees.[16] As a result, state interest rate ceilings not only have the effect of keeping interest rates low, they also have the effect of reducing discriminatory kickbacks on car loans. Indeed, these studies have shown that there is less discriminatory impact in Arkansas than in most other states, presumably as a result of the state cap on interest rates.

C. S. 884 is *NOT* a consumer protection bill--it is solely designed to protect the rent to own industry from meaningful consumer protections.

Despite its name **The Consumer Rental-Purchase Agreement Act of 2003 S. 884** is not what it purports to be; it is *not* a consumer protection bill. This bill only provides protections for industry, not for consumers.[17] Although the bill pretends to advance consumer protections in

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[15] *Jones v. Ford Motor Credit Company*, 00 Civ. 8330 (S.D. N.Y.); *Cason v. Nissan Motor Acceptance Corp.*, C.A. No. 3-98-0223 (M.D. TN); *Coleman v. General Motor Acceptance Corp.*, C.A. No. 3-98-0211 (M.D. TN); *Baltimore v. Toyota Motor Credit Corporation*, CV 01-05564 (C.D. CA); *Smith v. Chrysler Financial Company L.L.C.*, C.A. No. 00-6003 (D. N.J.);. In addition, four cases were filed in 2002 against banks. *Osborne v. Bank of America*, C.A. No. 02-CV-364 (M.D. TN); *Russell v. Bank One*, C.A. No. 02-CV-365 (M.D. TN); *Claybrook* v. *Primus Automotive Financial Services, Inc.*, C.A. 02-CV-382 (M.D. TN); and *Bass v. Wells Fargo Financial Acceptance, Inc.*, C.A. No. 02-CV-383 (M.D. TN); *Rodriguez v. Ford Motor Credit Company*, C.A. No. 01 C 8526 (N.D. IL). Information concerning these cases may be found at **www.consumerlaw.org** and **www.faircreditlaw.com**.

[16] Mark Cohen, *Report on the Racial Impact of GMAC's Finance Markup Policy, In the Matter of Addie T. Coleman v. GMAC*, pp. 22, Aug. 29, 2003.

[17] When S. 884 was first introduced a letter opposing the bill was sent to the entire Senate. The letter was signed by ACORN; Coalition for Responsible Lending; Consumer Federation of America; Consumers Union; International Union, UAW; National Association of Consumer Advocates; National Community Reinvestment Coalition; National Consumer Law Center; National Council of La Raza; U.S. Public Interest Research Group;

rent-to-own (RTO) transactions, in actuality it does no such thing. Instead, the bill preempts the state laws providing the strongest protections for the consumers of these transactions. Congress should not overturn state laws that prevent predatory financial practices.

Rent-to-own businesses are essentially appliance and furniture retailers which arrange lease agreements rather than typical installment sales contracts for those customers who cannot purchase goods with cash or who are unsophisticated about money management. These lease agreements contain several special features. First, the leases are short term, so that "rental payments" are due weekly or monthly. Second, the lease agreements contain purchase options which typically enable the consumers to obtain title to the goods by making an additional payment at the end of a stated period, such as eighteen months. Third, the leases are "at will." In other words, the leases theoretically need not be renewed at the end of each weekly or monthly term.

The RTO industry aims its marketing efforts at low-income consumers by advertising in minority media, buses, and in public housing projects. Statistics from the FTC show that the RTO customer base is among the poorest, and that the vast majority of their customers enter into these transactions with the expectation of buying an appliance and are seldom interested in the rental aspect of the contract. This attitude is encouraged by RTO dealers who emphasize the purchase option in their marketing even while they are minimizing its importance in the written contract.

The chief problems with RTO contracts are that these supposed leases are used to mask installment sales, and that these sales are made at astronomic, and undisclosed, annual percentage rates. Under most RTO contracts, the customer will pay between $1000 and $2400 for a TV, stereo, or other major appliance worth as little as $200 retail, if used, and seldom more than $600 retail, if new. This means that a low-income RTO customer may pay 1½ to 12 times what a cash customer would pay in a traditional retail store for the same appliance.

There should be no misunderstanding about S.884: it is *not* designed to protect consumers. The entire purpose of this bill is to preempt stronger state laws that provide more meaningful consumer protections (*see* Sec. 1018(b)). A cursory reading of the bill might lead one to believe that some of the provisions would actually help consumers. However, a close evaluation reveals that there are no meaningful protections whatsoever in this bill. The section that comes closest to requiring some helpful information to consumers (Sec. 1010), would require disclosures about the cost of the RTO transactions to be displayed on a tag attached to the item. However, the penalty to a dealer for failing to comply with this provision is meaningless--only equaling one quarter of one month's lease payment--thus providing no incentive for dealers to comply with even the minimal protection provided in S. 884.

The RTO customer base, almost exclusively low-income, could certainly benefit from

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Center for Civil Justice of Saginaw, Michigan; Coalition of Religious Communities; Community Legal Services of Philadelphia; Consumers League of New Jersey; Florida Legal Services; Mid Minnesota Legal Assistance; and Mountain State Justice Inc (WV).

meaningful consumer protections from an industry which preys upon consumers' lack of perceived options. Mostly these consumers need protection from high costs and unfair practices. There are numerous ways in which RTO legislation can be improved, none of which are included in a meaningful way in S. 884. Instead, RTO consumers would truly benefit from protections such as the following:

1. **Limitations on the total of payments** that a consumer should be required to pay for the purchase of the item. Some states have these limits already, but many do not.

2. **Limits on "fees"** such as late fees, insurance fees, home pick-up fees, reinstatement fees, and etc. Some states have limits already, many do not.

3. **Reinstatement rights** that clearly allow the consumer to have payments made on previous contracts applied to new contracts for the same types of items. While S. 884 has a minimal provision on this point (Sec. 1005(a)(4)), it provides little protection to consumers, and there is no enforcement mechanism.

4. **Price tag disclosures,** as well as contract disclosures. By the time the customer gets the contract the decision to proceed with the transaction has often been made. Yet, S. 884, while requiring price tag disclosures--in section 1010--does not provide an effective remedy for a dealer's failure to comply with this requirement.

5. **Meaningful penalties** for dealers who violate the provisions of the RTO statute. As the maximum penalties to be assessed against a dealer who violates the minimal *disclosure* requirements of S. 884 is 25% of one month's rental payment, there is virtually no incentive for dealers to comply.

6. A disclosure like the **annual percentage rate(APR)** which shows the consumer the true cost of renting to own, to allow comparison with other methods of purchasing personal items.

7. **Limits on maximum RTO interest rates**, as New Jersey requires.

S. 884 only serves to preempt the state laws of Wisconsin, Michigan, Minnesota, Vermont, North Carolina, and New Jersey--all of which provide more protections to consumers. It does not, in any way, advance consumer protection.

D. Allowing virtually unlimited diversity jurisdiction in federal courts for national banks and federal thrifts is a bad idea.

The House bill includes a provision (Section 213 of H.R. 1375) which would establish that for diversity purposes in federal court, a savings bank would be considered to be a citizen only in the state in which it has its main office. We understand that the Comptroller of Currency is advocating a similar provision applicable to national banks. Both provisions are very bad ideas--they would clog up the federal courts, and worse, in most states they would create a procedural morass that would likely result in many consumers losing their homes to illegal foreclosure.

These proposals would essentially make the federal courts the collection mills for the federally chartered banks and thrifts. This is not good federal policy. Moreover, it is likely to hurt consumers, as federal courts have been known, on numerous occasions to interpret state laws differently--and in a less friendly fashion--than state courts.

A prime example of how damaging this proposal would be to homeowners and communities is its potential application to the foreclosure process. The procedural requirements to *stop* a foreclosure are complex in many states, often requiring that a separate action be filed to enjoin the foreclosure action while the homeowner's defenses and claims are determined in a separate proceeding. How would this work in a foreclosure situation? If the bank initiated a non-judicial foreclosure against a homeowner, and the homeowner sued in state court to stop the foreclosure, the bank could then remove the consumer's case to federal court based on this new diversity jurisdiction. But the while all these legal maneuvers are worked through, the foreclosure process would continue unabated. This would likely leave homeowners with valid claims to stop foreclosures unable to effectively fight through the procedural morass of state versus federal court jurisdiction, resulting in needless and unfair loss of homes.

The concept of diversity jurisdiction is based on the idea that a person or business which does not have a real presence in the community will not receive a fair hearing in the state court, thus necessitating hearing the dispute in the more "neutral" arena of the federal court. However, this proposal threatens to make a mockery of this basic idea, as the bank or thrift would be "foreign" in name only. The bank or thrift might have hundreds of branches, and employ hundreds of state residents. Yet because of this arcane proposed language to be added to the federal statutes, it would legally be considered to not be a resident of the state.

These proposals are an absurd and cynical use of the federal courts to further tilt the balance of power away from consumers. Both national banks and federal thrifts should be considered residents of the states in which they have a legal presence, for purposes of federal court diversity jurisdiction.

E. Exempting Mid-Size Banks from Full CRA Exams Would Hurt Communities.

The Community Reinvestment Act (CRA) is an extremely important tool for stimulating bank lending and improving access to banking services for the nation's underserved urban and rural communities. The proposal currently pending before the banking agencies to exempt mid-size banks from important aspects of the CRA compliance examination would significantly undermine this important law. Some in Congress are seeking even broader exemptions that would remove virtually all banks from being required to meet their current CRA standards.

The banking agencies' proposal would revise the definition of "small bank" from any institution with less than $250 million in assets and not part of a holding company with over $1 billion in assets to include all institutions with less than $500 million in assets regardless of holding company size. The CRA examination for small banks has been streamlined since 1995 and focuses predominately on an institution's lending record. For a large bank, the CRA examination is far more comprehensive. In addition to reviewing the institution's lending record, the more comprehensive examination considers the extent to which a bank provides

banking services to its entire community and its record of investments. The banking agencies' proposal would reduce the number of banks that are subject to the broader CRA examination by about 50 percent (from 2,236 to 1,105). Should the exemption be raised to banks with $1 billion in assets it would mean a reduction of another 50%, leaving fewer than 600 banks nationwide still covered by the more comprehensive CRA examination standard.

The application of such an exemption would mean that only 12 percent of the nation's insured depository institutions (only 6 percent should the exemption be raised to $1 billion) will undergo agency review to determine how well they are meeting the non-lending banking services needs in their communities. This exemption would also disproportionately affect rural communities and small cities where these mid-sized banks continue to have significant market share.

A mid-sized bank exemption takes away the incentive for these institutions to maintain and open new branches or ATM machines serving the low- and moderate-income families in their communities. It is likely to also undercut the extent to which these institutions offer affordable basic banking accounts often necessary for bringing unbanked households into the financial mainstream or money transfer and remittance services that are particularly important to ethnically diverse communities.

Removing the bank holding company as a factor in differentiating between small and large banks will allow many institutions with sufficient resources to unfairly enjoy a streamlined test and abdicate their responsibilities for providing branches and community development investments and loans in low and moderate income communities. A significant number of banks between $250 and $500 million are part of holding companies with assets considerably above $1 billion. For example, FBOP Corporation is a bank holding company of $11 billion in assets and it has four banks between $250 and $500 million in assets.

While these proposals may be billed as "reducing regulatory burden," they actually work at cross purposes with CRA's statutory mandate that banks, regardless of their size, have a continuing and affirmative obligation to serve the credit and deposit needs of their local communities. We strongly urge, therefore, that mid-sized banks should not be exempted from the comprehensive CRA examination either through legislation or via rulemaking.

F. Consumer protections from unfair, deceptive and over-reaching debt collectors should not be reduced.

There are a number of formal and informal legislative proposals floating around this Congress which would seriously undermine the consumer protections of the Fair Debt Collection Protection Act. This would be a mistake, especially without comprehensive hearings to consider all sides of the complicated questions facing consumers in the debt collection process.

The FDCPA does nothing to prevent the collection of a valid debt. It only prohibits debt collectors from inappropriate activities in the collection of those debts. The law establishes general standards of proscribed conduct, defines and restricts abusive collection acts, and provides specific rights for consumers. Collectors cannot harass consumers or invade their privacy, make false or deceptive representations, or use abusive collection tactics. Specific acts that are prohibited include late night or repetitive phone calls and false threats of legal action.

Studies have shown overwhelmingly that consumers generally fall behind on their debts because of a serious illness, a death in the family, or the loss of a job. Very few consumers deliberately avoid their debts when they have the ability to pay them. Now, when this recession is costing millions of Americans their jobs, more consumers will be struggling to pay their bills, it is essential that the basic consumer protections in the FDCPA not be undermined.

In this testimony we address two anti-consumer proposals on debt collection. One is HR 3066, the other is a proposal to exempt check diversion companies from coverage of the FDCPA.

HR 3066. HR 3066 would hurt consumers. This legislation would significantly reduce consumer protections in seven important areas:

Section 2. This provision would make much of the FDCPA inapplicable to legal pleadings. The collectors claim this is necessary to protect them from compliance with conflicting laws, so that they will not be required to include the notice of the right to validate a debt (required by 15 U.S.C. § 1692g(a)) on legal pleadings. The collectors neglect to mention, however, that there have been no lawsuits on this point. More importantly, the amendment goes far beyond simply deleting the requirement for the validation notice on pleadings. It would immunize collectors who violate other important provisions of the FDCPA in formal pleadings, such as when they sue for more than is actually owed by the consumer; or obtain default judgments even after settling the case with the consumer. Moreover, this provision would do away with the informal debt validation procedure if the debt collector initiates contact by filing suit. This will force consumers to raise disputes in court when they could have been settled informally. Yet many consumers who are unable to represent themselves in court will find themselves subject to garnishments and seizures of assets for debts they never owed.

Section 3. This section would codify a verbose and difficult to read validation notice instead of a notice that simply tells consumers that they have a right to require the collector to verify a disputed debt. The notice proposed in Section 3 is used frequently in current collection letters, and is far from a model of simple language that Congress should endorse for a consumer notice. The proposed notice requires consumer education efforts that could be easily avoided by the use of simpler words and sentence structure.

Section 4. This section would add a statement in the statute's debt validation provision that a debt collector may engage in collection activities during the 30-day period in which a consumer may request the debt to be verified by the collector. Since that is already allowed by both existing case law and an FTC formal advisory opinion, this amendment can only be viewed as an attempt to reduce the current law's requirements that the notice of the debt validation right not be rendered ineffective by debt collection threats that are either confusing or overshadow the notice of validation rights. Unless its intent is clarified, this amendment will simply stimulate litigation about its meaning. If it is intended to sanction efforts to obscure the debt validation right, it will diminish an essential consumer tool designed to avoid mistaken collection efforts that waste the time of consumers and collectors alike.

Section 5. Currently, two provisions of the FDCPA shield represented consumers from

duns as long as the collector knows of their legal representation and the consumer's lawyer responds to collectors within a "reasonable" time. (15 U.S.C. §§ 1692b(6), 1692c(a)(2)). Section 5 of the bill would shield only a consumer represented by an "attorney at law" and replace the reasonable time requirement with a 30-day requirement. These amendments seem to be targeted at preventing the attorney's employees from preparing responses to debt collector inquiries, creating unnecessary drain on consumer attorney resources.

Section 6. The FDCPA currently requires a debt collector to stop requesting payments from the consumer once the consumer tells the debt collector to stop contact. Current law then permits the collector to notify the consumer only that the collector is terminating its collections, to explain the collector's ordinary remedies, or to state that the collector's remedy will be pursued. The existing protection gives consumers a respite from dunning calls and letters, without preventing the communication of real consequences which consumers need to know. However, Section 6 of this bill would restrict the debt collector to one notice to the consumer even if they are pursuing multiple remedies at different points in time. It's difficult to understand what interest is served by this proposal.

Sections 7 and 8. These sections would amend the FDCPA to require that the consumer send a written statement disputing the debt before the debt collector would have to pay attention to the dispute. These amendments would make it legal for a debt collector to actually ignore the consumer's telephone statements contesting the validity of the debt, requiring consumer disputes to be raised in writing before they will be considered by debt collectors. The collector would be permitted to presume the debt is valid even if it is disputed orally. The collector could threaten to report an orally disputed debt to a credit reporting agency as if it was uncontested. Collectors would be entitled to threaten the consumer: "I don't care what you say about fraud, having paid the debt, or identity theft; if you don't put a check in the mail today, we will ruin your credit." It's difficult to believe that this amendment has been introduced in a Congress that has repeatedly expressed its strong concern with the increasing crime of identity theft and telephone frauds!

Millions of American consumers would be considerably harmed if this misguided bill were to become law. HR 3066 weakens the substantive and procedural protections of the FDCPA.

Check Diversion Exemption. We also urge you to resist the efforts of check diversion companies to obtain an exemption from the Fair Debt Collections Practices Act ("FDCPA"). If this exemption is granted, hundreds of thousands of innocent American consumers will pay unnecessary and unauthorized charges to these for-profit companies in response to deceptive threats to criminally prosecute them for writing bounced checks.

Check diversion companies are debt collectors which enter into contracts with District Attorneys to collect bounced checks for local merchants. These companies send letters on the DA's letterhead threatening criminal prosecution if the consumer does not attend a "financial responsibility" class, and pay high extra fees for these classes. Many consumers have been deceived by these companies into believing that if they did not pay these extra fees they would

be criminally prosecuted, even when no prosecutor had ever determined that a crime had been committed, and the local prosecutor would never actually prosecute.

FDCPA does not stop or inhibit the legal activities of check diversion companies. In fact, most collectors of bounced checks operate fruitful businesses while fully complying with the FDCPA. However, check diversion companies are so profitable that they share their income with the DA's office, providing funds to this government office rather receiving money from it to perform a governmental function. Yet, in these check diversion programs the DAs have not done any investigation to determine the critical requirement of the crime--intent to defraud. Indeed most of these consumers have not intended to defraud, and quickly pay off the checks upon receiving notice. As a result, many consumers who have inadvertently bounced small checks are deceived into paying as much as $140 extra to avoid a criminal prosecution which would never occur if the DA were actually handling the case. Indeed, regardless of the involvement of the for-profit check diversion program, the majority of bounced check cases are not criminally prosecuted because there is no intent to defraud, a required element of the crime.

The FDCPA only limits the activities of check diversion companies in its requirements that no deception be committed, that consumers be advised of their right to request validation of the debt, and that only authorized fees be collected. These are requirements with which all debt collectors collecting bounced checks are able to comply and still successfully collect. Specifically, check diversion companies have consistently been found by the courts, or have settled cases alleging three types of illegal conduct:

- **Deceptive Behavior.** The check diversion companies' letters to consumers were deceptive because they looked like they actually came from the District Attorney and implied that the DA had determined the consumer had committed a crime. In fact no DA ever reviews cases before the letter threatening criminal prosecution is mailed. In many situations, if the DA had reviewed the case, no intent to defraud would have been found, and no criminal prosecution would have been threatened.

- **Failure to Provide Notice of the Right To Verify the Debt.** Unlike all other private debt collectors collecting debts, including bounced checks, the check diversion companies refuse to provide notice to consumers that they have the right to request verification of the debt. In many situations this right would allow consumers to explain that they have already paid off the check, or do not believe they owe it.

- **Attempted Collection of Illegal Fees.** Generally, state laws specifically provide the extra fees that consumers owe when they write a check that bounces. Often the courts can impose monetary penalties after a conviction for writing a bounced check (which must include a finding of intent to defraud). Yet the check diversion programs insist upon the payment of these fees even when no court has found--or would find--the consumer guilty of bouncing a check. For consumers, this often turns a mistake of a $10 or $20 bounced check into a cost approaching $200.

The majority of District Attorneys in the nation do not use check diversion companies, finding alternative, far less abusive, ways to enforce laws against writing checks which bounce

for insufficient funds. Many DAs use dispute settlement programs to resolve bounced check issues between merchants and consumers. Other DAs simply write their own letters explaining the process to consumers. These letters do not require the payment of the exorbitant additional fees charged by the check diversion companies, they simply advise of the process involved when a payee of a check which has bounced brings the case to the criminal court. These DAs find that even without employing private companies which make millions of dollars in profit from consumers who have inadvertently bounced a check, only a very few cases are criminally prosecuted.

Check diversion companies do not need an exemption from the FDCPA. They can operate profitable, effective businesses without this exemption, simply by complying with the law. This would only mean that 1) the check diversion company not imply that the DA has reviewed the consumer's case and found that a crime has been committed, unless the DA has done so; 2) the letter to the consumer includes the required notice of the consumer's right to request validation of the debt; and 3) the company only collect fees that can be legally charged.

The Fair Debt Collection Practices Act does not inhibit the collection of debts; it only prohibits deception and abuse, and requires that consumers be allowed an opportunity to show they do not owe the debt. These requirements are appropriate and necessary for private individuals who are collecting debts--whether they are acting for private creditors or government officials. As Congress determined when passing the FDCPA, once the incentive of profit is injected into the collection effort, more protections are required.

We urge you to resist the effort of one small part of the collection industry to evade compliance with the Fair Debt Collection Practices Act. Bounced checks can be collected quite effectively by collectors complying with this important consumer protection law.

II. Important proposals to update federal laws to protect consumers include:

G. Make sure the EGRPRA process is fair to consumers.

Currently all of the federal supervisory agencies are jointly engaged in the process of reviewing laws and regulations affecting depository institutions to determine updates and necessary changes pursuant to the Economic Growth and Paperwork Reduction Act of 1996.[18] We are very concerned that this process will yield results which inappropriately favor industry over consumers.

A fair review cannot be limited to issues which favor those institutions. A full and fair analysis of appropriate updates for the regulations and laws must include proposals to benefit consumers. The Economic Growth and Paperwork Reduction Act simply requires the regulatory agencies to review regulations and laws:

> "in order to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions."[19]

To date, all of the written materials accompanying the request for comments regarding the rules display the agencies' unfortunate bias towards evaluating regulations and federal statutes *only* from the perspective of the financial institutions. Every single one of the questions posed to the participants in the focus groups to discuss this review reveals this skewed evaluation. To be fair, and to accomplish the overall goal of EGRPRA, and of underlying purposes of the regulations, the agencies must broaden their perspective, and include a full evaluation of *the impact on consumers* of all proposed changes.

We have filed extensive comments with the agencies regarding the consumer positions in the EGRPRA process.[20] We ask that the Senate Banking Committee instruct the agencies to ensure that their recommendations will be fair and protective of consumers.

H. Clarify the Application of the Truth in Lending Act to Bounce Loans

The Federal Reserve Board recently announced new, proposed rules to cover overdraft extensions of credit under the Truth in Savings Act, Reg DD. That is a completely inadequate response to the real need consumers have for information about the exorbitant costs of these loan products. Congress should step in and require--at the least--that bounce loans be treated just as all other extensions of credit are treated under the federal Truth in Lending Act. This equivalent treatment would simply--and most importantly--require that creditors of bounce loans *inform*

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[18] 12 U.S.C. § 3311.

[19] 12 U.S.C. § 3311(a).

[20] http://www.federalreserve.gov/SECRS/2004/April/20040427/R-1180/R-1180_462_1.pdf

consumers about the true costs of this credit.

Bounce "protection"[21] is a new form of overdraft protection that some banks are using to boost their non-interest revenue.[22] It is a systematic attempt to induce consumers into using overdrafts as a form of high-cost credit. These plans offer short-term credit at triple-digit rates.[23] When a consumer uses bounce credit, the bank deducts the amount covered by the plan plus the fee by setting off the consumer's next deposit, even where that deposit is protected income, such as a welfare or Social Security check. The fee is often the same amount charged for an NSF fee on a returned check, and in some cases the bank also charges an additional, per-day fee. The Office of Comptroller of Currency has recognized that bounce loans are credit as defined by TILA.[24] Some state regulators have reached the same conclusion.[25]

Bounce credit fees clearly meet Regulation Z's definition of finance charge. Section 226.4(c)(3) of Regulation Z, which excludes fees for traditional overdrafts, provides that overdraft fees are finance charges when "the payment of such items and the imposition of the charge were previously agreed upon in writing." Although banks offering bounce credit have sought to avoid Regulation Z's coverage by claiming that the bank's payment of an overdraft in a "bounce protection" plan is "discretionary" and that such payments have not been agreed to in writing, these assertions fail. First, bounce credit is not discretionary. These plans are administered through computer software and thus are formal, systematic programs rather than an occasional customer courtesy. Moreover, banks extend bounce credit pursuant to an agreement in writing, whether through advertisements, correspondence, or on a website. Consumer assent is not necessary, and consumers often are held accountable for fees unilaterally imposed by banks.

There is considerable confusion and misunderstanding among consumers about the rules and obligations of bounce loans. Consumers often do not understand the full cost of these loans, and they do not understand the recurring nature and exorbitant cost of the ongoing use of bounce

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[21]Bounce "protection" is a euphemism used by banks to describe this high-cost credit product.

[22]For more information on bounce credit, *see* Consumer Federation of America & National Consumer Law Center, *Bounce Protection: How Banks Turn Rubber Into Gold By Enticing Consumers to Write Bad Checks* (2003), available at www.consumerlaw.org/initiatives/test_and_comm/appendix.html.

[23]For example, a $100 overdraft will incur at least a $20 fee. If the consumer pays the overdraft back in 30 days, the APR is 243%. If the consumer pays the overdraft bank in 14 days, which is probably more typical for a wage earner, the APR is 541%. This arrangement is much more expensive than alternatives that most banks offer, such as overdraft lines of credit, linking the account to a credit card, and transfers from savings.

[24]Daniel P. Stipano, Deputy Chief Counsel, Office of Comptroller of Currency, Interpretive Letter #914, September 2001.

[25]Indiana Department of Financial Institutions, Newsletter--Winter 2002 Edition (Nov. 2002), at 2, Clearinghouse No. (D/E: Fill in number); Letter from Assistant Attorney General Paul Chessin, Colorado Department of Law, Consumer Credit Unit, Mar. 21, 2001 (in response to referral from the Administrator for the Colorado Uniform Consumer Credit Code).

loans. Consumers would benefit enormously from application of TILA's open-end disclosure rules to these expensive and deceptive products.

I. Prohibiting all banks, including state chartered banks, from providing exorbitantly priced pay day loans in violation of state laws.

The Federal Deposit Insurance Corporation has failed to protect consumers and is instead threatening the safety and soundness of state-chartered, federally-insured banks by permitting them to partner with store front payday lenders. These "rent-a-bank" arrangements are designed to allow payday lenders to evade state usury and small loan laws.[26] We urge you to clarify that bank charters are not for rent and to insist that the FDIC take action against state banks involved in payday lending.

The FDIC is the only federal regulatory agency that permits banks it supervises to engage in payday lending with third-party check cashers, pawn shops and payday loan outlets. Following vigorous enforcement by the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve Bank of Philadelphia, no federally-chartered banks or members of the Federal Reserve System align themselves with quick cash payday lenders that charge triple-digit interest rates for small loans and trap vulnerable consumers in perpetual debt.

The FDIC guidelines for state banks engaged in payday loan partnerships do not protect consumers and do not regulate payday lending. Three state banks have joined the ranks of rent-a-bank payday lenders since the FDIC announced its guidelines last July. Their guidelines do not substitute for state usury and small loan laws and do not regulate loans made in partnerships between banks and third-parties. FDIC guidelines do not cap fees for payday loans, set loan size or term limits, or prevent perpetual debt. FDIC subprime capitalization requirements have little impact on banks that immediately sell 85% or more of loans back to their payday loan partners.[27]

Payday lenders face growing resistance from state legislatures, especially in states where loans are not legal. In 2004 the Michigan Governor vetoed a safe harbor bill and Georgia legislators passed a tough anti-payday loan enforcement bill. West Virginia refused to enact an industry bill and a bill to legalize payday loans is stalled in Pennsylvania. New York's Attorney General filed suit against County Bank and two of its payday loan partners.

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[26] *See* report from Consumer Federation of America titled *"Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury,"* which documents the failure of the Federal Deposit Insurance Corporation to protect consumers and the safety and soundness of state-chartered, federally-insured banks that partner with store front payday lenders.

[27] The payday loan industry's goal is legal status in every state. Fifteen states prohibit payday lending through operation of usury or loan laws and a growing number of states prohibit retailers from brokering loans for out-of-state banks. Currently 33 states and the District of Columbia grant safe harbor for check-based loans with laws or regulations that carve out payday lending from usury and small loan laws. Two more states set no usury limits for small loans by licensed lenders.

Congress never intended for state chartered, federally insured banks to be empowered to rent their interest rate exportation powers to third party entities to make predatory loans. Rent-a-bank payday lending undercuts state authority to enforce usury laws, small loan regulations, and, even state payday loan laws. We urge you to take immediate action to stop this practice.

J. The jurisdiction limits and statutory penalties of the Truth in Lending Act and the Consumer Leasing Act need to be brought up to the 21st Century standard

TILA's jurisdictional limit for non-dwelling secured consumer credit transactions was set at $25,000 in 1968. That amount in today's dollars would be over $132,000.[28] The equivalent for the statutory damages amount of $1,000 in 1968 would be over $5,000 today. The numbers in the current statute need to be updated, and an inflation factor built in. The Consumer Leasing Act requires similar treatment.

K. Credit unions should be permitted to provide check cashing and remittance services to anyone in their field of membership.

All consumers face the problem of skyrocketing bank fees. Numerous studies by our organizations have documented both that bank fees are rising and that credit unions offer a substantially better deal to their members than banks do to their customers.[29]

Yet, America's estimated 11 million or more un-banked and under-banked families (13% of all families) face even greater problems than bank customers do, when they seek to obtain financial services from the high-priced companies that make up the fringe banking system: check cashing stores, rent-to-own stores[30], refund anticipation loan purveyors,[31] payday loan companies, and wire transfer or remittance operators. Some products from banks, such as over-

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[28] *See* Consumer Price Index, Inflation Calculator, U.S. Department of Labor, Bureau of Labor Statistics, http://www.bls.gov/bls/inflation.htm.

[29] *See* "Big Banks, Bigger Fees," October 2001, U.S. Public Interest Research Group, finding that "the average annual cost of regular checking at the three hundred largest banks was $266, but only $191 at small community banks, and only $101 at credit unions." Also see "Banks Charge More Fees and Higher Fees Than Credit Unions," Consumer Federation of America, March 1998, available at http://www.consumerfed.org/bankchgpr.pdf The Federal Reserve Board of Governors publishes annual reports to Congress on "Fees and Services of Depository Institutions," finding consistently that fees are rising and that larger multi-state banking institutions impose higher fees than community banks. The Federal Reserve studies at this time do not include credit unions. Its 2003 report is available at http://www.federalreserve.gov/boarddocs/rptcongress/2003fees.pdf and previous reports can be accessed at http://www.federalreserve.gov/boarddocs/rptcongress/

[30] For an archive of materials on rent to own stores *see* http://www.pirg.org/consumer/#rent

[31] *See* "All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans," Consumer Federation of America and National Consumer Law Center, January 2004, available at http://www.consumerfed.org/RefundAnticipationLoanReport.pdf

priced, deceptively marketed "bounce protection," also look more and more like fringe banking products.[32]

We support section 307 of the House bill, which would allow credit unions to offer check cashing and remittance services to anyone in their field of membership, not only to members, increasing competition in two very over-priced financial services. Not only would the consumers who take advantage of the services benefit, so would others, since the competitive effect of the credit union services would lower prices in the marketplace overall.

Remittances. The problem of the high cost of remittances especially affects immigrant families. According to Federal Reserve Governor Ben Bernanke, "typical nonbank fees for remittances remain high on an absolute basis, and consumers who deal with the less-scrupulous providers of remittance services may bear a significant financial cost."[33]

According to a recent Pew Hispanic Center report, "Billions In Motion,"[34] while the average cost of remittances has declined significantly (e.g., to just under 10%, or $20 for a $200 wire transfer to Central America), an increase in competition could lower costs even further. As Sheila Bair, then-Assistant Secretary of the Treasury for Financial Institutions pointed out at a conference in 2002, "[t]he industry continues to be dominated by a small number of money transmitters that generally tend to charge higher fees than banks or credit unions. By increasing competition, the price of remittances should continue to drop." The report estimates that a cost reduction to an average of 5% of the amount sent could transfer a billion dollars from high-priced operators to working families.

Credit unions could help provide that competition if they could provide remittance services to any consumer who qualifies to join their field of membership, instead of just to their members. A secondary benefit is that these consumers, frustrated by high bank fees, would be attracted to becoming full –fledged credit union members.

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[32] *See* "Bounce Protection: How Banks Turn Rubber into Gold by Enticing Consumers to Write Bad Checks, An Examination of Bounce Protection Plans." April 2003, Consumer Federation of America and National Consumer Law Center, available at http://www.nclc.org/initiatives/test_and_comm/appendix.shtml/.

[33] "Financial Access for Immigrants: The Case of Remittances." Remarks by Governor Ben S. Bernanke at the Financial Access for Immigrants: Learning from Diverse Perspectives conference, Federal Reserve Bank of Chicago, Chicago, Illinois, April 16, 2004, available at http://www.federalreserve.gov/boarddocs/speeches/2004/200404162/default.htm

[34] *See* "Billions In Motion: Latino Immigrants, Remittances and Banking," the Pew Hispanic Center and the Multilateral Investment Fund, November 2002.

Of course, consumer groups believe that consumer protections for remittances should be provided, regardless of who provides remittance services. For example, the Electronic Funds Transfer act should cover these transfers. There should be a limit on fees, minimum timing requirements for delivery of funds, limits on increases in exchange rate between the time the consumer hands over money and the transmittal is received on the other end. Consumers should get receipts and/or similar documentation and have access to a dispute resolution procedure. The sender should be responsible for losses if the remittance was not delivered to the right person or was delivered in the incorrect amount.

Check Cashing Services For Non-Members. When consumers cannot afford bank accounts, they often cash their paychecks at check cashing stores, or even at banks, which also impose high non-customer checking fees[35] Many consumers may not be able to afford high bank fees, if they live from paycheck to paycheck, or they may have previous bounced check activity or other circumstances that prevent them from obtaining a bank account.

These consumers pay significant fees – ranging from 1-20% of face value -- to cash their checks at fringe banking outlets. Fees are highest for personal checks, lower for payroll and government checks. In the last several years, many retail companies, from 7-11 to Wal-Mart—have cashed in on the profitable business. Credit unions could cash checks for consumers in their field of membership at lower cost, while encouraging consumers to become members.

L. Expand the Electronic Fund Transfer Act to apply to all forms of electronically processed payments.

Payments methods are increasingly converging, but the consumer rights available differ vastly depending on how the payment was initiated. A consumer who pays by debit card, for example, has the protections of the federal Electronic Fund Transfer Act, including a 10-day right of recredit of all disputed funds. The consumer never has to be without his or her funds for more than 10 business days when paying by electronic debit. When a consumer pays by check, however, the applicable consumer rights are much more murky. A paper check, or a check which is processed wholly electronically under bank to bank image exchange agreements, is subject to the Uniform Commercial Code and carries no baseline federal consumer protections. Even though image exchange is an electronic processing method, the EFTA exemption for checks means that consumers don't get the crucial 10 day right of recredit, and thus are at the mercy of their banks or the courts to win a return of disputed funds. When the check is processed using a substitute check, the new Check 21 Act provides a 10 day right of recredit, but the Federal Reserve Board's narrow interpretation of the availability of this right in this proposed

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[35] A relatively new and rapidly growing industry is marketing under-regulated payroll cashing cards that work at ATMs but are not connected to bank accounts. Employers lower their check transaction costs and the un-banked find them convenient, but the cards are no substitute for a bank account in terms of the potential for building wealth, nor are they free, since the cost of frequent ATM transactions can easily equal or exceed the cost of a bank account. Consumers
Union has compiled resources on the pitfalls of payroll cards as an alternative. *See*, e.g., "Questions for Employees to Ask About Payroll Cards." By Gail Hillebrand, 2004, available in English at
http://www.consumersunion.org/pub/core_financial_services/000920.html and in Spanish at
http://www.consumersunion.org/pub/core_financial_services/000921.html

regulations will restrict this right to those consumers who were provided with a physical substitute check, and not even require that banks provide that document on request. If, instead of image processing (no federal rights) or Check 21 processing (limited federal rights), the check is processed through lockbox conversion or point of sale conversion, it is covered by the EFTA (full federal rights).

When something goes wrong with a check payment, the consumer shouldn't have to sort out how that check was processed after it left the consumer's hands in order to learn his or her rights. Congress can take a significant stop toward solving this mess by amending the EFTA to include all checks which are processed in whole or in part by the transmission of electronic information.

Attachment 1

AFL-CIO
Americans for Democratic Action
American Federation of Teachers
Association of Community Organizations for Reform Now (ACORN)
Common Cause
Consumer Federation of America
Consumers Union
Lawyers' Committee for Civil Rights Under Law
Leadership Conference on Civil Rights (LCCR)
National Association for the Advancement of Colored People (NAACP)
National Association of Consumer Advocates
National Community Reinvestment Coalition
National Consumer Law Center
National Council of Churches
National Council of La Raza
National Gay and Lesbian Task Force
National Urban League
Unitarian Universalist Association
United Food and Commercial Workers
United Mine Workers of America
U. S. Public Interest Research Group

October 16, 2003

The Honorable Blanche Lincoln
United States Senate
Washington, DC 20510

The Honorable Mark Pryor
United States Senate
Washington, DC 20510

Dear Senators Lincoln and Pryor:

We, the undersigned national civil rights, labor and consumer rights organizations, are writing to express our opposition to S. 904, which will likely be offered as an amendment to the "National Consumer Credit Reporting System Improvement Act of 2003." S. 904 would amend the Federal Deposit Insurance Act to remove usury limits currently applicable to Arkansas lenders under the state's constitution. This amendment not only undermines states' rights, it also will mean that Arkansas consumers will pay far more than necessary for credit and risk exposure to discriminatory lending practices.

The people of Arkansas have determined that there should be a usury limit and have passed one in their state Constitution. Nevertheless, S. 904 deliberately exempts state lenders from this constitutional provision and the express wishes of the people of Arkansas. Despite the clear intent of the majority of voters in Arkansas that they be protected from high interest rates, S. 904 would allow "any other lender" doing business in the state to avoid the interest caps set by the people and the legislature of the state of Arkansas.

S. 904 extends most-favored-lender status to non-bank finance companies. The "other lenders" who would be able to evade state credit and usury limits under this amendment would range from car dealers to auto finance companies, buy-here-pay-here subprime auto dealers, furniture stores, home improvement-based mortgage lenders, and appliance and electronic stores. Removal of such usury limits would open the door to unscrupulous and discriminatory lending practices by these lenders.

Recent studies have shown that African-American and Latino consumers are likely to pay higher markups for auto loans than white consumers when usury limits are not in place.1 Several auto finance companies and others have been sued by African-American and Latino consumers for such discriminatory markup practices in a number of states.2 In Arkansas, however, as the constitutional usury limits restrict the ability of automobile dealers to markup higher interest rates at their discretion, this type of discrimination appears to be less of a significant problem.3 Yet, S. 904 would eliminate this protection from discrimination and produce a financial environment where discriminatory pricing could prosper. We urge you not to allow this to occur.

While the amendment appears to only impact Arkansas, it sets a dangerous precedent for overturning the credit laws of all states. While depository institutions are subject to some supervision and examination, non-depository credit companies are less regulated. Many states exempt *banks* from usury and interest rate limits, permitting rates as agreed between the parties to be charged, largely because of the allowed exportation of interest rates by national banks. In contrast, most states have extensive laws and regulations that apply to non-depository institution lenders to protect at-risk consumers who have less bargaining power and to restrain abusive credit practices.

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[1] Mark Cohen, *Report on the Racial Impact of GMAC's Finance Markup Policy, In the Matter of Addie T. Coleman v. GMAC*, pp. 22, Aug. 29, 2003.

[2] *Jones v. Ford Motor Credit Company*, 00 Civ. 8330 (S.D. N.Y.); *Cason v. Nissan Motor Acceptance Corp.*, C.A. No. 3-98-0223 (M.D. TN); *Coleman v. General Motor Acceptance Corp.*, C.A. No. 3-98-0211 (M.D. TN); *Baltimore v. Toyota Motor Credit Corporation*, CV 01-05564 (C.D. CA); *Smith v. Chrysler Financial Company L.L.C.*, C.A. No. 00-6003 (D. N.J.);. In addition, four cases were filed in 2002 against banks. *Osborne v. Bank of America*, C.A. No. 02-CV-364 (M.D. TN); *Russell v. Bank One*, C.A. No. 02-CV-365 (M.D. TN); *Claybrook v. Primus Automotive Financial Services, Inc.*, C.A. 02-CV-382 (M.D. TN); and *Bass v. Wells Fargo Financial Acceptance, Inc.*, C.A. No. 02-CV-383 (M.D. TN); . *Rodriguez v. Ford Motor Credit Company*, C.A. No. 01 C 8526 (N.D. IL). Information concerning these cases may be found at www.consumerlaw.org and www.faircreditlaw.com.

[3] Id.

S. 904 ignores this important distinction between banks and non-depository institution lenders.

If the people of Arkansas, or any other state, feel that the state limits on credit charges are hurting access to credit, the people of Arkansas can change those limits. It is entirely inappropriate for Congress to preempt the historical powers of the state to protect consumers in this regard. If the Congress grants this privilege to non-bank lenders in Arkansas, the industry will demand the same preemption privilege for the other forty-nine states. This is a very dangerous and an extremely controversial amendment. We strongly oppose adding this amendment to the Fair Credit Reporting Act bill.

Sincerely,

William Samuel
AFL-CIO

Charlotte Fraas
American Federation of Teachers

Darrell Fagin
Americans for Democratic Action

Maude Hurd
Association of Community Organizations for Reform Now (ACORN)

Chellie Pingree
Common Cause

Travis Plunkett
Consumer Federation of America

Janell Duncan
Consumers Union

Barbara Arnwine
Lawyers' Committee for Civil Rights Under Law

Wade Henderson
Leadership Conference on Civil Rights

Hilary O. Shelton
National Association for the Advancement of Colored People (NAACP)

Ira Rheingold
National Association of Consumer Advocates

John Taylor
National Community Reinvestment Coalition

Margot Saunders
National Consumer Law Center

Bob Edgar
National Council of Churches

Brenda Muniz
National Council of La Raza

Shanna Smith
National Fair Housing Alliance

Matt Forman
National Gay and Lesbian Task Force

William Spriggs
National Urban League

Meg Riley
Unitarian Universalist Association

Patricia Scarelli
United Food and Commercial Workers

Cecil E. Roberts
United Mine Workers of America

Edmund Mierzwinski
U. S. Public Interest Research Group

cc: The Honorable Richard Shelby
The Honorable Paul Sarbanes

Testimony of

Bill Cheney
President/CEO of Xerox Federal Credit Union

on Behalf of
The National Association of Federal Credit Unions

Regulatory Relief

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate

June 22, 2004

Introduction

The National Association of Federal Credit Unions (NAFCU) is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU is comprised of more than 800 federal credit unions—member owned financial institutions across the nation—representing approximately 25 million individual credit union members. NAFCU–member credit unions collectively account for approximately two-thirds of the assets of all federal credit unions. NAFCU and the entire credit union community appreciate this opportunity to participate in this discussion regarding regulatory relief for America's financial institutions and particularly its impact on federal credit unions.

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created and has been recognized as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have no access to financial services. Congress established credit unions as an alternative to banks and to fill a precise public need—a niche that credit unions fill today for over 85 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While nearly 70 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- Credit unions remain totally committed to providing their members with efficient, low cost personal service; and,
- Credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

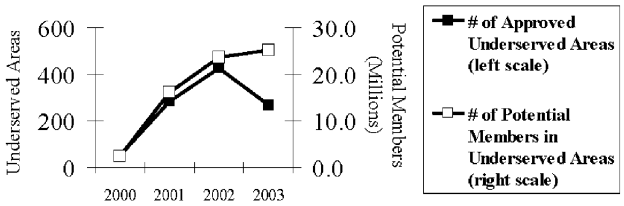
Credit unions are not banks. The nation's approximately 5,700 federally insured credit unions serve a different purpose and have a fundamentally different structure,

existing solely for the purpose of providing financial services to their members. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for profit stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit Unions have an unparalleled safety and soundness record. Credit unions—unlike banks and thrifts—have never cost the American taxpayer a single dime. Unlike the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loans Insurance Corporation (FSLIC) which were both started with seed money from the United States Treasury, every dollar that has ever gone into the National Credit Union Share Insurance Fund (NCUSIF) has come from the credit unions it insures. And unlike the thrift insurance fund that unfortunately cost American taxpayers hundreds of billions of dollars, credit unions have never needed a federal bailout.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the *Credit Union Membership Access Act* (CUMAA – P.L. 105-219). In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means … [and it] continue[s] to fulfill this public purpose." Since the passage of CUMAA in 1998, federal credit unions have added over 1,000 underserved areas, resulting in low-cost financial services being made available to over 67 million people.

UNDERSERVED AREAS ADDED TO FEDERAL CREDIT UNIONS MEMBERSHIP



Source: National Credit Union Administration

A 2004 Filene Research Institute study entitled "Who Uses Credit Unions" found that the average household income of those who hold accounts solely at a credit union was $42,664, while the average household income for those who only hold accounts at a bank was $76,923. Even of those who used multiple financial services providers, those that primarily used a credit union had an average household income of $67,475, while those who used multiple financial services providers but primarily used a bank had an average household income of $74,303. Credit unions also represent a very small portion of today's financial marketplace, holding only 1.6 percent of all household financial assets.

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed with the resulting de-personalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided but also—and in many cases more importantly—to quality and cost. Credit unions are second to none in providing their members with quality personal service at the lowest possible cost. According to the 2003 American Banker/Gallup Consumer Survey, credit unions had the highest rated service quality of all surveyed financial institutions. This has held true each year since the survey was initiated.

I serve as the President/CEO of Xerox Federal Credit Union, headquartered in El Segundo, California. Xerox FCU is a multiple common bond credit union with approximately 77,000 members and more than $760 million in assets. Xerox FCU serves employees of the Xerox Corporation and related companies nationwide through 17 credit union offices in eight states. My credit union has recently expanded to include underserved communities in Rochester, NY; Dallas, TX; St. Petersburg, FL; and Chicago, IL. I have a broad background in financial services, including more than 17 years working in the credit union industry. I joined Xerox Federal Credit Union in 1997 after 10 years with Security Service Federal Credit Union in Texas.

Currently I also serve as an at-large director and board secretary for the National Association of Federal Credit Unions; I am a member of the board of directors for Western Corporate Federal Credit Union (WesCorp), as well as a member of the Diversity Committee for the California Credit Union League. Finally, I am chairman of the board of XCU Capital Corporation, a broker/dealer owned and controlled by 17 credit unions.

I am also a director and a member of the Executive Committee of the American Red Cross of Greater Los Angeles, and I volunteer with numerous charitable organizations such as Heal the Bay and the Boy Scouts of America. I earned my Bachelor of Business Administration degree from The University of Texas at Austin in 1982.

Looking Beyond CUMAA

Credit unions have been the target of criticism by some in the banking industry for more than two decades, and the criticisms that the bankers are lodging today are nothing new. Over the past year, the banker attacks have intensified. The Supreme Court's decision in 1998 in the AT&T Family Federal Credit Union field of membership case followed by Congress' prompt passage of CUMAA in the summer of 1998, which

was seen by many as a significant victory for credit unions, brought the issue to a head. The fact of the matter is that when CUMAA was signed into law it overturned in eight short months a decision that had encompassed eight years of costly litigation initiated by the banks.

CUMAA was a necessary piece of legislation for credit unions at the time of its enactment because it codified a number of fundamental credit union concepts embraced by both federal and state-chartered credit unions. These include:

- the multiple-group policy that NCUA had initiated in 1984;
- the "once a member, always a member" principle followed by virtually every credit union in the country; and,
- the "family member" concept followed by many credit unions.

Yet CUMAA came with some provisions that were not widely supported by the credit union community. These include:

- limitations on member business loans;
- imposition of a bank-like Prompt Corrective Action or "PCA" requirement that, given the structure of credit unions, serves in many respects as an overly restrictive constraint on growth; and
- various artificial and arbitrary limitations on growth.

Following the passage of CUMAA, NAFCU recognized the need for additional credit union legislation. As a result NAFCU convened a task force of federal credit unions and former federal credit unions (that had converted to a state charter) to begin work on developing well-reasoned proposals to enhance the federal credit union charter and to ease the regulatory burdens of all credit unions.

This group met to discuss their concerns related to the federal charter in the post-CUMAA environment. Below are highlights of some of the comments NAFCU heard at that session and in subsequent meetings:

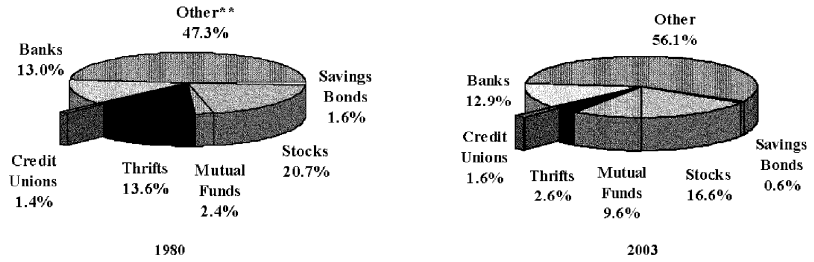
- NCUA should work to eliminate unnecessary and needless regulations and work with Congress to repeal laws which are only serving to drive small financial institutions out of business.
- Mergers seem to be a practical and necessary way of creating financially viable credit unions that can survive in today's financial marketplace.
- It is important that the regulatory environments allow for credit union growth and not impair the ability of credit unions to remain competitive.

As a result of these meetings, it became clear that both regulatory and legislative action was needed in the post-CUMAA environment.

The Current Situation

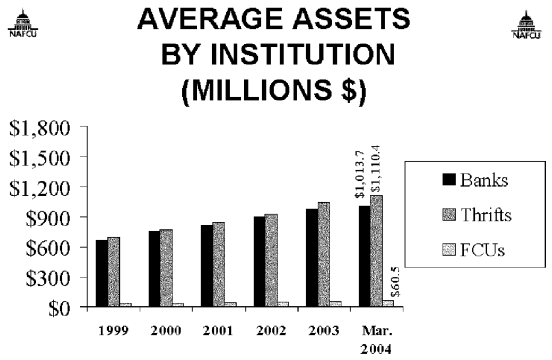
NAFCU is pleased to report to the Committee that credit unions today are vibrant and healthy. Membership in credit unions continues to grow with credit unions serving over 85 million Americans—more than at any time in history. At the same time, it is important to note that over the past 21 years credit unions have increased their market share only minimally and as a consequence provide little competitive threat to other financial institutions. According to data obtained from the Federal Reserve Board, during the 23 year period from 1980 to 2003 the percentage of total household financial assets held by credit unions increased from 1.4% to 1.6% or merely 0.2% over the course of 23 years.

HOUSEHOLD FINANCIAL ASSETS



****Other includes items such as life insurance reserves, pension fund reserves, mortgages, security credit, equity in noncorporate (e.g. farm) business, open market paper, and investments in bank personal trusts.**

The above chart only tells part of the story. Credit unions remain small financial institutions. The chart below indicates that the average credit union has $60.5 million in assets.



As you can see, a number of individual banks have total assets greater than the entire credit union community combined. The annual growth of the commercial bank

sector in recent years is almost equal to the size of the entire credit union community—with banks growing in just one year by a magnitude that it took credit unions nearly a century to achieve.

As is the case with the banks and thrifts, there has been consolidation within the credit union community in recent years. The number of credit unions has declined by more than 59 percent over the course of the past 30 years, from an all-time high of 23,866 in 1969 to 9,709 at year-end 2003. Similar to the experience of all credit unions, the number of federal credit unions has declined by just about 56 percent over that same period, from a high of 12,921 in 1969 to 5,732 today.

NAFCU Meets with Policymakers to Enhance the Federal Charter

Shortcomings or anachronistic characteristics of federal chartering policies as well as needless or outdated regulatory burdens clearly cannot be remedied without bringing these matters to the attention of policy makers in Washington. Over the past four years NAFCU has been working with former NCUA Board Chairman Dennis Dollar, current NCUA Chairman JoAnn Johnson, Board Member Deborah Matz and their staffs in a good faith effort to improve the regulatory environment for federal credit unions. We are pleased to see that these efforts have been fruitful in several respects.

On the legislative front, NAFCU has been meeting with legislators on both sides of the aisle to compile a package of initiatives to help credit unions better serve their members in today's sophisticated financial marketplace. An important part of that effort has involved identifying areas in which we believe Congress should provide what is now overdue regulatory relief. NAFCU has suggested a series of recommendations designed to enhance the federal charter, several of which are contained either in whole or in part within the House-passed *Financial Services Regulatory Relief Act of 2004*, H.R. 1375, or in the *Credit Union Regulatory Improvements Act* (CURIA), H.R. 3579, which has been introduced in the House. Both of those bills recognize the fact that today's credit unions

exist in a very dynamic environment and that the laws and regulations dealing with credit union issues are currently in need of review and refinement.

***Financial Services Regulatory Relief Act of 2004* and CURIA**

NAFCU believes that the *Financial Services Regulatory Relief Act of 2004*, H.R. 1375, is a positive step in addressing many of the regulatory burdens and restrictions on federal credit unions. We were pleased with the overwhelming bipartisan vote of support for this legislation when it passed the House on March 18, 2004, by a vote of 392-25.

NAFCU is also pleased to see the growing support in the House for the *Credit Union Regulatory Improvements Act*, H.R. 3579, introduced last November by Representatives Ed Royce (CA) and Paul Kanjorski (PA). This legislation addresses several additional key issues for credit unions that were not addressed in H.R. 1375. We hope that the Senate Banking Committee will consider provisions from both of these bills as it crafts its own regulatory relief bill.

Twelve provisions in particular have been included in both bills, and we would urge that they be included in any regulatory relief bill that is moved by the Committee:

Leases of land on federal facilities for credit unions

NAFCU supports the effort to give credit unions land leases on federal property under the same terms and conditions as credit unions now are provided space allotments under the *Federal Credit Union Act* (FCUA). The credit unions that will be impacted by this change are defense (military) credit unions that have tried to expand their service to our men and women in uniform by building (and paying for) their own member service centers on military facilities. Many credit unions that have expanded their services by building their own facilities to serve military personnel have had their leases go from a nominal fee (e.g. $1.00 a year) to a "fair market value" rate of over $2,000 a month. For non-profit cooperative credit unions, this change in leasing costs will inevitably lead to higher fees and/or fewer services for the men and women they serve.

Investments in securities by federal credit unions

NAFCU supports this effort to increase investment options for federal credit unions by allowing certain limited investments in securities. The current limitations in the FCUA unduly restrict federal credit unions in today's dynamic financial marketplace and have the potential of adversely impacting both safety and soundness in the future. We believe that the track record of safe and sound performance by credit unions warrants expanded investment authority in accordance with regulations promulgated by the NCUA Board.

Increase in general 12-year limitation of term of federal credit union loans

NAFCU supports this provision that would increase the general 12-year limit on federal credit union loans to 15 years or longer as permitted by the NCUA Board. The current 12-year limit is outdated and does not conform to maturities that are commonly accepted in the market today. We believe that it is also important that the NCUA Board have the discretionary authority to extend this limitation beyond 15 years when necessary in order to appropriately address marketplace conditions.

Increase in one-percent investment limit in credit union service organizations

NAFCU supports this provision to increase the one percent investment limit in credit union service organizations (CUSOs). However, in lieu of just raising the limit to three percent, as found in the House-passed version, NAFCU recommends that Congress give the NCUA Board authority to establish an appropriate investment limit recognizing that as time goes on, that limit may legitimately warrant further adjustment.

Member business loan exclusion for loans to non-profit religious organizations

NAFCU supports this effort to exclude loans or loan participations by federal credit unions to non-profit religious organizations from the member business loan limit.

Check-cashing and money-transfer services offered to those within the credit union's field of membership

NAFCU supports efforts to allow federal credit unions to offer check-cashing and money-transfer services to anyone within the credit union's field of membership. We

believe this new authority, which would be discretionary and not mandatory, will allow credit unions to help combat abuses by non-traditional financial institutions that prey on our nation's immigrants and others who live and work in underserved communities.

Voluntary mergers involving multiple common bond credit unions

NAFCU supports this clarifying amendment since there is no sound reason for imposing a numerical limitation of 3,000 on the size of a group that can go forward with a credit union merger before considering spinning off the group and requiring it to form a separate credit union. In addition, a credit union that converts to (or merges into) a community charter should be allowed to retain all employee groups in its field of membership at the time of conversion. Current law does not allow this, penalizing not only the credit union, but also those in its field of membership. In addition, we believe that the retroactive effective date of August 7, 1998 (the date of enactment of CUMAA), is an important part of this section and must be maintained.

Community charter conversions involving employee group credit unions

NAFCU supports efforts that give NCUA the authority to allow credit unions to continue to serve and add members from their select employee groups (SEG's) after a credit union converts to a community charter.

Credit union governance

The FCUA contains many antiquated "governance" provisions that, while perhaps appropriate in 1934, are outdated, unnecessary and inappropriate restrictions on the day-to-day operations and policies of a federal credit union. For example, credit unions are not allowed to expel disruptive or threatening members without a two-thirds vote of the membership. NAFCU supports other provisions in the House-passed *Financial Services Regulatory Relief Act of 2004* which would:

- allow credit unions to limit the length of service of members of the board of directors to ensure broader representation; and

- allow credit unions to reimburse volunteers on the board of directors for wages they would otherwise forfeit by participating in credit union-related activities.

In addition, NAFCU also believes that there are many more governance provisions in the *Federal Credit Union Act* that are out-of-date and that could be better addressed by the NCUA Board. These include:

- Allow the NCUA Board to set the amount at which the credit union board of directors must approve a loan to, or guaranteed by, a director or member of the credit union supervisory or credit committee (currently the Act sets it at $20,000); and,
- Allow the NCUA Board to determine policies for review of approved or pending applications for membership to the credit union (currently the Act stipulates that the Board must review approved or pending applications monthly).

Providing NCUA with greater flexibility in responding to market conditions

NAFCU supports the idea of giving NCUA the authority to adjust interest rates depending on market conditions. Under current law, federal credit unions are the only type of insured institutions subject to federal usury limits on consumer loans.

Exemption from pre-merger notification requirement of the Clayton Act

NAFCU supports the inclusion of this language which would exempt credit unions, just as banks and thrifts are already exempt, from the pre-merger notification requirements of the *Hart-Scott-Rodino Act.*

Treatment of credit unions as depository institutions under securities laws

Gramm-Leach-Bliley provided banks with registration relief from certain enumerated activities, and section 201 of the *Financial Services Regulatory Relief Act of 2004* provides similar relief to thrifts. NAFCU supports providing credit unions regulatory relief along those same lines from the requirement that they register with the Securities and Exchange Commission as broker/dealers when engaging in certain activities.

There are also additional provisions included in CURIA that are not included in the *Financial Services Regulatory Relief* Act *of 2004* as it passed the House. Given the bipartisan support of the legislation in the House, we hope that the Committee will consider including these provisions in any regulatory relief bill introduced in the Senate:

Risk-based capital

NAFCU supports this effort to modernize credit union capital requirements by redefining the net worth ratio to include risk assets. This would result in a new, more appropriate measurement to determine the relative risk of a credit union's assets and improve the safety and soundness of credit unions and the National Credit Union Share Insurance Fund.

Limits on member business loans

NAFCU supports elimination of the current asset limit on member business loans at a credit union from the lesser of 1.75 times actual net worth or 1.75 times net worth required for a well-capitalized credit union, and replacing it with a flat rate of 20 percent of the total assets of a credit union. NAFCU believes this provision would facilitate member business lending without jeopardizing the safety and soundness of participating credit unions. While the current cap was first imposed on credit unions as part of the *Credit Union Membership Access Act* in 1998, CUMAA also directed the Treasury Department to study the need for such a cap. In 2001, the Treasury Department released its study entitled "Credit Union Member Business Lending" in which it concluded that "credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions." We would urge the Committee to review this study and give it the weight it deserves when considering these provisions. NAFCU also supports revising the current definition of a member business loan by giving the NCUA the authority to exclude loans of $100,000 or less as de minimus, rather than preserving the current threshold of $50,000.

Leasing space in buildings with credit union offices in underserved areas

NAFCU supports the provision in CURIA that enhances the ability of credit unions to assist distressed communities with their economic revitalization efforts. It would allow a credit union to lease space in a building or on property in an underserved area in which it maintains a physical presence to other parties on a more permanent basis. It would permit a federal credit union to acquire, construct, or refurbish a building in an underserved community, and lease out excess space in that building.

We would like to call the Committee's attention to some additional issues that we believe should be considered in the upcoming regulatory relief legislation:

Modify the statutory definition of "net worth" to mean "equity" rather than the "retained earnings balance" of the credit union as determined under generally accepted accounting principles.

Currently, credit union mergers are accounted for by using the "pooling method," meaning that the net worth of each merging credit union is combined to form the net worth of the surviving credit union: $5M (net worth of credit union A) + $5M (net worth of credit union B) = $10M (net worth of credit union AB). However, the Financial Accounting Standards Board (FASB) has proposed eliminating pooling and imposing the "purchase method" of accounting on credit union mergers. Using this method and the current definition of net worth which is "retained earnings" as required by PCA, the net worth of the surviving credit union is only $5M ($5M (net worth of credit union A) + $5M (net worth of credit union B) = $5M (net worth of credit union AB)). Therefore, under the purchase method of accounting, only the surviving credit union's retained earnings count as net worth for PCA purposes. As a result, the surviving credit union may have trouble meeting PCA requirements, unless credit union net worth is redefined to mean equity. It should also be noted that the FASB has reviewed this proposed amendment and has noted in a letter to NAFCU that they "have an interest in supporting an expedited resolution of this matter" and that this amendment "proposes a way to resolve this matter."

Relax the "reasonable proximity" requirement

This requirement imposes an undue burden on credit unions, requiring them to have a physical presence within a reasonable proximity of the location of a group that the credit union wants to add to its field of membership. In today's financial services marketplace, the increase in Internet and remote banking has rendered this requirement unnecessary.

We hope that the Committee will consider these issues as the bill moves forward in the legislative process.

Conclusion

NAFCU believes that the state of the credit union community is strong and the safety and soundness of credit unions is unquestionable. Nevertheless, there is a clear need for easing the regulatory burden on credit unions as we move forward into the 21st century financial services marketplace. We urge the Committee to consider the important provisions we have outlined in this testimony for inclusion in any Senate regulatory relief bill. We understand that this legislation is a work in progress and we urge you to undertake careful examination of any other measures that fall within the scope of this legislation. We look forward to working with you on this important matter and would welcome your comments or questions.

STATEMENT

OF

WILLIAM A. LONGBRAKE

ON BEHALF OF

THE FINANCIAL SERVICES ROUNDTABLE

TO THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF

THE U.S. SENATE

JUNE 22, 2004

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, my name is Bill Longbrake, and I am Vice Chair of Washington Mutual, Inc. With a history dating back to 1889, Washington Mutual is a retailer of financial services that provides a diversified line of products and services to consumers and commercial clients. Washington Mutual and its subsidiaries have assets of $280.7 billion and operate more than 2,400 retail banking, mortgage lending, commercial banking, and financial services offices throughout the nation. Washington Mutual and its state and federally-chartered depository institutions have three primary banking regulators, the Office of Thrift Supervision ("OTS"), Federal Deposit Insurance Corporation ("FDIC"), and Washington State Department of Financial Institutions.

I am appearing today on behalf of The Financial Services Roundtable.[1] The Roundtable appreciates the opportunity to testify on the topic of regulatory burden relief. The Roundtable strongly supports efforts to reduce the regulatory burden on financial services firms. Outdated laws and regulations impose significant, and unnecessary, burdens on financial services firms. This regulatory burden makes financial services firms less efficient, and increases the cost of financial products and services to consumers. Thus, it is important for Congress to periodically review the laws applicable to the financial services industry, and we applaud your efforts in doing so.

As a starting point, we urge the Committee to review H.R. 1375, the Financial Services Regulatory Relief Act, which passed the House of Representatives in March of this year. There are a number of provisions in that bill that we support. Those provisions are summarized in an attachment to this statement. We also urge the Committee to include in its bill several other provisions, which do not appear in the House-passed bill. Those provisions also are summarized in the attachment to this statement.

In the remainder of this statement, I will highlight six provisions from the House-passed regulatory relief bill that are of special significance to The Roundtable. Two of the provisions relate to interstate banking; the others would ease regulatory burden on savings associations. I also will comment on a proposed simplified privacy notice, which would benefit both consumers and financial services firms.

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[1] The Roundtable represents 100 of the nation's largest integrated financial services companies, providing banking, insurance and investment products and services to millions of American consumers.

Interstate Banking

It was exactly ten years ago that Congress enacted the landmark Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Since then, the public benefits anticipated by that Act have been realized. The creation of new bank branches has helped to maintain the competitiveness of our financial services industry, and has improved access to financial products in otherwise underserved markets. Branch entry into new markets has enhanced competition in many markets, and this, in turn, has resulted not only in a better array of financial products and services for households and small businesses, but also in competitive prices for such products and services. There is, however, one remaining legal barrier to interstate branching, which should be eliminated.

De Novo Branching

Under the Riegle-Neal Act, a bank cannot establish a new or so-called "de novo" interstate branch without the affirmative approval of a host state. Since 1994, only 17 states have given that approval; 33 states have not. The time has come to remove this barrier to interstate branching. The Roundtable urges the Committee to do so by incorporating section 401 of H.R. 1375 in its version of the regulatory relief bill.

Section 401 of H.R. 1375 eliminates the provision in the Riegle-Neal Act that requires state approval for de novo branching. In other words, the enactment of section 401 would allow a bank to establish new branches in any state, without limitations.

Section 401 of H.R. 1375 is supported by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Conference of State Bank Supervisors. These federal and state regulators recognize the public benefits associated with expanding access to banking offices. They also realize that current law has created some competitive disparities between different types of institutions.

Section 401 of H.R. 1375 also makes other useful modifications to interstate operations. It removes a minimum requirement on the age of a bank that is acquired by an out-of-state bank. It allows state bank supervisors to permit state banks to engage in interstate trust activities similar to the trust activities permissible for national banks. It facilitates mergers and consolidations between insured banks and uninsured banks with different home states. All of these changes facilitate the provision of banking products and services to consumers.

Coordination of State Examinations

A second provision related to interstate banking that we would urge the Committee to incorporate in its version of a regulatory relief bill is Section 616 of H.R. 1375. Section 616 of H.R. 1375 clarifies the authority of state banking supervisors over interstate branches of state chartered banks. It provides that the bank supervisor of the state in which a bank is chartered (a "home" state supervisor) is responsible for the examination and supervision of branches located in other states, and that only a home state supervisor may impose supervisory fees on interstate branches. Section 616 also encourages state banking supervisors to enter into cooperative supervisory agreements related to the examination and supervision of state banks with interstate operations. Such an agreement could provide for joint examinations, and even the assessment of joint supervisory fees. **Furthermore**, Section 616 acknowledges the authority of a "host" state banking supervisor to examine the interstate branches of state banks for compliance with applicable host state law. The addition of this provision will help to avoid needless confusion, and potential conflict, over the examination and supervision of the interstate branches of state banks.

Regulation of Thrift Institutions

While The Roundtable supports all of the thrift provisions in H.R. 1375, I would highlight four of those provisions, which are particularly important to our members.

Parity for Thrifts Under the Federal Securities Laws

Section 201 of H.R. 1375 would establish regulatory parity between the securities activities of banks and thrifts. For years, the brokerage and investment activities of commercial banks have enjoyed exemptions under federal securities laws.[2] As a result, the securities activities of banks have been subject to regulation by banking regulators, not the Securities and Exchange Commission ("SEC"). Thrift institutions, on the other hand, have not enjoyed similar exemptions under the Exchange Act or the Investment Advisors Act, even though Congress has, over time, permitted thrifts to engage in the same brokerage and investment activities as

[2] The scope of this exemption was narrowed in the Gramm-Leach-Bliley Act.

commercial banks.[3] As a result, the securities activities of thrifts have been subject to regulation by both the SEC and the OTS.

Using its rulemaking powers, the SEC has attempted to address this regulatory disparity, first by granting thrifts a regulatory exemption under the Exchange Act, and most recently, by proposing a limited exemption for thrifts under the Investment Advisors Act. Unfortunately, those actions by the SEC do not fully resolve the disparity between the regulation of banks and thrifts. Therefore, we urge the Committee to include Section 201 in its version of the regulatory relief bill.

Section 201 would establish an explicit exemption for thrifts in the Exchange Act that is comparable to the exemption for commercial banks. This statutory change would remove any doubt about the permanence of the existing regulatory exemption adopted by the SEC.

Section 201 also would make the exemption for thrifts under the Investment Advisors Act parallel to the existing exemption for banks. The regulation recently proposed by the SEC grants thrifts an exemption from SEC regulation only when they are engaged in investment advisory activities in connection with trust activities. It would not apply to other investment advisory services, such as retail planning services. Section 201 draws no such distinction. It would give thrifts the same exemption as commercial banks.

The OTS examines the securities-related activities of thrifts, just as the OCC and other banking agencies examine the securities-related activities of commercial banks. Thus, the exemptions proposed in Section 201 do not leave a regulatory void. They simply place thrifts on a regulatory par with commercial banks, by eliminating the costs associated with registration with the SEC.

Citizenship of Federal Savings Associations for Federal Court Jurisdiction

The Roundtable supports Section 213 of H.R. 1375, which would clarify that for federal diversity purposes, a federal savings association is a citizen of the state in which it has its home office. There is uncertainty among the courts whether a federally chartered institution, such as a federal thrift, is a citizen of any state. Clarification in the law is needed to govern when an interstate savings association can remove a case to federal court based on diversity jurisdiction. This clarification in section 213 is similar to the treatment currently provided national banks.

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[3] In 1999, Congress did amend the Investment Company Act to treat thrifts the same as banks.

However, further clarification also may be needed to update the existing provision that specifies which state a national bank is located for purposes of federal court jurisdiction. The OTS supports section 213.

Auto Loans

The Roundtable urges the Committee to incorporate Section 208 of H.R.1375 in its version of the regulatory relief bill. Current law limits the amount of automobile loans by a thrift to no more than 35% of the institution's assets. Section 208 would remove this ceiling. Congress has previously determined that credit card loans and education loans by thrifts should not be subject to any asset limitation. Automobile loans should be placed in this same category. Doing so will allow thrifts to further diversify their portfolios and enhance their balance sheets. Also, this provision would increase competition in the auto loan business, to the benefit of consumers.

Dividends

The Roundtable supports the insertion of Section 204 of H.R. 1375 in the Senate version of the regulatory relief bill. Section 204 would replace a mandatory dividend notice requirement for thrifts owned by savings and loan holding companies with an optional requirement under the control of the Director of OTS. The existing mandatory requirement is no longer necessary. Other existing federal statutes and regulations give the OTS the authority to ensure that thrifts held by holding companies pay dividends only in appropriate circumstances. Moreover, the current mandatory requirement applies only to thrifts owned by savings and loan holding companies, not to those owned by other companies or banks. Thus, Section 204 removes a disparity in regulation that need not exist.

Simplified Privacy Notice

Like many consumers, The Roundtable member companies have found that the privacy notice required by the Gramm-Leach-Bliley Act (GLBA) is overly confusing, and largely ignored by many consumers. Accordingly, we recommend that the Committee use this opportunity to simplify the form of the notice required by GLBA.

There is extensive research in support of simple notices. That research indicates that consumers have difficulty processing notices that contain more than seven elements, and require the reader to translate vocabulary used in the notice into concepts they understand. Consumer surveys also indicate that over 60 percent of consumers would prefer a shorter notice than the lengthy privacy policy mandated by GLBA.

Recognizing the problem created by the existing GLBA privacy notice, the federal banking agencies, the FTC, NCUA, CFTC and SEC recently requested comment on alternative notices that would be more readable and useful to consumers. These federal agencies, however, lack the authority to make a simplified notice truly consumer-friendly because they cannot address conflicting and overlapping state privacy laws. Section 507 of GLBA permits individual states to adopt privacy protections that are "greater" than those established by GLBA. This provision allows states to adopt their own privacy notices, and this simply adds to consumer confusion and frustration.

We strongly recommend that the Committee include a provision in its regulatory relief bill that directs the relevant federal agencies to finalize a simplified privacy notice for purposes of GLBA, and provides that such a notice supercede state privacy notices. As the research has indicated, consumers will be better served if they are given a simple, uniform explanation of an institution's privacy policy and their privacy rights.

Conclusion

In conclusion, The Roundtable appreciates the efforts of this Committee to eliminate laws and regulations that impose significant and unnecessary burdens on financial services firms or impose unnecessary barriers in serving the marketplace. The costs savings that will result from this legislation will benefit the consumers of financial products and services. We look forward to working with the Committee on this important legislation.

Provisions that The Financial Services Roundtable would like to see incorporated into a Senate regulatory relief bill, which are included in H.R. 1375

A. Elimination of Barriers to De Novo Interstate Branching, Mergers, and Trust Activities

Section 401 of the bill would remove certain existing restrictions on interstate branching and mergers. Currently, banks may not establish new offices (so-called "de novo branches") outside their home state unless the host state specially authorizes de novo branching. Only 17 states have enacted legislation to allow de novo entry. Both large and small financial institutions have found this limitation on de novo branching to be costly and burdensome and, in some cases, an absolute barrier to entry.

Section 401 would permit de novo interstate branching for state and national banks without an affirmative opt-in from the host state. This change will bring benefits to financial institutions and their customers by permitting an institution to select which form of interstate expansion is best suited for its market.

Additionally, section 401 would allow state bank supervisors to permit state banks to engage in interstate trust activities, similar to what is allowed for national banks. Today, the trust activities of state banks remain subject to a variety of state laws. These laws have inhibited the ability of many state banks to provide trust services. Consumers today are more mobile than ever. Section 401 would facilitate the providing of trust services to a greater number of people.

B. Reduction of Cross-Marketing Restrictions

Section 501 of the bill would make two modifications to the cross-marketing restrictions imposed by the Gramm-Leach-Bliley Act of 1999 ("GLBA"). First, it would permit depository institutions controlled by a financial holding company to engage in cross-marketing activities with companies in which a merchant banking affiliate has made an investment to the same extent, and subject to the same restrictions, as companies in which an insurance affiliate has made an investment.

Presently, an insurance affiliate of a financial holding company may engage in cross-marketing with a company in which the insurance affiliate has made an investment if (1) the cross-marketing takes place only through statement inserts and Internet websites, (2) the cross-marketing activity is conducted in accordance with the anti-tying restrictions of

the Bank Holding Company Act ("BHCA"), and (3) the Board determines that the proposed arrangement is in the public interest, does not undermine the separation of banking and commerce, and is consistent with the safety and soundness of depository institutions. Under current law, however, a merchant banking affiliate of a financial holding company may not engage in such limited cross-marketing activities with the companies in which it makes investments. Section 501 would establish parity of treatment between financial holding companies that own insurance affiliates and those that own merchant banking affiliates.

Second, section 501 would permit a depository institution subsidiary of a financial holding company to engage in cross-marketing activities with a non-financial company held by a merchant banking affiliate if the non-financial company is not controlled by the financial holding company. When a financial holding company does not control a portfolio company, cross-marketing activities are unlikely to materially undermine the separation between banking and commerce. In these non-control situations, the separation of banking and commerce is maintained by the other restrictions contained in GLBA that limit the holding period of the investment and restrictions that limit the financial holding company's ability to manage and operate the portfolio company.

C. Parity for Banks and Thrifts Under Federal Securities Laws

Section 201 of the bill would extend to thrifts the exemptions that banks have from investment adviser and broker-dealer registration requirements. Under current law, banks are exempt from registration under the Investment Advisers Act of 1940, and have, in the past, enjoyed a blanket exemption from broker-dealer registration requirements under the Securities Exchange Act of 1934. Thrifts have had neither exemption. While the Securities and Exchange Commission ("SEC") has the authority to correct this disparity, and has taken some regulatory steps to do so, there is no certainty that it will do so.

The Office of Thrift Supervision ("OTS") and the SEC have recognized that this differential treatment is no longer logical. The trust powers of banks and thrifts are essentially the same. Additionally, banks and thrifts provide investment advice, trust and custody, third party brokerage, and other related services in relatively the same manner.

D. QTL Test for Multi-State Thrifts

Section 211 of the bill would eliminate the requirement that federal thrifts meet the qualified thrift lender ("QTL") test on a state-by-state basis, only requiring them to meet the test on a multi-state basis. Under current law, a thrift with operations in multiple states must meet the QTL test not only on a multi-state basis, but also in every state in which it has branches. The net result of this rule is to restrict the free flow of commerce between and among the states, and to misallocate resources to meet the arbitrary demands of the statute. With the barriers to interstate operations rapidly falling away, continuation of the individual state test for multi-state thrifts is anachronistic.

E. Auto Loans by Thrifts

Section 208 of the bill would remove the current restrictions on auto lending by federal thrifts. The Home Owners' Loan Act ("HOLA") limits the amount of loans a federal thrift can make for "personal, family and household purposes." Included in this category are automobile loans. Currently, a federal thrift cannot commit more than 35 percent of its assets to automobile loans. At the same time, HOLA places no limit on the amount of credit card and educational loans by a federal thrift. Removing this limitation allows thrifts to diversify their lending portfolios and enhance their balance sheets. It also provides more competition in the auto loan business and more consumer choice.

F. Coordination of State Examination Authority

Section 616 of HR 1375 is intended to improve coordination of supervision of multi-State State-chartered banks, by clarifying how State-chartered institutions with branches in more than one State are examined. While giving primacy of supervision to the chartering or home State, this provision, as slightly modified, requires both the home and host State bank supervisor to abide by any written cooperative agreement relating to coordination of exams and joint participation in exams. In addition, unless other-wise permitted by a cooperative agreement, only the home State supervisor may charge State supervisory fees on the bank. Under this provision, the host State supervisor may, with written notice to the home State supervisor, examine the branch for compliance with host State consumer protection laws. If permitted by a cooperative agreement or if the out-of-State bank is in a troubled condition, the host State supervisor may participate in the examination of the bank by the home State supervisor to ascertain that branch activities are not conducted in an unsafe or unsound manner.

If the host State supervisor determines that a branch is violating host State consumer protection laws, the supervisor may, with written notice to the home State supervisor, undertake enforcement actions. This section does not limit in any way the authority of Federal banking regulators and does not affect State taxation authority.

G. Other Provisions in H.R. 1375

The Roundtable believes that several other provisions of the bill are noteworthy:

- Section 103, which would simplify dividend calculations for national banks;
- Section 202, which would provide authority for thrifts to make investments for public welfare similar to those which banks are now permitted to make;
- Section 212, which eliminates the limit on small business loans and increases the lending limit on other business loans from 10% to 20 % for savings associations.
- Section 213, which would clarify that for federal diversity jurisdiction purposes, a federal thrift is a citizen of the state in which is has its home office.

- Section 403, which would eliminate certain reports from insiders that the Board has found do not contribute significantly to the effective monitoring of insider lending or the prevention of insider abuse;
- Section 502, which would provide discretion to the Board to make exceptions under the rule that attributes to a bank holding company ownership of shares held in trust by that company; and
- Section 601, which would permit the federal banking agencies to adjust examination schedules in order to more efficiently allocate resources among the institutions most in need of examination.

Other legislation which The Financial Services Roundtable would like to see incorporated into a Senate Regulatory Relief bill:

A. Simplify GLBA Privacy/Opt-out Notices

Like many consumers, the Roundtable's members believe that current privacy notices are overly confusing. Accordingly, the Congress should amend federal law to (1) direct the federal financial regulators to develop, by rule, a "summary" privacy notice and an easy, standardized opt-out form, (2) make the simple notice/easy opt-out preemptive to ensure that they stay simple, and (3) replace the annual notice requirement with a requirement that institutions distribute the summary notice when a customer relationship is established or whenever the terms of the institution's privacy policy are changed materially. An institution's entire privacy policy would be available and be required to be provided upon request.

B. H.R. 314: Mortgage Servicing Clarification Act

H.R. 314 passed the House 424-0 earlier this year on suspension. A similar bill also passed on suspension in the 107th Congress. HR 314 provides a narrowly crafted exemption from the so-called "Miranda" notice requirements in the Fair Debt Collection Practices Act. Under existing law, when a mortgage servicer acquires the rights to service a mortgage loan portfolio, the new servicer is generally exempt from the FDCPA because the Act extends the creditor's exemption to the new servicer. However, in a typical loan servicing transfer, a certain percentage of loans will be delinquent or in default at the time of the transfer. These loans are technically covered by the FDCPA. However, in a mortgage servicing transfer, rather than protecting delinquent borrowers the harshly worded Miranda notices actually discourage them from contacting their new servicer out of fear that the company is simply another debt collector. H.R. 314 establishes a narrow exemption from the Miranda notice requirements for servicers of federally related first lien mortgages. The exemption applies only to the Miranda notices – all other substantive borrower protections provided by the FDCPA remain in full force.

C. Flexibility for Limited Purpose Credit Card Banks

This provision, a similar version of which was included unanimously as Section 404 of during the U.S. Senate Banking Committee's mark-up of S. 576 in the 106th Congress, would permit limited purpose credit card banks to invest in, or directly offer, residential mortgage, small business and agriculture loans to help meet the credit needs of low and moderate income persons to provide the credit card banks the flexibility needed to meet the obligations of the Community Reinvestment Act (CRA). Credit card banks, which are limited purpose, do not have the same loan products or personnel as full-services banks. Under this amendment, a credit card bank with these limitations would be able to contribute more directly to community development needs by taking part in loan pools and other investments offered by state governments, housing organizations or financial literacy efforts that raise funds and underwrite such projects. This amendment would resolve in statute the regulatory ambiguity governing credit card banks and their unique CRA obligations. It would foster additional community development funding from credit card banks, while with the limitations in place, ensure that they would not be entering the business of making commercial loans or any other than the credit card business.

D. Savings Associations Acting as Agents for Banks

The Roundtable supports an amendment that would provide savings associations the same authority that banks have under section 18(r) of the Federal Deposit Insurance Act ("FDIA") to act as agents for their affiliated depository institutions. The agency activities currently permitted under section 18(r) of the FDIA allow a bank holding company's customers to deposit funds and service loans at any of the holding company's subsidiary banks, no matter which state the banks are located. Such agency services provide customers an important convenience. This convenience should also be extended to customers of savings and loan holding companies.

E. Protection of Information Provided to Banking Agencies

The Roundtable supports inclusion of an amendment that would protect the confidentiality of bank exam material. This amendment has been part of regulatory relief legislation in past Congresses and is supported by the bank regulatory agencies. Recent court decisions have created ambiguity about the privileged status of information provided to supervisors. The amendment would clear up this ambiguity by providing that when a depository institution submits information to a bank regulator as part of the supervisory process, the depository institution has not waived any privilege it may claim with respect to that information.

F. Credit Card Savings Associations

Another amendment supported by the Roundtable would allow thrift holding companies to own credit card savings associations and still be exempt from the activity restrictions imposed on companies that control multiple thrifts. Currently, limited-purpose credit card institutions are excluded from the definition of "bank" under the Bank Holding Company

Act, but are not excluded from the definition of "savings association" under the Home Owners' Loan Act (HOLA). While a thrift holding company could charter a credit card institution as a national or state bank and still be exempt from the HOLA activity restrictions imposed on multiple savings and loan holding companies, it could not charter such an institution as a savings association and retain the exemption. By allowing a thrift holding company to charter a credit card savings association and still maintain its exempt status, the company could take advantage of the efficiencies of having its regulator be the same as the credit card institution's regulator.

G. Anti-Tying Modernization Amendment

Section 106 of the Bank Holding Company Amendments of 1970 (12 USC 1972), which constitutes the "anti-tying" provisions of the Bank Holding Company Act, prohibits a bank from offering or discounting its products and services on the condition that a customer obtain additional products or services from the bank. The Roundtable supports an amendment that would limit these restrictions to products and services offered by a bank to individual consumers and small businesses. Another alternative is to limit the restrictions to products and services offer by a bank to customers who are not "qualified investors" as that term was defined in the Gramm-Leach-Bliley Act (GLB). The net effect of either of these amendments would be to exempt large corporate customers from the anti-tying provisions.

These provisions were enacted at a time when bank holding companies were relatively new, and their ability to compete in financial markets was strictly limited by the Glass-Steagall Act and new authorities under Section 4 of the Bank Holding Company Act. The provisions were intended to address a generalized concern of Congress that banks had economic power over their customers, particularly in the credit granting markets, and should not be allowed to use that power to compel their customers to purchase products and services the customers would otherwise not want.

While it is debatable whether banks had such economic power over their customers in 1970 (but still unlikely), in the 21st century, it cannot be argued that banks have such power over their sophisticated business customers. The market for both traditional and non-traditional financial products is broad and includes domestic and foreign banks, securities firms, insurance companies, and a host of specialized financial service providers. Additionally, the Internet provides a distribution network that inhibits the ability of individual financial entities to compel unwanted bundling through tying. Banks, however, participate in the financial services market at a significant legal disadvantage to their competitors. Non-banks have the ability to bundle the full range of financial services to their customers and thereby provide distinct pricing advantages for their customers over their bank competitors, which are still restricted from bundling many services.

The amendment is designed to place banks on the same level as their competitors, at lease as it applies to serving their sophisticated business customers. It would permit banks, for example, to offer business customers price breaks when the customer acquires more than one service from the bank and its affiliates. Consumers and small business would remain unaffected by this amendment.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM DONALD L. KOHN

Q.1. In his testimony, Mr. Maloney, from Federated Investors, indicated that repeal of Regulation Q could create conditions similar to the 1980's where a competition for "hot money" caused banks to offer unsustainable rates of interest to attract deposits. Yet during the second panel, witnesses from each of the regulatory agencies indicated that Reg Q repeal would pose no safety and soundness concerns. Would you please respond to Mr. Maloney's arguments in detail and provide an analysis of his comparison to the 1980's?

A.1. Mr. Maloney is an executive of Federated Investors, one of the largest companies that manages mutual funds. In his testimony, Mr. Maloney expressed a concern for the community banks that Federated includes among its customers and mentioned in particular his personal experience when banks were allowed to offer a new type of deposit account in 1982.

The Depository Institutions Deregulatory Committee (DIDC), established by the Depository Institutions Deregulation and Monetary Control Act of March 31, 1980, authorized a Money Market Deposit Account (MMDA) with no interest rate ceiling on December 14, 1982, with a required minimum account balance of $2,500. This type of account was specifically designed to allow banks to compete with money market mutual funds, which had been growing rapidly at the expense of bank deposits, largely because money market mutual funds were not subject to ceilings on the interest rates they could pay, while banks were.

In order to introduce their new product and begin competing with money market mutual funds, like those offered by Federated Investors, a number of banks and thrifts offered high initial teaser rates. Indeed, the advertisement from 1982 by the First National Bank of Atlanta, which Mr. Maloney attached.to his testimony, explicitly stated that the 18.65 percent interest rate would be paid only for the first month following authorization of the deposit. The ad stated that after January 14, 1983, the interest "rate will vary, just as it does with money market mutual funds. Our rate will be based on current market conditions . . ."

Banks and thrifts were able to attract a substantial volume of funds into the new MMDA account in early 1983, in part because it did improve their competitive position relative to money market mutual funds. Some thrifts priced their deposits too aggressively, particularly after they began to get into trouble, but the deregulation of interest rates was not the main reason for the thrift industry crisis of the 1980's. The thrift industry's problems owed much more to a fundamental imbalance between assets held primarily in long-term, fixed-rate mortgages and shorter-term liabilities with interest rates that varied more frequently. Thrifts also were subject to a high concentration of portfolio risk in the real-estate industry, poorly managed ventures into risky construction and real estate development activities, and weaknesses in regulatory oversight. Indeed, banks did not suffer the same experience as the thrift industry, despite their pursuit of funding through MMDA's and other ceiling-free deposits.

By April 1986, interest rate ceilings had been removed on all types of deposit accounts, except for demand deposits. The removal

of ceilings on a wide range of bank liabilities has not been an impediment to bank profitability. While the banking industry did experience softer profitability in the latter half of the 1980's, this was largely a result of credit quality problems, rather than reduced net interest margins. Bank profitability has been quite strong since the early 1990's, and has reached record levels in recent years, despite the absence of ceilings on most deposit interest rates.

Nevertheless, as I indicated in my testimony on June 22, and as also indicated in previous testimony by myself and by Governor Meyer, removal of the prohibition of interest payments on demand deposits, for banks, "likely would increase costs, at least in the short-run." However, removal of the prohibition would not result in a repeat of the "hot money" problems that occurred among failing thrifts in the 1980's. Banks already have many avenues for increasing the funding they obtain, such as by offering more attractive interest rates on time deposits or MMDA's. Indeed, demand deposits—the only remaining liabilities with a regulatory interest rate ceiling—currently represent only around 7 percent of the total liabilities of domestic commercial banks. If interest payments were authorized on demand deposits, banks would only pay interest on them to the extent they believed that demand deposits would remain at least as cheap a source of funding as the alternatives. Some banks might choose to pay a low rate of interest-on-demand deposits and instead rely more heavily on other funding sources.

Mr. Maloney cited estimates of potential costs to banks of removal of the prohibition of interest payments, but he did not provide the assumptions behind the estimates, so they are difficult to evaluate. Our own analysis of the cost to banks of paying interest-on-demand deposits begins by looking at interest rates on MMDA's. While banks would probably pay a range of interest rates on demand deposits, depending on minimum balances and other account features, they are unlikely to pay a higher interest rate on demand deposits than on MMDA's, because the latter allow only limited check-writing. Therefore, the direct cost of interest-on-demand deposits should be no higher (and probably would be lower) than what is obtained by applying the average MMDA rate to those demand deposits on which banks would be likely to incur explicit interest costs. At present, bank MMDA's are paying an average interest rate of only ⅓ of 1 percent. Under current conditions, then, as detailed further in the attachment, the estimated direct effect on bank profits of interest-on-demand deposits, before offsets, is only around $400 million, far less than the $7 billion to $9 billion figures cited by Mr. Maloney. Our estimate represents less than ½ of 1 percent of overall bank profits.

While these direct costs of paying interest-on-demand deposits would rise with the general level of interest rates, banks would make a number of adjustments over time in the entire array of loan and deposit rates, funding patterns, and service fees to offset such costs. For example, in order to more fully recoup costs, banks would likely reprice services that may be underpriced now to attract "free" demand deposits. In offering interest-earning checking accounts to households, banks have learned how to tailor accounts to the particular needs of various types of customers while maintaining profitability. In addition, if interest payments were com-

bined with interest earnings on reserves or the removal of reserve requirements, the costs of interest-on-demand deposits would be offset both directly, through higher earnings on assets, and indirectly, through savings on the costs of operating sweep programs that permit banks to pay interest to their larger business customers and allow banks to avoid reserve requirements.

As I mentioned in my testimony, one of the largest offsets to bank costs from paying interest-on-demand deposits would come from the improved ability of banks to compete for funds vis-à-vis nonbank institutions, like money market mutual funds. The analysis attached to Mr. Maloney's testimony cites the possibility of quite large flows of funds going to banks as a result of the authorization of interest-on-demand deposits. To the extent that the cost of these additional funds are lower than the returns banks earn by investing them, bank profitability would be thereby strengthened.

Of course, money market mutual funds could suffer from an improved ability of banks to compete. However, our economy is stronger when we remove barriers to effective competition. We should not lose sight of the fact that business firms will benefit from the removal of regulatory restrictions on the services banks can offer them. Small businesses, for which sweep accounts have not been available, should gain especially from interest on their checking accounts. Moreover, our financial sector has proved itself to be very resilient in recent years even to major unforeseen turbulence. We remain convinced that removal of the prohibition of interest-on-demand deposits poses no safety and soundness concerns for our financial institutions.

Attachment: Estimate of Possible Direct Costs to Banks of Interest-on-Demand Deposits

Survey evidence indicates that about 60 percent of demand deposits are held by—nonbank businesses (while about 25 percent are held by households and the remaining 15 percent by government institutions, nonprofit organizations, and other depository institutions).[1] Households, government institutions, and nonprofit organizations are already allowed to earn interest on checking deposits through NOW accounts; they likely hold demand deposits either as low-minimum balance accounts that would not earn interest even if the prohibition were removed or as compensating balances. Compensating balance accounts already earn a return in the form of credits that defray the cost of bank services. Such accounts are used extensively by larger business firms; indeed, about 60 percent of the overall demand deposits of businesses are reportedly held as compensating balances. The implicit interest rate on such balances is a competitive rate typically based on a spread under Treasury bill rates. Therefore, as regards compensating balances, the removal of the prohibition of interest-on-demand deposits would merely involve a switch from implicit to explicit interest, implying no significant cost effect for banks.

To calculate the amount of demand deposits that are not compensating balances and that might earn explicit interest, if authorized,

[1] See, for instance, the Senior Financial Officer Survey of 1998 (Federal Reserve). Other surveys, over different time periods, provided roughly similar results.

we begin with the total gross demand deposits of commercial banks (including the deposits of individuals, partnerships, corporations, nonprofits, governments, other depository institutions, and including cash items in process of collection from other banks). On average in June 2004, such deposits amounted to $477 billion. Of this total, the nonbank business portion is estimated to be $286 billion (477 × 60 percent), while deposits of other-depository institutions amounted to $38 billion. The portion of these bank and nonbank business deposits that is not in compensating balance programs is estimated to be $130 billion ((38 + 286) × 40 percent).

As is the case for MMDA's and NOW accounts, banks likely would pay a variety of interest rates on such deposits, if authorized, depending on the minimum balance maintained in the account and other aspects of their relationships with accountholders. However, because demand deposits permit unlimited checking, while MMDA's allow a maximum of only six checks per month, banks would almost surely pay a lower rate of interest-on-demand deposits than on MMDA's.

According to data from Bankrate, Inc., the average interest rate on commercial bank MMDA's during June 2004, was 31 basis points. NOW accounts paid a lower average rate of 14 basis points. Even if banks paid as high as the current MMDA rate on all the business demand deposits that were not in compensating balance accounts, their annualized interest cost, based on June deposit levels, is estimated to be about $403 million ($130 billion × .0031). Total profits of domestically chartered commercial banks in 2003 amounted to $100.4 billion. The interest cost computed above would therefore amount to less than ½ of 1 percent of bank profits (403/100400).

While this estimate of direct costs would rise with the general level of interest rates, a bank would likely make adjustments over time in the whole array of its loan and deposit interest rates, funding patterns, and service fees that would tend to offset the cost of interest-on-demand deposits. Moreover, with the authorization of interest payments, the level of demand deposits could eventually be boosted substantially, and—to the extent that the cost of these additional funds were lower than the return a bank could earn on investing them—bank profitability would be thereby strengthened.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM JOHN M. REICH

Q.1. In his testimony, Mr. Maloney, from Federated Investors, indicated that repeal of Regulation Q could create conditions similar to the 1980's where a competition for "hot money" caused banks to offer unsustainable rates of interest to attract deposits. Yet during the second panel, witnesses from each of the regulatory agencies indicated that Reg Q repeal would pose no safety and soundness concerns. Would you please respond to Mr. Maloney's arguments in detail and provide an analysis of his comparison to the 1980's?

A.1. In the 1930's, Congress provided for interest-rate ceilings on time and savings deposits and enacted the current prohibition against banks paying interest-on-demand deposits. At the time, two principal arguments were made for controlling the cost of deposits. The first was that deposit competition had the potential to desta-

bilize the banking system. The second was that money-center banks would draw deposits from rural communities and divert funds from productive agrarian uses to stock speculation.

Whatever validity these arguments may have had then, they have little today. Congress has removed all the Depression-era bank price controls except the prohibition on paying interest-on-demand deposits. Removing the last of these controls should not threaten the stability of the banking system.

First, banks should be able to manage additional costs that might result from this legislative change. Some banks already provide nonpecuniary compensation to businesses for demand deposits through "free" or discounted services or lower interest rates on loans for which they hold compensating demand deposit balances. Banks that begin paying interest on their commercial demand deposits may charge explicitly for services they now provide free or at a discount. Banks and their customers now spend time and money circumventing the prohibition against the payment of interest-on-demand deposits by, for instance, setting up interest-bearing sweep accounts. Eliminating the prohibition should reduce or eliminate these expenses.

Second, not all demand deposit accounts will necessarily pay interest. Many consumers, for a variety of reasons, presently choose to hold noninterest-bearing demand deposits rather than interest-bearing NOW accounts. Instead of receiving interest, customers with these accounts may receive other benefits, such as returned canceled checks, lower minimum-balance requirements, lower service charges, including lower per check charges, or a package of other banking services.

Further, banks already pay interest-on-demand-like deposits without threatening the stability of the banking system. Interest-bearing sweep accounts, for example, function as demand deposits for businesses. Interest-bearing NOW accounts function much like demand deposits for consumers, nonprofit groups, and governmental units.

Finally, no worthwhile analogy can be drawn to the relaxation of Regulation Q in the early 1980's. The economy, the banking industry, and the regulatory environment are very different today. The banking industry has been making record profits for years and capital levels are high. Banks lack the kinds of incentives that existed in the 1980's to take excessive risks or offer exorbitantly high rates of interest. Statutory changes since the bank and thrift crisis significantly curb banks' ability to take excessive risks in any event. The regime of prompt corrective action supervisory rules and capital requirements, in effect since the early 1990's, gives regulators a powerful tool to curb excessive risk taking financed with insured deposits. Regulators have much more sophisticated tools to analyze bank risk-taking. Restrictions on brokered deposits prevent weak banks from offering above market rates of interest. Risk-based deposit insurance premiums, which did not exist in the 1980's, provide a significant incentive to institutions to not increase their risk profile in ways that impair their capital levels or overall soundness.

For these reasons, I believe that eliminating the prohibition against paying interest-on-demand deposits and the related prohi-

bition against business NOW accounts would cause no safety and soundness problems.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM JOANN JOHNSON

Q.1. In his testimony, Mr. Maloney, from Federated Investors, indicated that repeal of Regulation Q could create conditions similar to the 1980's where a competition for "hot money" caused banks to offer unsustainable rates of interest to attract deposits. Yet during the second panel, witnesses from each of the regulatory agencies indicated that Reg Q repeal would pose no safety and soundness concerns. Would you please respond to Mr. Maloney's arguments in detail and provide an analysis of his comparison to the 1980's?

A.1. Regulation Q was issued by the Board of Governors of the Federal Reserve System to prohibit State-chartered banks that are members of the Federal Reserve, all national banks, and some other depository institutions from paying interest-on-demand deposits. Regulation Q does not apply to Federal credit unions (FCU's) so its repeal would have no effect on FCU's.

Additionally, FCU's do not pay interest on their accounts. Rather, FCU's pay dividends based on available earnings. There are no contractual obligations on FCU's to pay dividends. In fact, FCU's are statutorily prohibited from paying dividends unless they have sufficient earnings to cover the dividend, 12 U.S.C. 1757(6), 1763. This significantly reduces any risk associated with paying a return on demand deposits. As a result of this statutory restriction and other factors, chasing "hot money" has not been a serious problem for FCU's. Finally, under certain circumstances, NCUA's prompt corrective action rule restricts or prohibits a credit union from offering rates on shares above certain limits. 12 CFR Part 702.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM JULIE L. WILLIAMS

Q.1. In his testimony, Mr. Maloney, from Federated Investors, indicated that repeal of Regulation Q could create conditions similar to the 1980's where a competition for "hot money" caused banks to offer unsustainable rates of interest to attract deposits. Yet during the second panel, witnesses from each of the regulatory agencies indicated that Reg Q repeal would pose no safety and soundness concerns. Would you please respond to Mr. Maloney's arguments in detail and provide an analysis of his comparison to the 1980's?

A.1. Mr. Maloney expressed concern that the repeal of Regulation Q would result in community banks becoming less competitive and, therefore, create conditions like those in the early 1980's that he believes led to the thrift industry crisis. Banks and thrifts were able to attract a substantial volume of funds into the new MMDA allowed in 1983. Some thrifts did price their deposits too aggressively, particularly after they began to experience difficulties after the increase in general market interest rates. The thrift industry's problems, however, were not caused by the deregulation of interest rates payable on deposit accounts. The thrift industry's problems were generally caused by its portfolio concentration in long-term, fixed interest rate mortgages at a time when general market interest rates increased dramatically. If interest rate ceilings had not

been relaxed, depository institutions would have experienced further disintermediation and thrifts still would have failed.

The removal of interest rate ceilings on a wide range of bank liabilities has not been an impediment to bank profitability. While the banking industry did experience weaker profitability in the late 1980's, that was due primarily to credit quality issues. Bank profitability has been strong since the early 1990's and has reached record levels recently, despite the absence of a ceiling on most deposit rates.

While removal of the prohibition on interest payments on demand deposits might tend to increase bank costs, that impact will be limited by the ability of banks to adjust their funding composition. Demand deposits are currently only one source of funding for banks. If interest payments were allowed on demand deposits, banks would pay that interest only to the extent that such deposits were as cheap as the all-in cost of alternative sources of funding. With the payment of interest-on-demand deposits, some banks would raise the price of services associated with those deposits, which they are currently underpricing to attract those deposits. Thus, for some banks that cost of demand deposits would not increase as much as the interest rates paid on those deposits. However, if the cost of demand deposits does increase, some banks might rely more heavily on other funding sources.

Based on the foregoing, we do not believe elimination of the prohibition on payment of interest-on-demand deposits raises safety and soundness concerns.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM JOHN E. BOWMAN

Q.1. In his testimony, Mr. Maloney, from Federated Investors, indicated that repeal of Regulation Q could create conditions similar to the 1980's where a competition for "hot money" caused banks to offer unsustainable rates of interests to attract deposits. Yet during the second panel, witnesses from each of the regulatory agencies indicated that Reg Q repeal would pose no safety and soundness concerns. Would you please respond to Mr. Maloney's arguments in detail and provide an analysis of his comparison to the 1980's?

A.1. In 1996, the Federal banking agencies reported to Congress that the statutory prohibition on paying interest-on-demand deposits no longer serves a valid public purpose. The Office of Thrift Supervision continues to maintain this position and strongly supports the proposed legislation. (See, Joint Report, *Streamlining of Regulatory Requirements,* issued by the Federal Reserve, FDIC, OCC, and OTS, 1996.)

Before the 1980's, Regulation Q prohibited banks from paying interest on checking deposits and set a ceiling on interest paid on savings accounts. A vestige of Regulation Q remains in the prohibition of interest-on-demand deposits held by businesses.

This prohibition is obsolete because a financial institution can use sweep accounts to effectively circumvent the prohibition. It makes no sense to allow indirect payment of interest on business checking accounts without also allowing institutions the option of direct payments.

Removing the Regulation Q prohibition would help smaller institutions compete with other financial providers such as money market mutual funds that offer liberal check writing, ATM access, and similar services through interest-paying transaction accounts.

RESPONSE TO A WRITTEN QUESTION OF SENATOR CRAPO FROM JOHN E. BOWMAN

Q.1. Mr. Bowman, your testimony talks about eliminating disparate treatment of thrifts under the Federal securities laws. Didn't the SEC just propose a rule that grants partial relief to thrifts from the Investment Advisers Act? Why should Congress go further?

A.1. The SEC has issued several recent proposals that will continue the inequitable treatment of thrifts (versus banks) under the Federal securities laws. These involve the application of the Investment Advisers Act of 1940 (IAA) and the definition of broker and dealer under the Securities Exchange Act of 1934 (1934 Act). Both SEC proposals contain no policy justification for this disparate treatment. Under the SEC's IAA proposal, most thrifts will continue to be subject to an entirely duplicative SEC oversight regime. In the other proposal, the SEC indicated it intends to roll back an interim rule extending equal treatment to thrifts vis-à-vis banks for purposes of the broker-dealer exemption. Clearly, this is not heading in the direction of charter neutrality between banks and thrifts with respect to the application of the Federal securities laws.

With respect to the IAA issue, of the approximately 130 thrifts that have applied for and received trust powers from the OTS, 45 institutions are currently registered with the SEC as investment advisers. Not one of these 45 thrifts would be able to deregister as an investment adviser under the SEC's IAA proposal based on their current account activity—a fact made clear to the SEC Commissioners by the SEC staff during deliberations on the proposal during the SEC's April 28, 2004 meeting. Given that the proposal provides no regulatory burden relief to these existing thrifts, it is unclear what is accomplished by the proposed rulemaking—the application of the IAA remains anything but charter neutral.

Currently, banks and thrifts may engage in the same types of activities covered by the investment adviser requirements of the Federal securities laws, and are subject to substantially similar supervision with respect to these activities. However, banks—but not thrifts—are exempt from registration under the IAA.

Treating thrifts and banks the same under the Federal securities laws makes sense for a number of reasons. Thrifts fill an important niche in the financial services arena by focusing their activities primarily on residential, community, small business, and consumer lending. The Home Owners' Loan Act allows thrifts to provide trust and custody services on the same basis as national banks. Not only are the authorized activities the same, but also OTS examines those activities in the same manner as the other banking agencies.

While the bank and thrift charters are tailored to provide powers focused on different business strategies, in areas where powers are similar, the rules should be similar. No legitimate public policy rationale is served by imposing additional and superfluous adminis-

trative costs on thrifts to register as an investment adviser when banks are exempt from registration. There should be similar treatment for regulated entities in similar circumstances. The circumstances here are that:

- First, thrifts—like banks—have a regulator that specifically supervises the types of activities covered by the investment adviser registration requirements.
- Second, thrifts—like banks—are subject to the same functional regulatory scheme endorsed by the Gramm-Leach-Bliley Act.
- Third, thrifts—like banks—are subject to substantially similar customer protections with respect to the activities covered by the registration requirements.

The only difference is that thrifts, unlike banks, are subject to an additional—and clearly burdensome—administrative registration requirement. As best stated, in the SEC's own words, from the preamble to their May 2001 interim final rule extending broker-dealer parity to thrifts, "insured savings associations are subject to a similar regulatory structure and examination standards as banks . . . [E]xtending the exemption for banks to savings associations and savings banks is necessary or appropriate in the public interest and is consistent with the protection of investors."

OTS strongly supports legislation similar to that in Section 201 of H.R. 1375, the bill passed by the House in March of this year, to extend the bank registration exemptions to thrifts. Absent this treatment, thrifts are placed at a competitive disadvantage that is without merit—and that imposes significant regulatory costs and burdens.

As recently as the GLB Act, Congress affirmed the principles underlying the bank registration exemption. We believe the best way to resolve this matter for thrifts—with certainty and finality—is for Congress to extend, by statute, the same exemption to thrifts.

RESPONSE TO A WRITTEN QUESTION OF SENATOR CRAPO FROM WILLIAM A. LONGBRAKE

Q.1. I see in your written submission that The Financial Services Roundtable supports H.R. 314, The Mortgage Servicing Clarification Act, which passed the House last year on suspension. Is that something we should consider including in a regulatory relief bill?

A.1. The Financial Services Roundtable supports the inclusion of H.R. 314 in regulatory relief legislation. H.R. 314 provides a narrowly crafted exemption for mortgage servicers from a disclosure requirement that is triggered in certain mortgage servicing transfers. The Fair Debt Collection Practices Act requires third party debt collectors to provide a so-called "Miranda" warning upon initial contact with a debtor. The Miranda notice requires the new mortgage servicer to identify itself as a "debt collector" and to disclose that the contact represents an attempt to collect a debt and that any information will be used for that purpose. The purpose of these warnings is to prevent true debt collectors from using false or deceptive tactics (such as a phony sweepstakes winning) to trick consumers into divulging private financial information, home address, and telephone number. However, in the context of a mortgage servicing transfer, the harshly worded Miranda notice does

not accurately describe the relationship between the borrower and the new servicer. In fact, the notice actually discourages delinquent borrowers from contacting their new servicer out of fear that the new servicer company is a debt collector seeking to foreclose.

While the Miranda warnings are clearly appropriate for true third party debt collection activities, they actually put borrowers at greater risk in mortgage servicing transfers and impair the ability of servicers to establish strong customer relationships at a critical juncture. H.R. 314 resolves the problem for servicers and borrowers by establishing a very narrow exemption from the Miranda notice requirements for servicers of first lien mortgages. The bill passed the House last year on suspension (424–0) and has broad bipartisan support and co-sponsorship by Members of the House Financial Services Committee.

RESPONSE TO A WRITTEN QUESTION OF SENATOR REED FROM JOANN JOHNSON

Q.1. Chairman Johnson, we have heard testimony from Deputy Commissioner Little that NASCUS supports giving privately insured State-chartered credit unions access to Federal Home Loan Bank System. You noted the NCUA's concern with certain components of the House provision, as it relates to the NCUA. More generally, however—and especially in light of the savings and loan debacle that this country has been through and the experience my State has had with private insurance—do you believe that allowing them to have access to the Federal Home Loan Bank is prudent?

A.1. NCUA is neither the regulator nor the insurer of State-chartered, privately insured credit unions and has previously stated it has no official position on the public policy issues related to them being able to join the Federal Home Loan Bank System. We remain concerned, however, that language in Section 301 of H.R. 1375 makes it appear that NCUA has oversight responsibility over privately insured, State-chartered credit unions and certain State-regulated, private share insurance companies. NCUA does not have any regulatory or supervisory jurisdiction over these institutions and does not seek such jurisdiction. As we have previously stated, Section 301 should be revised to eliminate any appearance of NCUA responsibility for private share insurance.

This change, and effective implementation of the recent amendments to the Federal Deposit Insurance Corporation Improvement Act giving the Federal Trade Commission a mandate to enforce Federal disclosure requirements on privately insured institutions, should reduce any chance of confusion on the part of members of privately insured institutions about the nature of their insurance coverage.

RESPONSE TO A WRITTEN QUESTION OF SENATOR REED FROM JOHN E. BOWMAN

Q.1. Mr. Bowman, can you explain OTS's view of eliminating the lending limit restriction on small business loans for savings associations while increasing the aggregate lending limit on other commercial loans to 20 percent? How are small businesses defined currently in terms of size and assets?

A.1. Savings associations have proven their ability to make commercial and small business loans in a safe and sound manner. Commercial and small business loans held by thrifts have performed satisfactorily over the past 10 to 15 years. Some thrifts are at or near the current statutory limits and unless the statutory limits are increased, they must curtail otherwise safe and sound business lending programs.

Eliminating the lending limit on small business loans and increasing the aggregate lending limit on other commercial loans will promote safety and soundness by giving thrifts greater flexibility to diversify. Additional flexibility, particularly in small business lending, would provide opportunities to counter the undulations of a cyclical mortgage market. This would enable thrift managers to continue to meet their ongoing customers' mortgage and consumer lending needs, while providing additional resources to manage their institutions safely and soundly.

These changes would also assist savings associations in meeting the credit needs of their communities by providing small businesses more avenues to obtain credit. This would increase competition for, and the availability of, small business and other commercial loans now and in the future as thrifts develop this line of business. In particular, this will benefit smaller businesses that have experienced difficulty in obtaining relatively small loans from large commercial banks that set minimum loan amounts as part of their business strategy—a problem that may increase with industry consolidation. Finally, the proposal will assist businesses that prefer borrowing from entities like thrifts that meet the needs of borrowers with greater personal service.

OTS uses two alternative definitions in this area. A small business is defined in accordance with the most recent regulations of the Small Business Administration. A small business loan is defined as a loan (or group of loans) to one borrower that does not exceed $2 million dollars and is for commercial, corporate, business, or agricultural purposes.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM MARK E. MACOMBER

Q.1. Why are you concerned with the extension of the interstate branching proposal to ILC's? Does this pose a safety and soundness risk?

A.1. America's Community Bankers supports the interstate branching provision adopted by the House of Representatives in the Financial Services Regulatory Relief Act of 2003 (H.R. 1375). Section 401 prohibits industrial loan companies owned by commercial firms (those with at least 15 percent of gross revenues from nonfinancial activities) from acquiring or establishing a branch outside its home State. Section 401 would not apply this restriction to industrial loan companies (ILC's) that had been approved for FDIC insurance by October 1, 2003. In 1999, policymakers—ignoring the successful history of commercial ownership of savings associations—made the judgment that commercial firms should not be allowed to charter or acquire savings associations and grandfathered unitary thrift holding companies, which have the authority to operate on interstate basis. We do not oppose the option of commercial companies

to establish new ILC's, but support consistency in policy across charter types that would deny expanded branching authority to newly formed ILC's with commercial parents. We consider this a parity issue, rather than a safety and soundness issue.

Q.2. What would the regulatory landscape look like for a State-chartered, Federal Reserve member bank branching into a new State?

A.2. The Federal Reserve would be the primary Federal banking regulator of the branch established in the new State. The home-State banking regulator of the State-chartered member bank would be the primary State bank regulator of the new out-of-State branch. The State banking regulator of the host State of the branch (that is, the new State) would have authority to enforce the host State's consumer protection laws with respect to the new branch, but only to the extent that those laws apply to a branch of an out-of-State national bank.