S. HRG. 109–937

THE CONSIDERATION OF REGULATORY RELIEF PROPOSALS

HEARING

BEFORE THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

PROPOSALS TO REDUCE UNNECESSARY REGULATORY BURDEN ON DEPOSITORY INSTITUTIONS INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 21, 2005

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C O N T E N T S

TUESDAY, JUNE 21, 2005

WITNESSES

THE CONSIDERATION OF REGULATORY RELIEF PROPOSALS

TUESDAY, JUNE 21, 2005

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

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Senator Mike Crapo, presiding.

OPENING STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Good morning, everyone. This is the hearing of the Committee on Banking, Housing, and Urban Affairs on the consideration of regulatory relief proposals.

Chairman Shelby is not going to be able to be with us this morning, and has asked that I chair this hearing. Because of the multitude of things going on this morning, we do not know how many of the other Senators are going to make it. We know at about 11:30 it is going to be very sparse around here, so we will begin proceeding without them, and as other Senators may show, we will give them an opportunity to make their opening statements.

Last year, the Banking Committee held a hearing on proposals providing regulatory relief for banks, credit unions, and thrifts. The hearing covered all points of view and was made up of three panels of witnesses, Members of Congress, regulators, trade organizations, and consumer groups. The witnesses built a strong legislative record by describing the cost of regulations and by providing specific recommendations to reduce this ever-growing burden without compromising safety and soundness.

The sheer volume of regulatory requirements facing the financial services industry today presents a daunting task for any institution. Many of the witnesses also noted that this is not simply an issue for banks and credit unions. The customer feels the impact in the form of higher prices, and in some cases, diminished product choice.

One example that was stressed as an outdated regulation is the Depression era provision prohibiting the payment of interest on demand deposits, otherwise known as business checking accounts. At the end of the hearing, I asked FDIC Vice Chairman Reich as the leader of the interagency EGRPRA Task Force to review the testimony presented at the hearing and to prepare a matrix of all the recommendations and positions for the Committee. The result was 136 burden-reduction proposals. Since that time the list has grown to 187. That was a huge undertaking and I am very appreciative of the hard work and cooperation of so many involved, especially Vice Chairman Reich.

As this comprehensive list demonstrates, it is important for Congress to periodically review the laws applicable to the financial services industry to ensure that compliance and red tape does not impose an unreasonable and unproductive burden on the economy and truly achieves its important goals.

Today, we are going to receive testimony from regulators, financial services industry groups, consumer groups, and small businesses on these proposals. As we proceed we need to make sure that we enact enough meaningful reform so that the cost of change is not a burden in and of itself.

The specific recommendations of witnesses today will be of great use to me and to other Members of the Senate Banking Committee as we create legislation to address the important issues of financial services regulatory reform.

Our first panel today will be the regulators. I believe that all of the witnesses have received very clear instructions that we want you to be very careful to stay within the time limits. We have a very full hearing. As you might see, the table has been modified. The second panel is going to be 11 witnesses, and I have never quite seen how we could accommodate the table to fit that many, but it appears that they have done so, and we are going to need to have the witnesses stick within their 5-minute allotted time period so that we have time for interaction and discussion of the issues that are presented.

Let us start with the first panel composed of John M. Reich, Vice Chairman of the Federal Deposit Insurance Corporation; Julie Williams, the Acting Comptroller of the Office of the Comptroller of the Currency; Mark Olson, Member of the Board of Governors of the Federal Reserve System; Richard M. Riccobono, the Acting Director of the Office of Thrift Supervision; JoAnn Johnson, the Chairman of the Board of Directors of the National Credit Union Administration; and Eric McClure, Commissioner of the Missouri Division of Finance.

Ladies and gentlemen, we will proceed in that order, and we will begin with you, Mr. Reich.

STATEMENT OF JOHN M. REICH
VICE CHAIRMAN,
FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. REICH. Thank you very much, Mr. Chairman. I appreciate very much the opportunity to be here today. I want to thank you particularly, Senator Crapo, for your interest, your leadership and your commitment to this endeavor.

After 2 years of work under the EGRPRA mandate we are prepared to make our initial recommendations to Congress. We have issued many regulations for public comment and received nearly 1,000 comment letters in response. We have held 12 outreach meetings around the country with bankers and community and consumer groups.

My own involvement in this project has increased my awareness of the developing fragility of the long tradition of community banking in this country. It has intensified my commitment to pursue meaningful regulatory relief legislation. But as a bank regulator I also know it is important to maintain the safety and soundness of the industry and to protect consumer rights.

I am here today as Vice Chairman of the FDIC, but also as the nominal leader of the interagency regulatory review project mandated by the EGRPRA Act. When Congress enacted EGRPRA in 1996 it directed the agencies to work together in an effort to eliminate outdated, unnecessary, and unduly burdensome regulations. I am pleased to report that over the last 2 years the agencies represented at this table have worked together closely to fulfill the objectives set out in the EGRPRA statute. I believe we have made considerable progress, but we still have much work to do.

My written statement indicates a number of substantive initiatives the agencies have taken to reduce burden. These initiatives include streamlining our examination process, proposing amendments to the CRA regulations, working to improve the required privacy notices, and providing detailed guidance to the industry to assure uniform and consistent examination of and compliance with the Bank Secrecy Act and the U.S.A. PATRIOT Act.

Since most of our regulations are, in fact, mandated by statute, it is my sincere hope that Congress will agree with our premise concerning accumulated regulatory burden and the need to do something about it and will accept our recommendations to make a number of changes to the underlying statutes.

Last year, this Committee held a regulatory burden hearing in which 18 witnesses testified, including myself. At that hearing Senator Crapo asked me to review the testimonies, extracting all the regulatory burden reduction proposals made at that hearing. The result was a matrix containing a total of 136 burden reduction proposals.

I called together representatives of all the bank and thrift trade groups in a single meeting to review the proposals. Out of that meeting came an agreement among the trade groups to either jointly support or not oppose 78 of those 136 proposals.

The FDIC subsequently reviewed the 78 industry consensus items to determine whether in our judgment there were significant safety and soundness, consumer protection, or other public policy concerns with the industry proposals. As a result of our review we decided to affirmatively support 58 of the 78. We took no position on 15 proposals and we opposed 5 of the proposals. Since that time we have been working on a consensus building process among the Federal bank regulators.

The next step toward this objective was to share FDIC's views with the other regulatory agencies. After considerable interagency discussions, the agencies have agreed to jointly support 12 of the industry consensus items. They are outlined in my written testimony. I refer to them as "the bankers' dozen," but I hope that the 12 are only the beginning.

Included in the matrix are dozens of proposals beyond the original 12 which are supported by more than one agency, and where no significant safety and soundness, consumer protection, or other public policy concerns have been raised. To be fair, however, some agencies have indicated they have not had the opportunity to fully consider all of the proposals, and have therefore taken no official position on them. My hope is that at the end of all reviews there will be a significantly greater number of consensus provisions that will be recommended to and accepted by Congress.

Mr. Chairman, banks large and small labor under the cumulative weight of our regulation. I believe that the EGRPRA process created by Congress appropriately addresses the problem of accumulated regulatory burden. I have expressed on several occasions publicly my concern that if we do not provide relief, a vital part of the banking system, namely America's community banks, may be in jeopardy.

Mr. Chairman, I believe the time for action is now. I urge the Committee to review our recommendations carefully and hope you will accept and incorporate them into a regulatory relief bill which will provide real relief for the industry. I look forward to working with the Committee toward this end.

Thank you very much for this opportunity to testify and I look forward to the questions.

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

Ms. Williams.

STATEMENT OF JULIE L. WILLIAMS
ACTING COMPTROLLER OF THE CURRENCY,
OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. WILLIAMS. Thank you. Mr. Chairman, Senator Bunning, I appreciate the opportunity to appear before you today to discuss the challenge of reducing unnecessary regulatory burden on our Nation's banking institutions. The Office of the Comptroller of the Currency welcomes the Committee's effort to advance regulatory burden relief legislation. I also want to express particular appreciation to you, Mr. Chairman, for your commitment and dedication to this issue.

My written testimony and the appendices to that testimony describe a number of burden-reducing initiatives that the OCC supports. This morning I also want to touch upon two broader themes that I hope will guide our efforts to reduce unnecessary regulatory burden.

My testimony emphasizes that the regulatory burdens on our banks arise from several sources. First, we, as Federal bank regulators, have a responsibility to look carefully at the regulations we adopt to ensure that they are no more burdensome than is necessary to protect safety and soundness, foster the integrity of bank operations, and safeguard the interests of consumers.

In this connection I must mention the EGRPRA regulatory burden reduction initiative that is being led so capably by FDIC Vice Chairman John Reich. As part of this process, the OCC, together with the other Federal banking agencies has been soliciting and reviewing public comment on our regulations and participating in banker and consumer outreach meetings around the country. Using the input gathered from the public comment and outreach process, the banking agencies, as Vice Chairman Reich has noted, are now developing specific recommendations for regulatory as well as legislative relief.

Second, we also must recognize that not all the regulatory burdens imposed on banks today come from regulations promulgated by the bank regulators. Thus, we welcome the interest of the Committee in issues such as implementation of Bank Secrecy Act and antimoney laundering standards and reporting requirements, and in the ongoing efforts by the Securities and Exchange Commission to implement the so-called “push-out” provisions of the Gramm-Leach-Bliley Act in a manner that is both faithful to GLBA’s intent and not so burdensome as to drive traditional banking functions out of banks.

A third key source of regulatory burden is Federal legislation, and relief from some manifestations of unnecessary regulatory burden does require action by Congress. My written testimony contains a number of recommendations for legislative changes, and this list includes consensus recommendations developed and agreed to in our discussions with the other banking agencies and with the industry.

Before closing, I would like to highlight two broader themes that I hope will guide us in our efforts to tackle unnecessary regulatory burdens. The first involves consumer protection disclosure requirements. Here is an area where we have an opportunity to reduce regulatory burden and improve the effectiveness of disclosures to consumers. Today, our system imposes massive disclosure requirements and massive costs on financial institutions, but do these requirements effectively inform consumers? I firmly believe that it is possible to provide the information that consumers need and want in a concise, streamlined, and understandable form. The Federal banking agencies have broken new ground here by employing consumer testing as an essential part of our rulemaking to simplify the GLBA privacy notices. This project has the potential to produce more effective and meaningful disclosures for consumers and reduced burden on institutions that generate and distribute private notices. We need to do more of this.

My second point goes back to basics. Why do we care about regulatory burden? We care because unnecessary regulatory burden saps the efficiency and competitiveness of American enterprise. And, we particularly care because of the critical impact of regulatory burden on our Nation’s community banks. Community banks thrive on their ability to provide customer service, but the very size of community banks means that they have more limited resources available to absorb regulatory overhead expenses.

We need to recognize that the risks presented by certain activities undertaken by a community bank are simply not commensurate with the risks of that activity conducted on a much larger, complex scale. One-size-fits-all may not be a risk-based, or a sensible, approach to regulation in many areas. I hope we can do more to identify those areas where distinctions between banks based on the size and complexity and scope of their operations makes sense as a regulatory approach.

In conclusion, Mr. Chairman, on behalf of the OCC, thank you for holding this hearing. We would be pleased to work with you and the staff to make the goal of regulatory burden relief a reality. Thank you.

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

Mr. Olson.

STATEMENT OF MARK W. OLSON, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. OLSON. Thank you very much, Senator Crapo, Members of the Committee. Thank you for holding this hearing, and thank you for inviting the Federal Reserve to testify.

The Federal Reserve Board strongly supports efforts to streamline laws and regulations without compromising safety and soundness. We have taken a number of initiatives in that direction. In 2003, the Board responded to a request from Senator Shelby to provide legislative proposals consistent with that goal. We applaud also the efforts of John Reich and the FDIC in taking the leadership role with respect to the EGRPRA efforts, and we applaud your efforts, Senator Crapo, in putting together the matrix.

We have provided our specific approval or support for a number of legislative regulatory relief proposals. There are other initiatives that are in that matrix that we will continue to look at in an effort to clarify our position. A significant number of them we will probably have no opposition to. I suspect, we will support additional proposal, and there will be a small number where we probably will have some objection.

Our complete testimony is included in the written record, but let me just highlight three priorities for this morning. The first is the ability to pay interest on reserves and reserve requirement flexibility. Banks are now required to provide reserves on transaction accounts between 8 and 14 percent, and that reserve requirement gives banks an incentive to look for ways to get around the reserve requirements by providing sweep arrangements or other initiatives that will eliminate the reserve requirement.

Authorizing the Federal Reserve to pay interest on those reserves would simplify that process. It would also be an important tool to us in our implementation of monetary policy. The payment of interest would perhaps give us an assurance of reserve levels with which monetary policy is based in terms of monitoring the money supply. It could also potentially reduce the need for mandatory reserves, at minimal cost to the Treasury because the fact that the vault cash for many institutions could provide most of the reserve requirements so the impact on the Treasury we suspect would be minimal.

The second priority is to allow depository institutions to pay interest on demand deposits which you have appropriately characterized as a Depression-era regulation. We strongly support removal of the prohibition of paying interest on demand deposits. Again, many institutions provide a fairly complex, cumbersome sweep mechanism to allow for the payment of interest. That is more easily done by larger banks than by smaller banks, and the removal of that prohibition we think would certainly constitute regulatory relief.

The final priority that we would like to mention this morning is the small bank examination flexibility. Currently, on-site examinations are required for all banks every 12 months, except an exclusion is granted for banks of under $250 million in assets, meeting certain capital and managerial standards. Our proposal is to raise that limit to $500 million which we think would reduce the regulatory burden for perhaps as many as 1,100 additional institutions.

Mr. Chairman, I would be happy to expand on any of those remarks in the question and answer period.

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

Mr. Riccobono.

STATEMENT OF RICHARD M. RICCOBONO ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. RICCOBONO. Good morning, Senator Crapo and Members of the Committee and thank you for the opportunity to testify on regulatory burden relief on behalf of the OTS. I want to thank the Committee for holding this hearing and I want to thank you in particular, Senator Crapo, for your leadership and continuing focus in this area.

I would also like to thank and recognize the efforts of FDIC Vice Chairman John Reich on the interagency EGRPRA project. And, Senator, I would have said those nice things about Vice Chairman Reich even if he was not going to be my boss soon.

[Laughter.]

We look forward to working with the Committee on legislation to address the issues we discussed today.

While it is always important to remove unnecessary regulatory obstacles in our financial services industry that hinder profitability, innovation, and competition, and in turn job creation and economic growth, this is a particular good time to be discussing these issues given where we are in the economic cycle. Today, we have an opportunity to explore numerous proposals to eliminate old laws, that while originally well-intended, no longer serve a useful purpose.

Before addressing these issues it is important to note that there are two areas not addressed in my statement that many of our institutions have identified as unduly burdensome, the Bank Secrecy Act requirements and the rules under Sarbanes-Oxley. Virtually all institutions raise these issues as regulatory relief priorities. While we recognize the need for relief in these areas, I do not believe we are at a point right now to make sound recommendations on effective reforms without compromising the underlying purpose of these laws, but we are working on it.

In my written statement I describe a number of proposals that would significantly reduce burden on saving associations. I ask that the full text of that statement be included in the record.

Senator CRAPO. Without objection.

Mr. RICCOBONO. Four items that we believe provide the most significant relief for savings associations are: Eliminating the duplicative regulation of savings associations under the Federal securities laws; eliminating the existing arbitrary limits on savings association consumer lending activities; updating commercial and small business lending limits for savings associations; and establishing succession authority for the position of the OTS Director.

Currently banks and savings associations may engage in the same types of activities covered by the investment adviser and broker/dealer requirements of the Federal securities laws. These activities are subject to supervision by the banking agencies that is more rigorous than that imposed by the SEC, yet savings associations are subject to an additional layer of regulation and review by the SEC that yields no additional supervisory benefit. While the bank and thrift charters are tailored to provide powers focused on different business strategies, in areas where powers are similar, the rule should be similar. No sound public policy rationale is served by imposing additional and unwarranted administrative costs on a savings association to register as an investment adviser or as a broker/dealer under the Federal securities laws. OTS strongly supports legislation to exempt savings associations from these duplicative investment adviser and broker/dealer registration requirements.

Another important proposal for OTS is eliminating a statutory anomaly that subjects the consumer lending authority of Federal savings associations to a 35 percent of assets limitation, but permits unlimited credit card lending. This exists even though both types of credit may be extended for the same purpose. Removing the 35 percent cap on consumer lending will permit savings associations to engage in secured consumer lending activities to the same extent as unsecured credit card lending. This makes sense not only from a regulatory burden reduction perspective, but also for reasons of safety and soundness.

We also support updating statutory limits on the ability of Federal savings associations to make small business and other commercial loans. Currently, Federal savings associations lending for commercial purposes is capped at 20 percent of assets, and commercial loans in excess of 10 percent must be in small business lending.

Legislation removing the current limit on small business lending and increasing the cap on other commercial lending will provide savings associations greater flexibility to promote safety and soundness through diversification, more opportunities to counter the cyclical nature of the mortgage market, and additional resources to manage their operation safely and soundly.

A final but important issue is the statutory succession authority for the position of OTS Director. In many respects this issue is more important for the thrift industry than it is for OTS. We strongly urge consideration of a provision authorizing the Treasury Secretary to appoint a succession of individuals within OTS to serve as OTS Acting Director in order to assure agency continuity. It is equally important to modernize the existing statutory appointment authority for the OTS Director, by providing every appointee a full 5-year term.

Statutory succession authority would avoid relying on the Vacancies Act to fill any vacancy that occurs during or after the term of an OTS Director. This is important, given our continuing focus on maintaining the stability of our financial system in the event of a national emergency.

OTS is committed to reducing burden whenever it has the opportunity to do so consistent with safety and soundness and consumer protections. We look forward to working with you, Senator Crapo, and the Committee to address these and other regulatory burden reduction items we discuss in my written statement.

I will be happy to answer any questions. Thank you.

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

Before we move to Ms. Johnson, I should have stated at the outset that the written statements of all of the witnesses, not just this panel, but all of the witnesses, will be made a part of the record.

Ms. Johnson.

STATEMENT OF JOANN M. JOHNSON
CHAIRMAN, BOARD OF DIRECTORS,
NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Thank you, Senator Crapo and Members of the Committee. On behalf of the National Credit Union Administration, I am pleased to be here today to present our views on regulatory reform initiatives.

The reform proposals being considered by Congress will benefit consumers and the economy by enabling financial institutions and their regulators to better perform the role and functions required of them.

In my oral statement I will briefly address some of the proposals that are of the greater importance to NCUA. The first is prompt corrective action reform. Prompt corrective action, capital requirements for credit unions enacted in 1998 as part of the Credit Union Membership Access Act, are an important tool for both NCUA and credit unions in managing the safety and soundness of the credit union system and protecting the interests of the National Credit Union Share Insurance Fund.

Our 7 years of experience with the current system, however, have shown there are significant flaws and need for improvement. PCA, in its current form, establishes a one-size-fits-all approach for credit unions that relies primarily on a high-leverage requirement. This system penalizes low-risk credit unions and makes it difficult to use PCA as intended, as an incentive for credit unions to manage risk in their balance sheets.

NCUA has developed a comprehensive proposal for PCA reform that addresses these concerns. NCUA's proposal establishes a more reasonable leverage requirement to work in tandem with more effective risk-based requirements.

Our proposal accounts for the 1 percent method of capitalizing the Share Insurance Fund and its effect on the overall capital in the insurance fund and the credit union system. The result is a leverage requirement for credit unions that averages 5.7 percent under our proposal, as compared to 5 percent in the banking system.

We have submitted our proposal for Congress's consideration and it has been included in the new CURIA proposal introduced in the House of Representatives. I urge the Senate to include our proposal in any financial reform legislation that is considered and acted upon this year.

As I have previously testified, an important technical amendment is needed to the statutory definition of "net worth" for credit unions. FASB has indicated it supports a legislative modification to the definition of "net worth" and that such a solution will not impact their standard setting activities. I am encouraged that the House voted just last week in support of a legislative solution to this problem, and I urge the Senate to give its prompt consideration.

Federal credit unions are authorized to provide check cashing and money transfer services to members. To enable credit unions to better reach the unbanked, they should be authorized to provide these services to anyone eligible to become a member. This is particularly important to furthering efforts to serve those of limited means who are forced to pay excessive fees.

The current statutory limitation on member business lending by federally insured credit unions, which is 12¼ percent of assets for most credit unions, is arbitrary and constrains many credit unions in meeting the business loan needs of their members. Credit union have an historic and effective record of meeting small business loan needs of their members, and this is an issue of great importance in the many credit unions that are expanding into underserved areas and low-income communities. NCUA's strict regulation of member business lending ensures that it is carried out on a safe and sound basis.

With these facts in mind, NCUA strongly supports proposals to increase the member business loan limit to 20 percent of assets and raise the threshold for covered loans to a level set by the NCUA Board, not to exceed $100,000.

NCUA continues to support other provisions in the previously considered regulatory relief bills, such as improved voluntary merger authority; relief from SEC registration requirements for the limited securities activities in which credit unions are involved; lifting certain loan restrictions regarding maturity limits; and increasing investments in CUSO's.

Also we have reviewed the other credit union provisions included in the previously mentioned bills and in Senator Crapo's matrix, and NCUA has no safety and soundness concerns with these provisions.

Thank you, Mr. Chairman, for the opportunity to appear before you today on behalf of NCUA to discuss the public benefits of regulatory efficiency for NCUA, credit unions and 84 million credit union members.

I am pleased to respond to any questions the Committee may have or to be a source of additional information if you require. Thank you.

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

Mr. McClure.

STATEMENT OF ERIC McCLURE
COMMISSIONER, MISSOURI DIVISION OF FINANCE,
ON BEHALF OF
THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. MCCLURE. Good morning, Senator Crapo, Senator Sarbanes, Members of the Committee. I am excited and honored to be here today. My name is Eric McClure. I am the Banking Commissioner in Missouri. I am here on behalf of the Conference of State Bank Supervisors, of which I am Chairman. I appreciate you inviting CSBS to be here today to discuss strategies for reducing regulatory burden on our Nation's banks.

We especially appreciate this opportunity to discuss these issues because we are the chartering authority and primary regulator for the vast majority of the Nation's community banks. We believe a bank's most important tool against regulatory burden is its ability to make meaningful choices about both its regulatory and its operating structures.

The State charter has been and continues to be the charter of choice for most community-based institutions because the State-level supervisory environment is locally focused, accessible, meaningful, and flexible, and that matches just the way our banks do business.

Our State banking industry is a success story. Our banks are focused on the success of their communities because they share in the success of their communities. While our current regulatory structure and statutory framework may recognize some differences among financial institutions, too often it mandates overarching one-size-fits-all requirements for any institution that can be described by the word "bank." These requirements are often unduly burdensome on smaller or community-based institutions.

My colleagues and I are seeing growing disparity in our Nation's financial services industry. The industry is becoming bifurcated between large and small institutions. Congress must recognize this reality and the impact this two-tiered system has on our economy. Excessive statutory burdens are crushing community banks and slowing the economic engine of small business in the United States. Regulatory burden relief for community banks would be a booster shot in the arm for our Nation's economic well-being.

CSBS does not endorse approaches such as the Communities First Act, as introduced in the House by Congressman Ryun from Kansas, that recognize and encourage the benefits of diversity within our banking system. We ask that Congress include some type of targeted relief for community banks in any regulatory relief legislation.

Today, I would like to highlight a few specific changes to Federal law that would help reduce regulatory burden on our banks. We ask that the Committee include these provisions in any legislation it approves.

First, we ask that Congress extend the mandatory Federal examination cycle from 12 months to 18 months for healthy, well-managed banks with assets of up to $1 billion, just as has been done for many years for banks with less than $250 million in assets. We believe this is real regulatory relief and that advances in off-site monitoring techniques and technology and the health of the banking industry make annual on-site examinations unnecessary for the vast majority of our healthy financial institutions.

Second, many of our banks are operating in multiple States. CSBS and the State banking departments have developed comprehensive protocols that govern coordinated supervision of State-chartered banks that operate branches in more than one State. To further support these efforts, we strongly support including language in a Senate regulatory relief bill that reinforces these principles and protocols. We also believe that *de novo* branching across State lines is a good idea whose time has come.

Finally, CSBS believes that a State banking regulator should have a vote on the Federal Financial Institutions Examination Council. While we have input at council meetings, we do not get a vote on policies that affect the institutions that we charter and supervise. We ask that Congress change the State position on the council from one of observer to that of a full voting member.

As you consider additional ways to reduce these burdens, we urge you to remember that the strength of our banking system is its diversity. The fact that we have a very large number of banks of different sizes and specialties that meet the needs of the world's most diverse economy every day is something that we celebrate. Regulatory relief measures must allow for further innovation and coordination at both the State and Federal levels for the benefit of institutions of all sizes. I am a career regulator, but I am extremely sensitive to regulatory burden, as are my fellow State supervisors, and we must constantly look for ways to be smart, focused, and reasonable in our regulatory approach.

Your own efforts, Chairman Shelby's efforts in this area, have greatly reduced unnecessary regulatory burden on financial institutions. We commend the Chairman and the Members of this Committee for their efforts in this area, and we thank you for this opportunity to testify and look forward to any questions that you or the Committee Members may have.

Senator CRAPO. Thank you very much.

Before we go to questions of this panel, we have been joined by three other Senators: Senator Sarbanes, Senator Bunning, and Senator Stabenow, although Senators Bunning and Stabenow have already had to leave for other obligations. It is going to be a morning like that. This is an incredibly busy morning. But I would like to move back and give Senator Sarbanes, our Ranking Member, an opportunity for an opening statement at this point.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I will be very brief.

First, I want to welcome the representatives of the Federal and State financial institution regulatory agencies and also the next panel that will follow with the representatives of various industry and consumer groups. This is an important hearing, and I am pleased to be able to participate in it. I am not sure I will be able to stay the whole morning.

Let me just say at the outset that the term "regulatory reform" or "regulatory relief" is a broad term. A lot of it is in the eye of the beholder, and it can encompass virtually any change that might be sought to Federal laws governing federally insured financial institutions.

I gather there is a list of 12 proposed legislative changes that have been jointly endorsed by the Federal Reserve, the Comptroller of the Currency, the FDIC, and the OTS. In addition, each of the Federal financial institution regulatory agencies has a supplementary set of suggestions to make, as I understand it. I believe the Fed includes eight additional proposals in its testimony. The OCC has a list of 27. The OTS has a list of 11. NCUA has a list of 16. And I think at your request, Mr. Chairman—and I want to commend you for the effort you have been making in this effort on this issue—the FDIC has compiled a matrix of 136 proposals by the regulators, industry, and consumer groups based on the hearing held last year in this Committee and, furthermore, that an additional 50 proposals have been added to the matrix.

I would just make this observation: Many of these proposals are rather complex and far-reaching. There also appears, I think, to be a tendency to characterize at least some of these proposals as consensus proposals. It is not altogether clear to me who constitutes that consensus or who is embraced within the parameters when you are developing a consensus proposal. And I have a question I will put to Mr. Reich at some point which I think underscores that concerns.

So, Mr. Chairman, as we move ahead, I obviously think that we need to exercise some very careful review of each of these proposals. There is a whole range of options here, as it were, and I think we need to weigh each of them carefully. Some of them, you know, virtually everyone says is a good idea; others provoke a considerable amount of discussion and dissension.

Thank you very much.

Senator CRAPO. Thank you very much, Senator Sarbanes.

I will begin with the questioning, and, frankly, I will start out along the same line that Senator Sarbanes has started out in his comments. As has been indicated by Senator Sarbanes and myself and I think most of the witnesses, there are a number of proposals on the table. We have a very extensive matrix in front of us, and we have witnesses from many different interest groups and perspectives to follow this panel of Federal and State regulators, who each have their perspective on the different proposals that are before us.

One of the concerns that I have is that I want to try to bring some finality to this process. It is my objective to move to a markup as soon as we can, and it is very clear that we are not going to include in the markup every single proposal that has been put before this Committee. In fact, as Senator Sarbanes indicated and as others on the panel have indicated, there are some proposals that I oppose, there are some that I strongly support. There are some that I support but which I believe it may not be the right time for them to be included in the legislation or some that are still under consideration.

Each of these proposals has a different status among different perspectives and different interests. But we have before us here the regulators who have an opinion or who have an expertise on a number of these proposals. It appears to me that there has been some hesitation from the regulators to comment on the proposals that are outside of their immediate jurisdiction. And although that is very understandable, I want to make sure that silence or lack of comment on a certain position is not construed as opposition or as a concern about safety and soundness.

And so what I would like to do, at least to try to bring some finality as to whether there is opposition on some of these proposals, is to in a rather prompt way move forward to get some finality on the agency evaluation of the proposals that are before us in the matrix, and this is what I have in mind.

Since the agencies have had the 136 provisions of the matrix before them for several months, at least, and, in fact, many of these have been proposed by the agencies themselves, I would like to bring this review and comment period to a close in a short period of time. It is my idea that if the agency does not comment on a particular provision within the next short timeframe, I would like us to understand that the assumption will be that the agency has no formal objection to us evaluating those provisions. In other words, I would like you to be able to at least tell us the provisions to which you have an objection.

Mr. Reich, you have been the one who has been coordinating this, and I wondered if it would be agreeable to you if I ask you to coordinate with the other agencies to identify the provisions upon which there is any objection from any of the agencies. Is that agreeable to you, Mr. Reich?

Mr. REICH. Absolutely. I would be happy to do that, Senator Crapo.

Senator CRAPO. And do you believe that you could accomplish that by about July 1?

[Laughter.]

I heard that sigh.

Mr. REICH. That is an ambitious timetable, but I will be happy to work with my fellow regulators at this table to accomplish that deadline.

Senator CRAPO. Do you think the rest of you could work with him to try to achieve that? Again, I am not asking you to comment on every position. I am just asking you to tell us if there are proposals to which you have objections, to identify those.

Ms. WILLIAMS. Senator, if I could just note that we have not seen the text for some of the proposals. We would need to be looking at the text rather than just a description of it. But we certainly want to cooperate and do so expeditiously.

Senator CRAPO. All right. I appreciate that.

Yes, Mr. Olson.

Mr. OLSON. Senator, a very similar response from the Fed. There are some proposals where we would like to see the full text as well, but we certainly endorse the direction that you are going, and we will try and work within the timeframe to provide a more specific response. There are a few proposals for which we have already indicated concerns that we have, and to the extent that we have additional concerns, we will express those.

Senator CRAPO. I appreciate that.

Any other comments?

Mr. RICCOBONO. I think it is a great idea. It is what is needed to wrap this up, and you absolutely have our commitment.

Senator CRAPO. Thank you.

All right. I see that my time has expired or will in just a few seconds here on my first round.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman. Actually, your question leads into an issue I want to raise, and I have a somewhat different perspective on this matter than the one that has just been enunciated by Senator Crapo.

First, Mr. Reich, let me ask you, you are the head of the interagency group reviewing various regulations pursuant to the Economic Growth and Regulatory Paperwork Reduction Act. Is that correct?

Mr. REICH. Yes, sir, Senator.

Senator SARBANES. Who constitutes the interagency group?

Mr. REICH. The member agencies of the FFIEC, the OCC, the Fed, the OTS, the FDIC, and the NCUA.

Senator SARBANES. And how did you become the head of the group?

Mr. REICH. Two years ago, Chairman Donald E. Powell of the FDIC was Chairman of the FFIEC. He asked if I would undertake as an assignment the leadership of an interagency effort to comply with the mandates of EGRPRA.

Senator SARBANES. Now, whose views do you think the interagency group needs to hear from or consult in the course of doing its work?

Mr. REICH. Well, we, of course, start with the banking industry and the views of the industry, and we have sought industry comment through two different methods—the public comment process as well as interagency meetings around the country. We met in Seattle, Orlando, New York, San Francisco, and many points in-between. We have accumulated dozens, in fact, hundreds of comments. We have also met with community and consumer groups in this area, in the Washington metropolitan area, Chicago, and San Francisco. We have a consumer and community group meeting planned in Boston later this year.

I have considered it to be important to obtain a consensus of the agencies represented at this table under the belief that if the recommendations that we come forth with have been vetted by each one of our agencies for safety and soundness concerns and for consumer protection concerns, that the fact that the recommendations have been vetted at each of our agencies and that we are able to reach a consensus agreement would hopefully supply some confidence to the Congress and to the Senate Banking Committee that these have been thoughtfully considered.

At the FDIC we have a policy committee consisting of broad representation of members who have vetted each of the proposals for safety and soundness concerns and consumer protection concerns. I assume that the other agencies have followed a similar process.

So, I hope that is responsive to your question.

Senator SARBANES. Well, that moves me along the path a bit. I am concerned that the regulators are not undertaking sufficient outreach to the consumer and community groups. And, in fact, we have heard complaints from them about the process. As I understand it, the agencies have sponsored nine bank outreach meetings across the Nation, but only three with consumer groups.

First of all, as I understand it, you do them separately. You do not convene an outreach in which you have the banking and the consumer groups present and interacting with one another, which seems to me you may be losing an important part of the process, particularly if you are concerned about developing a consensus. Groups have complained about a lack of time to adequately present their points. The website of the Economic Growth and Regulatory Paperwork Reduction Act contains a prominently listed top-ten issues for banks, but there does not seem to be a corresponding section containing prominent consumer and community group issues.

I would like you to provide to the Committee detailed information on your outreach effort to banks, thrifts, and consumers. How are the cities chosen? How are the participants chosen? How are entities and individuals informed of the outreach meetings? I think it is very important that your process be thorough and comprehensive.

Now, people may differ in the end on the recommendations, and that is something we have to deal with, but I do not think we want a situation in which people can with legitimacy claim that the process did not work fairly to all concerned. And I think we need to be very sensitive to that.

For instance, in your statement this morning, you say that you developed this matrix with a total of 136 burden reduction proposals. That is in your statement. And you then go on to say,

> Thereafter, I convened a meeting of banking industry representatives from the American Bankers Association, America's Community Bankers, the Independent Community Bankers of America, and the Financial Services Roundtable, who together reviewed the matrix of 136 proposals in an effort to determine which of these proposals they could all support as industry consensus items. This process yielded a list of 78 banking industry consensus items.

My first question is: Did you also convene a meeting of consumer groups to review the matrix and give you their views?

Mr. REICH. I did not convene such a meeting, Senator.

Senator SARBANES. Why not?

Mr. REICH. I have been operating under the assumption that several consensus undertakings were important in order for us to make recommendations to the Congress—first of all, that the industry needed to be supportive of the items that were under consideration; and, second, the regulators also needed to be supportive.

We have held 3-day-long meetings with consumer groups, and as I indicated, a fourth one is planned. We have invited many people to these consumer group meetings. Our attendance has been somewhat less than we expected. We have received a fair amount of input from the consumer groups, and I have felt that we have made a reasonable effort to communicate with consumer groups and allow them appropriate participation in the process. We are not trying to minimize their input or eliminate their input.

One of the reasons that we decided to hold separate meetings between the bankers and the consumer groups was to stimulate maximum input from each group, with some apprehension that if there was a combined meeting that some people would feel inhibited from participating fully. And so that was the reason that we decided to have separate groups, so that the people representing each group would feel free to speak freely.

Senator SARBANES. I have to tell you I think there is a problem here. I am looking at the agenda for the meetings in San Francisco. The bankers meeting went from 9 to 3 o'clock in the afternoon. The consumer one went from 9 to noon. The consumer groups tell us that they do not feel they are getting a fair shake just in terms of being heard, let alone what recommendations are made. It seems to me imperative that there be a very open and fair hearing process to give us some assurance the regulators are reaching a balanced judgment.

I do not think that developing a matrix by the regulators and then meeting with the industry groups and reaching a consensus within that circle alone constitutes a genuine consensus in terms of moving forward on these issues. Clearly, these consumer groups and community groups and so forth have an important role to play, and the notion that the regulators and the industry groups can get together and strike the bargain, so to speak, and then that constitutes the recommendation does not seem to me to be developing the kind of credibility and legitimacy that we need for these proposals.

Now, some of these proposals are inherently controversial. I mean, they affect important issues, banking and commerce, for example, and later I have a question of Mr. Olson on that subject, one I have taken a keen interest in consumer protection rights and so forth and so on. So if you could get that information to me with respect to the outreach efforts, we would be very interested in going over it carefully just to see how this process has been working, or not working, as the case may be.

Mr. Chairman, I see the red light is on. Thank you.

Mr. REICH. I will be happy to do that, Senator.

Senator SARBANES. Thank you very much.

Senator CRAPO. Thank you very much.

We have been joined by Senator Carper.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thank you, Mr. Chairman.

To our guests, our witnesses this morning, thanks for joining us. It is good to see you all. I have a question. Initially I thought I would just direct it to Mr. McClure. Are you from Missouri?

Mr. MCCLURE. Yes, sir.

Senator CARPER. Okay. Are you the examiner for the banks there?

Mr. MCCLURE. Yes, sir.

Senator CARPER. State-chartered banks, and you are here representing the Conference of State Bank Supervisors?

Mr. MCCLURE. Yes, sir.

Senator CARPER. I want to ask a question of you, but I think I am going to ask the others to respond as well, but I will let you be the lead-off hitter, if you would.

As we all know, in the wake of the corporate scandals of the early part of this decade, we passed the historic Sarbanes-Oxley bill, and in the years since its enactment, we have heard—I have heard and my guess is we all have heard from a lot of people things they like about it and some things that they do not like about it. One of the things we have heard some people do not care very much for is Section 404. I think while Section 404 is producing benefits, we have also heard from some other entities about problems with the implementation. We have heard from some how cumbersome it is, from some others how expensive it is. And some say that the cost is resulting—it is the first year that it has been done, and it is the start-up costs. Others say that they see a broader problem.

I am encouraged that in response to some of the concerns that were raised, I think the SEC held, maybe in April, what they describe as a roundtable to hear from a lot of different people. And

I would just ask of you, Mr. McClure, and our other witnesses today if you would not mind commenting, just sharing with us your views on the implementation of Section 404, the cost versus its benefit, realizing we are only a couple of years into this, and any suggestions for future Congressional or agency action that you might like to present to us.

Mr. MCCLURE. Okay. Thank you very much for the opportunity to answer the question.

Senator CARPER. You bet.

Mr. MCCLURE. I have to confess, I am not familiar with Section 404 per se. What is that regarding?

Senator CARPER. I tell you what, let me just go to our next witness.

Mr. MCCLURE. Okay.

Senator CARPER. That is probably not fair to have picked on you, and I do not want to do that. I will just go to Ms. Johnson and we will just work our way down. Thank you for your candor. You do not hear that every day, from either side of the table.

Ms. JOHNSON. Thank you, Senator. NCUA has issued a guidance letter in regard to Sarbanes-Oxley encouraging many of the specific recommendations within that legislation. We are also raising the awareness as we have the opportunity to meet with different groups, especially in regard to independent auditing and other measures within Sarbanes-Oxley. So credit unions do not specifically fall under Sarbanes-Oxley, but it is something that we have taken very seriously and are encouraging and really promoting.

Senator CARPER. All right. Thanks.

Our next witness, do you pronounce your name Riccobono?

Mr. RICCOBONO. Riccobono, yes.

Senator CARPER. Riccobono.

Mr. RICCOBONO. Riccobono.

Senator CARPER. All right. People call me Crapo sometimes, but it is really Carper. When they call me Crapo, I always say, "I have been called worse."

[Laughter.]

Truth be known, sometimes he gets called Carper. I hope he responds similarly. Mr. Riccobono.

Senator SARBANES. The two of you have a tough time of it, don't you?

Senator CARPER. We do.

[Laughter.]

Mr. RICCOBONO. I think we have heard very much the same thing from our institutions, and I would say, it is one of those things that you are trying to look for a balance. The first thing that, personally, I must tell you, my reaction to this is we put all this in place because of a lapse in our accounting professional in our accounting industry, and now we have raised their revenue five-fold by all of this. So something just tells me it is not quite right and it needs to be fixed.

With respect to banking, I think many of the reforms that were put in place were needed but already existed within the banking laws put in place by this Committee and the House as well, and existed prior to all of the lapses that took place.

So, perhaps a relook at that maybe as time goes on and we do this cost/benefit analysis, because it has turned out to be an incredibly expensive undertaking, and I guess I would ask the question of what do we ultimately get out of it with respect to an industry already very heavily regulated.

Senator CARPER. All right. Thanks.

Mr. Olson, with a special focus on 404, if you would, Section 404, for our last three witnesses. Thanks.

Mr. OLSON. I have some trepidation speaking as an expert on Sarbanes-Oxley when Sarbanes is in the room.

Senator CARPER. We all feel that way.

Mr. OLSON. It appears that the wording in Section 404 is very similar to what was in FDICIA 112 that passed in 1991. FDICIA 112 required the external auditor to opine on management's assertions regarding the adequacy of internal controls and financial reporting. All banks over $500 million were required to conform to FDICIA 112. So, incrementally, we expected there would be minimal additional cost for the banks to comply with 404. But the cost was substantial. It was not as a result of what was in the legislation, we believe, but the additional cost was the difference of interpretations involving the SEC, PCAOB, and the accounting industry with respect to the extent to which they could rely on the attestations from their own internal audit.

So, I think initially there was some confusion as to the extent to which each could rely on the other's work. The hearing that you referred to that the SEC held, our sense is that that helped relieve the confusion. And so we think that we should be able to remove that gap, but that is what we are waiting to see.

Senator CARPER. All right. Good. Thanks, Mr. Olson.

Ms. Williams.

Ms. WILLIAMS. Senator, I agree completely with what Governor Olson noted about the FDICIA provisions and Section 404. What has happened is that the PCAOB's auditing standard number 2 is very complicated and requires very extensive work by auditors, in their view, to satisfy the requirements of Section 404. What you have for a number of depository institutions is a perfect storm of the convergence of the Section 404 requirements and the FDICIA requirements, which are not the same. So you can have some institutions that are subject to both, and some institutions that are not subject to Section 404 because they are not registered companies, but yet are subject to increased costs from their auditors, reacting to the potential exposure and additional work that they do under Section 404.

So there is a complex combination of issues that we have today as a result of the application of the 404 standards and the application of FDICIA standards to depository institutions with assets above $500 million, regardless of whether they are registered, and then you have a class of institutions that are subject to both and the standards are not the same.

Senator CARPER. All right. Thanks.

Mr. Chairman, my time has expired. Could we hear just briefly from Mr. Reich, please?

Mr. REICH. Senator, I agree with many of the comments expressed by Governor Olson and Ms. Williams. Through my contacts with bankers over the past 2 years, through outreach meetings and through events that we host at the FDIC, we have heard many comments from bankers who are subject to Section 404 and bankers who are not subject to 404 about the impact that they have seen on the bills from their external auditing firms.

My own view is that the internal control process has been a critical element of the banking business from day one. Bank examiners examine the internal controls of every operation of the bank. It is a component of the CAMELS rating: Capital, Asset quality, Management, Earnings, and Liquidity. Internal controls are integral to the entire operation of the bank, and bankers, particularly those that are not subject to 404, are experiencing increased audit fees from CPA firms who are taking a more diligent approach. Those bankers are feeling that there is a great deal of redundant and unnecessary cost without benefit.

Senator CARPER. All right. Thank you all.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you very much.

Let me begin a second round with a couple more questions of my own, and in that context, Mr. Reich, I do not know that it needs to have a lot of clarification, but I want to be sure we all understand the difference between the EGRPRA process and the process of this Committee in terms of the evaluation of these proposals. And I would also like your perspective on that because you have basically been tasked to be the task force leader for the EGRPRA process, and then also in the Committee hearing last year agreed to coordinate for me in terms of some of the evaluation that was undertaken.

But a year ago, when we had our hearing on regulatory burden relief before this Committee, as we had indicated earlier, there were 18 witnesses. A lot of proposals came forward in that testimony, and at that time, as you indicated in your testimony today, I asked you, since you were already in the position of being the interagency EGRPRA task force leader, if you would help us to consolidate and develop a matrix on the proposals that had come to this Committee. In my mind, those are to a certain extent connected, the EGRPRA process and this Committee's review, but also to a certain extent different.

Could you clarify how you view this?

Mr. REICH. How I view the matrix and the origination of the matrix?

Senator CRAPO. Yes.

Mr. REICH. Well, it is a combination of issues that have been raised by bankers around the country and a combination of issues that were raised by those who testified at the hearing a year ago. It is a combination of recommendations that have originated both within the EGRPRA process and external to the EGRPRA process.

Senator CRAPO. And then as a result of the request that I made of you last year with regard to helping us to put together the compilation, which is now called the matrix, of these issues that were proposed to us, you have taken further action at our request, as well as at, I assume, at your initiative, to try to develop consensus and to determine where there is opposition and where there is support and the like. I have observed that, and I have not observed that I had seen any effort to preclude any group from having input. I can certainly say to Senator Sarbanes, once we received the 136 proposals, we made it very public that this was the parameter with which we were operating. We put it on our website. We invited comment from anybody who wanted to make comment and have been very open to receive comment and input from anybody who wanted to make comment and, in fact, have received sufficient comment that we have been asked to add another 50 or so recommendations for people to evaluate, some of which have come from consumer groups who are interested in the issue.

The point that I want to make is that I guess I do differ a little bit with the perspective that there has been any effort here to reduce or to inhibit the opportunity for any interest group in this country or any individual in this country from having the opportunity to give input on this information. In fact, we have tried to do everything we can to make it as widely spread and to distribute the information as widely as we can.

I would just ask this question of each member of the panel, with the exception maybe of Mr. McClure, who has not been a part of this process until today, as to whether you believe there has been adequate opportunity for the consumer groups to give their input on this set of proposals. I will start with you, Mr. Reich.

Mr. REICH. I believe that we have made a serious effort to obtain input from community groups and consumer groups.

Senator SARBANES. If the consumer groups and the community groups feel that they have not had sufficient access, is that a matter of concern to you?

Mr. REICH. Yes, it is, Senator. And I am willing to address that by scheduling meetings with them anytime, anywhere.

Senator CRAPO. I do not know that the rest of you need to comment unless you would like to. But I view this, to a certain extent, that the agencies, the Federal regulators who have authority over these issues have authority to evaluate consumer interests and a responsibility to make certain that consumer interests are evaluated. And I just wanted to know if you felt that consumer groups had had an opportunity to provide information.

Mr. OLSON. As you know, the Federal Reserve has a Consumer Advisory Council. And, as it happens, they are meeting today. I can at the next meeting be sure that this issue will be on their agenda so we can get additional input from that group.

Senator CRAPO. I can certainly agree with the tenor of Senator Sarbanes' last question, and that is, if the consumer groups feel that they have not had an opportunity, then certainly we should make it clear or I will make it clear right now from the Committee's perspective that their input is welcome and our doors are open. And I think that each of you should be encouraged to make an additional outreach to make sure that their input on the proposals before us is received.

Ms. JOHNSON. Senator, I would add that the National Credit Union Administration has not been a part of those separate meetings that have gone around the country. But what we did—the consumers for credit unions are actually the members, and so last fall NCUA actually held a forum—we called it a capital summit—to comment especially on the risk-based capital proposal to get the input from the members themselves and what the benefit might be.

On the other proposals that are before us today, we have made great efforts, as we are out addressing credit unions and their conferences, whatever, those are made up of credit union members, and so we do bring these proposals before them on a regular basis.

Senator CRAPO. We have just been notified—I did not realize it, but there is a vote on, and so we are going to have to call a quick recess. But we have a couple of minutes left before the vote wraps up, and Senator Sarbanes would like to have another opportunity for questioning before we break for the vote, which we will then do.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman. I want to just clarify two points.

First of all, my concern about the process that has been followed by the EGRPRA group is reflected in Mr. Reich's statement: We got the matrix.

> Thereafter, I convened a meeting of banking industry representatives . . . to determine which of these proposals they could all support as industry consensus items. [That] yielded 78 banking industry consensus items.
>
> The FDIC reviewed the 78 banking industry consensus proposals for safety and soundness, consumer protection . . . other public policy concerns and determined that we could affirmatively support 58 of the 78 industry consensus proposals. There are others that we have "no objection" to . . . take "no position" on . . . five of [them] that FDIC opposes.
>
> The next step in the consensus building process was to share our positions with the other Federal banking agencies in an effort to reach interagency consensus.

Then you say you were able to agree on some of these consensus proposals.

Now, my reading of that is a truncated process, not fully inclusive and not fully comprehensive. Now, I have not gone to the substance of the proposals. I may be for some, I may be against some. I mean, I do not really know at this point. I intend to examine them very carefully. But I do have this very strong concern about the process, and I just want to reemphasize it, and I would appreciate receiving the information I asked for.

Now, Ms. Johnson, if you all did it differently, you were not part of this group, if you could submit to us the process which the National Credit Union Administration followed, that would be very helpful to us.

Ms. JOHNSON. I would be glad to do so.

Senator SARBANES. Now, before we break, obviously since I was in the room when Sarbanes-Oxley was mentioned, all the statute requires is two short paragraphs. One paragraph is it says you have to have a system of internal controls. Does anyone on the panel believe that these companies should not have a system of internal controls? Is there anyone who thinks that?

[No response.]

Senator SARBANES. I take it no from the response.

Now, the second paragraph says—again, a very short paragraph. It says that "these systems of internal controls have to be certified and attested to so you have some assurance that they are a bone fide system of internal controls and not simply a fake system of internal controls, which, of course, if you had that would vitiate the requirement for a system of internal controls."

It seems to me, as far as the statute is concerned, there is not an arguable other position. Now the question becomes the implementation since the statute does not contain the implementation, and that was left to the SEC and the PCAOB to do.

They have made very substantial progress, and they are trying very hard to address some of the concerns that have been raised of a delay of the applicable dates of some of these things. The SEC has asked the Council of Sponsoring Organizations, who are the authors of the framework of internal controls, to provide additional guidance about the way that framework should be applied, particularly to smaller companies. The SEC has established an advisory committee to look at the impact of the Act, again, with a primary focus on smaller companies.

The PCAOB is holding a series of fora on auditing in the small business environment. They have held meetings with accountants in Denver; Fort Lee, New Jersey; meetings are scheduled in Pittsburgh, Orlando, Boston, and so forth. So there is an effort here to fine-tune the provision.

Now, it is quite true that the requirement to some extent was taken from the Federal Deposit Insurance Corporation Improvement Act. In fact, these requirements had been applied to banks. The FDIC has excluded banks of less than $500 million from the internal control rules because it felt that application of controls to such banks was not necessary to protect the bank insurance fund. But the purpose of Sarbanes-Oxley is different, and that is to protect investors in public companies. And I see no reason why banks that choose to sell their stock to the public should be treated differently from other public companies in terms of the requirements that they have to meet.

So it becomes a question of what is the proper auditing process and the proper governance, but the provisions are very broad, and the implementations of them have been left to the SEC and the PCAOB, and I think both Donaldson and McDonough have shown considerable sensitivity to some of the concerns that have been raised in terms of trying to fine-tune it.

We are barely 2 years into this regime, and I think the auditors may have been particularly rigid in the early stages. They are trying to give them guidance now as to how they proceed. But it seems to me if we are going to standards, I see no reason why a bank which is a public company and listed on an exchange, whose stock can be bought by investors, should not meet the same requirements that other public companies have to meet.

I do not think I understood anyone on the panel to argue to the contrary. Am I incorrect about that?

Mr. OLSON. That is correct. We did not argue to the contrary. The distinction that we noted is the one that you referenced. It is the incremental cost of complying with 404 over and above 112 for whom it applies, that both apply. And I agree with your conclusion also that the SEC and PCAOB and their respective leadership do appear to be looking at working out some of the lack of understanding or confusion on that issue.

Senator SARBANES. The expectation is that the costs will go down in subsequent years, first because there was an overload, I think, in the first year, because a lot of people had to meet the standards.

Second, if you did not have a fully developed system of internal controls, you, in effect, had to make what may amount to a capital investment in order to get them into place. The assumption is in subsequent years the costs for applying them will diminish. But, in any event, we ought not to lose sight of the basic purpose, which is to get people up to standard, and we have had a lot of testimony from various companies that the internal controls have significantly enhanced their control over their company, their ability to know what is going on, and as a consequence, many of them have corrected defaults or oversights that existed in their processes which they think have served them well.

Mr. Chairman, I gather that they are going to close the vote if we do not——

Senator CRAPO. They have told us we have about 6 minutes to get there.

Senator SARBANES. All right. I will cease and desist. Thank you very much.

Senator CRAPO. Because of this, what I propose to do at this point is to recess for about 10 or 15 minutes. I would like to have gotten into more with this panel, but we have another large panel. If you do not have an objection, I will excuse this panel, and when we come back, we will start the next panel.

Senator SARBANES. I will forego the questions I wanted to ask. I wanted to ask Mr. Olson about the——

Senator CRAPO. I had a couple of questions, too. If you would like, we can——

Senator SARBANES. No, I think we should let the panel go.

Mr. OLSON. I am looking forward to responding, too, so I will either do it here or in writing, whichever you prefer.

Senator SARBANES. Why don't you send me a response in writing about the industrial loan companies, because it has been suggested in the testimony of one of the people on the next panel that the Fed supports Section 401 of H.R. 1375, and that provision has been interpreted to allow industrial loan companies to branch *de novo* interstate. And I understand that the Fed is very much opposed——

Mr. OLSON. The Fed does not support applying that provision to ILC's. To banks, yes. To ILC's, no.

Senator SARBANES. Okay.

Senator CRAPO. All right. Thank you. And I have a few questions of my own. I did want to get into some of these other issues, and I apologize that we have been stopped from doing that by this vote. But I will submit some written questions, and I think you may get some other written questions from other Members of the Committee as well.

With that, we thank this panel. We excuse this panel. We recess the Committee and hopefully we will reconvene in just a few short minutes. Thank you.

[Recess.]

This hearing will reconvene, and I appreciate everybody's patience with our short delay.

I have to say, I think we were just talking about whether this might be a record. It is the largest panel I have ever been in a

Committee that has been before us, but perhaps that is just an indication of the interest in this issue.

Let me introduce the panel that we have before us. I would like to encourage everybody to remember my instructions to try to pay attention this light up here or that one there, if you can see it. I do not think very many can see the one on your table very well. But it is going to be important to try to stick to the time limits. As you probably have noted, your testimony is read and reviewed, and your testimony will all be a part of the record.

Our second panel—and this will be the order in which we hear you—consists of Mr. Steve Bartlett, President and CEO of Financial Services Roundtable; Ms. Carolyn Carter, Counsel for the National Consumer Law Center; Mr. Arthur Connelly, Chairman and CEO of the South Shore Savings Bank; Mr. David Hayes, President and CEO of the Security Bank; Mr. Christopher A. Korst, Senior Vice President of Rent-A-Center, Inc.; Mr. Chris Loseth, President and CEO of the Potlatch No. 1 Federal Credit Union from Idaho; Mr. Ed Pinto, President of Courtesy Settlement Services; Mr. Eugene Maloney, Executive Vice President of Federated Investors, Inc.; Mr. Travis Plunkett, Legislative Director of Consumer Federation of America; Mr. Bradley Rock, President and CEO of the Bank of Smithtown; and Mr. Michael Vadala, President and CEO of the Summit Federal Credit Union.

Now, did I miss anybody?

[No response.]

Good. Now, I do not know if you are sitting in the order in which I read your names, but we will go by the order in which I read your names, and that means we will start with you, Mr. Bartlett.

STATEMENT OF STEVE BARTLETT
PRESIDENT AND CHIEF EXECUTIVE OFFICER,
FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Thank you, Mr. Chairman.

Mr. Chairman, my name is Steve Bartlett and I am testifying on behalf of the Financial Services Roundtable. The Roundtable represents some 100 of the largest integrated financial services companies in America.

Mr. Chairman, I am here to impress on you and the Members of the Committee the urgency of regulatory relief. It has been 6 years since the passage of Gramm-Leach-Bliley, the last time that many of these issues were addressed. Many of those issues, in fact, predated Gramm-Leach-Bliley. Since then, though, technology, mobility, and consumer demands have accelerated, and our companies are increasingly unable to respond to those changes. So, I am going to describe in my oral testimony several of the ways in which we believe regulatory relief is long overdue, and I have submitted a much longer list in my written testimony.

First, Mr. Chairman, one that was not on the list 6 years ago is suspicious activity reports. The current system of SAR's reporting is simply not working. It is not working for law enforcement, and it is not working for consumer access. The best evidence of that is the dramatic increase in SAR's filings: From 1997, some 81,000 SAR's; this year, we think it will hit about 600,000, and it may be a million or more next year or the year thereafter.

This dramatic increase, in fact, stops law enforcement from being able to use SAR's, but it also masks an even larger problem, and that is that many consumers are simply pushed out of the banking market by the requirements of SAR's or the Bank Secrecy Act. The failure to file a SAR has become—the reason we believe that SAR's have—defensive SAR's have increased so dramatically is it has become a criminal issue. That means that a financial institution simply cannot afford the risks with the failure to file a single SAR's. There are no clear standards for when SAR's should be filed, and so the net result is defensive filings.

There are several solutions which I have submitted in writing, but the most important is that Congress should give financial institutions a safe harbor from prosecution when an institution has an isolated incident of failing to file a suspicious activity and the institution has a satisfactory anti-money laundering program in effect.

Second, Mr. Chairman, is interstate branching. It has been over 10 years ago that Congress enacted the loophole legislation of the Riegle-Neal Interstate Banking Efficiency Act of 1994. That Act eliminated some of the legal barriers to interstate banking, but essentially just set up another type of loophole. Consumers now have somewhat better access to products and services, and the financial services industry is somewhat more competitive. But, frankly, Mr. Chairman, it is still a loophole. Riegle-Neal is at best a law that gets around the ban on interstate branching. It is time for Congress to eliminate that ban and legalize interstate branching, as happens in every other industry in the country, and allow customers to follow their banks and vice versa.

Third is the elimination of costly unintended regulatory barriers for thrifts. Over the years, Congress has permitted thrift institutions to engage in the same type of retail brokerage and investment activities as commercial banks so that thrifts now look, walk, act, and talk like banks. But for reasons which are lost in the muddle of history, Congress has not given thrifts the same exemption from Federal securities laws that are available to banks. And so thrifts, unlike banks, face unnecessary and costly SEC registration requirements for no apparent reason of either safety and soundness or consumer protection. So we urge the Committee to establish exemptions for thrifts that are comparable to exemptions for commercial banks.

Fourth, diversity jurisdiction. For companies other than national banks and Federal savings associations, Federal law clearly provides that a business corporation will be deemed to be a citizen of, one, the State in which it is incorporated and, two, the State in which it has its principal place of business. But several court decisions have eroded that to where now the rule is quite muddy and, in fact, access to Federal courts is in many cases being denied.

Fifth, simplified privacy notices. Like all consumers, Roundtable member companies have found that the privacy notices required by Gramm-Leach-Bliley are overly confusing and largely ignored because of the confusing aspect as well as the size by many consumers. We recommend that the Committee use this opportunity to simplify the form of notice required by Gramm-Leach-Bliley. Regulators have tried to do that, but they simply do not have the statutory authority.

And sixth is we believe that the SEC regulation of broker-dealers, it is time for Congress to act. Title II of Gramm-Leach-Bliley we believe was clear. It was intended to provide for SEC regulation of new securities activities of banks but permit banks to continue to engage directly in traditional trust and accommodation activities that have long been regulated by banking agencies. We think that this Committee should restore Congressional intent on that front.

We do call on Congress to act, or at least this Committee to act before Independence Day to give the Nation's consumers an independence from these costly regulations.

Senator CRAPO. Thank you, Mr. Bartlett.

Ms. Carter.

STATEMENT OF CAROLYN CARTER
COUNSEL, NATIONAL CONSUMER LAW CENTER

Ms. CARTER. Thank you, Mr. Chairman, for the opportunity to address you today. My name is Carolyn Carter. I am testifying on behalf of the low-income clients of the National Consumer Law Center and also on behalf of a host of other consumer protection organizations. I will address just a few of the issues covered in the written testimony we filed jointly with Consumer Federation of America. Travis Plunkett of CFA will address several other issues. And as the process goes forward, consumer groups would very much like greater involvement in consensus building and decision-making on these important issues.

First, we urge you not to expand diversity jurisdiction for national banks. Expanding diversity jurisdiction would move thousands of foreclosure cases, thousands and thousands of foreclosure cases onto the Federal dockets, even though those cases deal primarily with issues of State law, not Federal law. Federal courts have enough on their plates and should not be turned into foreclosure processing machines. Homeowners facing foreclosure should have their cases heard in locally accessible, nearby their community courts.

Another proposal, Senate bill 603, proposes to roll back consumer protection requirements for rent-to-own transactions in Wisconsin, New Jersey, Vermont, and several other States. If this were a consumer protection measure, as it is being termed by some industry groups, consumer groups would support it. It is not and we urge you to reject it.

There is also a proposal before you to exempt mortgage services from the notice requirements of the Fair Debt Collection Practices Act. There have been many abuses involving mortgage servicers in recent years. The FTC has undertaken massive cases against mortgage servicers because of abuses. The notice that would be eliminated is an important notice because it alerts consumers of their rights under the Fair Debt Collection Practices Act. The exemption is fashioned as a narrow exception, but, in fact, it is not. It is a broad exception for reasons explained in our written testimony. Consumers need more, not less, protection against abusive mortgage servicing.

Another proposal deals with the right of rescission under the Truth in Lending Act. A consumer now has 3 days after closing to rescind a transaction that places the family home at risk. The consumer can review the transaction and back out of it if it is abusive, if it is different from what the lender promised, or if it is just a bad idea to place the family home at risk for an extension of credit. The right of rescission deters bait-and-switch tactics because the lender knows that the consumer will be able to review those documents after closing. And it is critical to preserving homeownership. The proposals before you would create three enormous exceptions that would completely gut the right of rescission. It would give the green light to predatory lending, and we urge you to oppose it.

Finally, let me say a few words about disclosure requirements. The Acting Comptroller of the Currency stated today that she favors more concise, streamlined, and understandable requirements for disclosures. And we agree with that, but we strongly disagree with any implication that in the name of streamlining, consumers should be deprived of information they now receive.

It is true that most people can absorb only a few bits of information when they initially see a disclosure statement or another document. But if the information is presented in a uniform manner, a uniform format, uniform terminology, the consumer can pick out what he or she needs. For example, with nutritional labeling, if I am interested in sodium I can pick that right out because I know exactly where it is going to be on the label. But the person sitting next to me can pick out protein content and can disregard everything else. The same is true of credit disclosure, and that means that the disclosure requirements must be detailed, they must be prescriptive, because otherwise the disclosures will not be uniform. And prescriptive, detailed requirements actually in my opinion make compliance easier because every financial institution then does not have to reinvent the wheel.

It should also be remembered that credit disclosures serve not just an immediate function but a long-term function. Unlike a nutritional label, which I may read once and then throw away when I eat the product, consumers save their financial papers and refer to them from time to time throughout the life of the transaction, for example, during that 3-day window for rescission. So consumer testing, which we strongly support, should look not just at what consumers can absorb when they first see a disclosure statement, but also what they can absorb and use in the long-run.

Thank you.

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

Mr. Connelly.

STATEMENT OF ARTHUR R. CONNELLY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
SOUTH SHORE SAVINGS BANK, SOUTH WEYMOUTH, MA
AND MEMBER,
EXECUTIVE COMMITTEE OF THE BOARD OF DIRECTORS,
AMERICA'S COMMUNITY BANKERS, WASHINGTON, DC

Mr. CONNELLY. Thank you. Senator Crapo, Senator Sarbanes, other Members of the Committee, I am Arthur Connelly, Chairman and CEO of the South Shore Savings Bank in South Weymouth, Massachusetts. We are a $900 million mutual State-chartered savings bank.

America's Community Bankers is pleased to have this opportunity to discuss our recommendations to reduce the regulatory burden community banks face and the unnecessary costs that we endure as a result.

These costs take their toll. Ten years ago, there were 12,000 banks in the United States. Today, only 9,000 of us have been left standing. We are particularly concerned about how the regulatory agencies are implementing laws intended to prevent money laundering and promote corporate governance. Community bankers fully support the goals of the laws against money laundering. We are resolute participants in the fight against crime, and especially terrorism. Yet we face an atmosphere of uncertainty and confusion because regulatory staff in the field, the region, and in Washington are giving banks inconsistent messages. There are also inconsistent regulatory messages between bank regulatory and law enforcement agencies.

Community bankers also support the Sarbanes-Oxley Act. However, the implementation of the Act by the SEC as well as PCAOB together with the way accounting firms interpret regulations have led to unintended consequences that are pretty costly and burdensome. This is true for all community banks, whether they are publicly traded, privately held, or mutual, like my own.

ACB has provided concrete suggestions to the banking agencies and other regulators on ways to cut the costs of compliance. ACB wants for the record to thank Senator Sarbanes for his assistance in securing the participation of community bankers in an SEC roundtable on the implementation of Sarbanes-Oxley. ACB will continue to work with Government agencies to improve the regulation of anti-money laundering and corporate governance laws. Congress has an important oversight role to ensure that a constructive dialogue between industry and regulators continues.

Our written statement endorses 32 amendments to the current laws that will reduce unnecessary regulations on community banks. Let me mention just three.

First, a modest increase in the business lending limit for Federal savings associations is a high priority for ACB members. Community banks who operate under Federal savings association charters are experiencing an increased demand for small business loans. To meet this demand, ACB wants to eliminate the lending limit restriction on these loans and increase the lending limit on other commercial loans by 20 percent. Savings associations could then make more loans to small and medium-sized businesses, enhancing their role as community-based lenders. This would clearly promote community development, economic growth, and job creation. And, after all, that is what it is all about: Community development, economic growth, and job creation.

Second, ACB strongly urges the elimination of required annual privacy notices for banks that do not share information with nonaffiliated third parties. We should provide customers with an initial notice and be allowed to provide subsequent notices only when the terms are modified. At my bank, for instance, we send out thousands of such notices each year at a significant cost, in both dollars and staff time, even though our policies and procedures have remained consistent over many years. The bottom line is that this redundancy does not enhance consumer protection at all. Redundancy really numbers our customers with volume.

The third point, ACB vigorously believes that the truth business of savings associations should have parity with banks under both the SEC Act as well as the Investment Advisers Act. There is no substantive reason to subject savings associations to different requirements. Savings associations and banks should operate under the same basic regulatory requirement when engaged in identical trust, brokerage, and other activities.

These three recommendations, along with our written statement, will make it easier and less costly for us to help our communities grow and prosper and create new jobs.

On behalf of America's Community Bankers, I want to thank you for your invitation to testify today, and we look forward to working with you and your staff, and I will be happy to answer any questions at the appropriate time.

Senator CRAPO. Thank you, Mr. Connelly.

Mr. Hayes.

STATEMENT OF DAVID HAYES
PRESIDENT AND CHIEF EXECUTIVE OFFICER,
SECURITY BANK, DYERSBURG, TN, AND CHAIRMAN,
INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. HAYES. Thank you, sir. Mr. Chairman, Senator Sarbanes, my name is David Hayes, and I am President and CEO of Security Bank and the Chairman of the Independent Community Bankers of America. My bank is located in Dyersburg, Tennessee, which is a town of 19,000, an hour and a half from Memphis, and we have 70 employees and we have $135 million in assets.

The ICBA appreciates the opportunity to testify today on behalf of our 5,000 member banks throughout this great Nation. We are especially pleased with your leadership, Senator Crapo, taking a broad approach to drafting regulatory relief for the Committee's consideration. It is vital that Congress expand on previous regulatory relief bills as they included regulatory relief for big banks, thrifts, credit unions, but little for our Nation's community banks. We are about reduction of regulation, not expansion of powers.

Community banks are the economic engines of Main Street America. There are reasons many of our country's businesses and communities continue to thrive. Local banks are particularly attuned to the needs of their communities and are uniquely able to facilitate local economic development through community and small business lending.

Community bankers are leaders in their communities. They spend time on economic development and not-for-profit organizations. All their efforts improve their communities. Increasingly, unnecessary regulation takes our time away from our customers and our communities. Our future depends on our community.

I assure you community bankers are not crying wolf. Recent studies highlighted in our written statement show that community banks are losing market share. I agree with Vice Chairman John Reich that the disproportionate impact of regulatory burden on community banks is the leading cause of consolidation in our industry. Community bankers are saying, "We have had enough."

Quite simply, community bankers are drowning in paperwork. If we do not get meaningful relief soon, more and more banks will throw up their hands and give up their independence. It is like being caught in quicksand. It has us and is pulling us down to death.

That is the reason the ICBA closely worked with Representative Jim Ryun on the Communities First Act. H.R. 2061 provides relief critical to community banks and their customers and would strengthen communities by freeing up resources currently being used for unnecessary compliance. We, like other financial groups, have been working on the interagency regulatory burden reduction project chaired by Vice Chairman Reich of the FDIC and endorse virtually all of the regulatory provisions.

The Vice Chairman has done an excellent job in identifying unnecessary bank regulations. Many of these are hard-wired in Federal statute. The Communities First Act would make key statutory changes building on the concept of a tiered regulatory and supervision system that recognizes the differences between community banks and more complex institutions.

Let me give you a couple of examples that affect my bank. Section 102 of the Act would permit strong banks with assets of $1 billion or less to file a short form call report in two of four quarters in any given year. The current call report instructions and schedules fill 458 pages. They are expensive and time-consuming to produce. Quarterly filings by community banks are not essential to the agencies. In a bank like mine, the world just does not change dramatically between March 31 and June 30 of each year. The FDIC will not lose track of me, and I assure you Chairman Greenspan will still be able to conduct monetary policy without our real-time data.

This is especially true today as I look at the retirement of my cashier who has been doing this job for many years, and I have to go out and try and find that person who will take that laborious task.

One of the most wasteful provisions of Gramm-Leach-Bliley has been the requirement that financial institutions send annual privacy notices, which most customers do not read. I question do we all read them, and I think the answer is no. We would recommend that an institution not be required to send an annual notice except for those times in which something substantial has changed in the method in which they do business or provide information to their customers. While any size institution could take advantage of this, I can tell you, my customers and the trash collectors in our city would greatly appreciate that.

The other item is the truth in lending 3-day right of rescission. Many times customers have said, “David, I signed the note. I want my money. Why do I have to wait 3 days?” So there are issues that we deal with in communities eyeball to eyeball with our customers, and we really understand the value of the customer relationship and the customer understanding the financial transaction.

Thank you very much.

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

Mr. Korst.

STATEMENT OF CHRISTOPHER A. KORST
SENIOR VICE PRESIDENT, RENT-A-CENTER, INC.

Mr. KORST. Thank you, Mr. Chairman. Good afternoon, Senator Sarbanes.

My name is Chris Korst, and I am Senior Vice President with Rent-A-Center, Inc., based in Plano, Texas. I appear today in support of S. 603, legislation that would regulate the rental-purchase or rent-to-own transaction for the first time at the Federal level, and in support of its inclusion in the proposed regulatory relief legislation. I speak to the Committee on behalf of the Coalition for Fair Rental Regulation, which includes in its membership roughly 4,300 of the 8,000 rental-purchase stores operating in the United States. Additionally, we are joined in support of this legislation by the Association of Progressive Rental Organizations, the national trade association representing rental dealers throughout the country.

S. 603 has been introduced once again in this Congress by Senator Mary Landrieu and is cosponsored by a number of other Senators, including Senators Shelby, Bunning, and Johnson on this Committee. In proposing this legislation, Senator Landrieu and her colleagues have successfully struck a balance between the interests of the consumers on the one hand and the rental merchants on the other.

By way of background, the rental-purchase industry offers household durable goods—appliances, furniture, electronics, and computers—along with musical or band instruments 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 without further financial obligation. Customers also have the option to continue renting after the initial or any renewal period and can do so simply by paying an additional weekly or monthly rental payment in advance of that rental period. In addition to that, our customers also 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 transaction.

This transaction appeals to a wide variety of consumers, including parents of children who this week want to learn the play the violin, only to find out a few weeks or months later their interests in that instrument have lagged. Military personnel use our services, as do college students and many others including campaign offices, summer rentals, and so forth, people who have similar limited or short-term needs or wants.

Importantly, however, because we do not check our consumer's credit histories and do not require down payments or security deposits, this transaction is also frequently used by individuals and families who are just starting out and who 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 of, and ownership if they so desire, the things that we all take for granted—beds for our children to sleep on, washers and dryers so that our customers do not spend all weekend at the laundromat, computers so that their children can keep up in school, decent furniture to sit on and eat at, and so on.

Rent-to-own gives working-class individuals and families a choice without the burden of debt and with all the flexibility they need to meet their sometimes uncertain economic circumstances.

Specifically, S. 603 does five major things:

One, it defines the transaction in a manner that is consistent with existing State rent-to-own laws, Federal tax provisions, and 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 would provide for comprehensive disclosure of key financial terms in advertising and on price cards on merchandise displayed in our stores, as well as in the body of the rental contracts themselves.

Three, the bill would establish a list of prohibited practices, a list similar in content and substance to the practices prohibited under the Federal Trade Commission Act.

Four, the bill adopts certain universal substantive regulations shared by all existing State rental laws.

And, five, the bill adopts the remedies available to aggrieved and injured consumers under the Truth in Lending Act.

In summary, this legislation would go farther in providing substantive protections to rent-to-own consumers than does any other Federal consumer protection law on the books today.

I would like to touch briefly on two additional points. First, regarding the issue of this legislation and its relation to existing State laws, if enacted, this legislation would serve only to establish a floor of regulation of the rent-to-own transaction. State legislatures would have the full opportunity to pass stronger laws and regulations, modify existing statutes, or even outlaw the transactions entirely if that is what those bodies believe was appropriate. Thus, it is clear that this bill does not preempt State law. At the same time, this bill would finally establish a Federal definition of the transaction rental-purchase consistent with the definitions found in the existing State statutes and within the Internal Revenue Code.

Importantly, just as is the case under other Federal consumer protection laws, including Truth in Lending and the Consumer Lease Act, States would not be permitted to define or mischaracterize this transaction in a manner that would be inconsistent with the definition in this bill.

Finally, as you may be aware, some groups have called for any Federal rental-purchase legislation to include the disclosure of an imputed or estimated annual percentage rate in these agreements. We believe that this view is misguided for several reasons.

First, in order for a transaction of any kind to include an interest component, there must be debt; that is, a consumer must owe a sum certain and must be unconditionally obligated to repay that sum. That is simply not the case under the typical rent-to-own transaction.

Second, the notion of imputed interest misleads consumers and misrepresents the true economics of the rent-to-own transaction, which has many benefits, services, and options that traditional credit transactions just do not offer, including delivery and set-up, maintenance on the merchandise throughout the rental, and replacement items if the original item cannot be repaired in the customer's home.

Additionally, as noted previously, rental customers always enjoy the absolute right to terminate the transaction and return the products without penalty at any time.

Finally, referring to the Federal Trade Commission's seminal report on the rent-to-own industry in the year 2000, I would like to quote from that report. First, they state,

> Unlike a credit sale, rent-to-own customers do not incur any debt, can return the merchandise at any time without any obligation for the remaining payments, and do not obtain ownership rights or equity in the merchandise until all payments are completed. An APR disclosure requirement for rent-to-own transactions may be difficult to implement and could result in inaccurate disclosures that mislead consumers.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you, Mr. Korst.

Mr. Loseth.

STATEMENT OF CHRIS LOSETH
PRESIDENT AND CHIEF EXECUTIVE OFFICER,
POTLATCH NO. 1 FEDERAL CREDIT UNION AND
CHAIRMAN, IDAHO CREDIT UNION LEAGUE
GOVERNMENT AFFAIRS COMMITTEE,
ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

Mr. LOSETH. Chairman Crapo, Senator Sarbanes, and Members of the Committee, on behalf of the Credit Union National Association, I appreciate this opportunity to express CUNA's views on the legislation to help alleviate the regulatory burden under which many insured financial institutions operate. I am Chris Loseth, President and CEO of Potlatch Credit Union in Lewiston, Idaho.

As a cooperative financial institution, credit unions have not been shielded from the mounting regulatory responsibilities facing insured depositories in this country, but given the limited time available, I will devote my statement to describing a few exceptionally important issues for credit unions.

As part of our mission, credit unions are devoted to providing affordable service to all of our members including those of modest means. One provision that has been passed by the House and is in legislation introduced by Senator Sarbanes would go a long way toward helping credit unions fulfill this part of their mission. It would permit credit unions to provide check cashing and wire transfer services to nonmembers within their field of membership.

Accomplishing our mission can also be greatly enhanced by revisiting two major components of the 1998 passed Credit Union Membership Access Act. Perhaps the most critical issue on the horizon for credit unions is the need for reforming the prompt corrective action regulations governing credit unions. Credit unions have higher statutory capital 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 potential losses than do other depository institutions.

And because of the conservative management style, credit unions generally seek to always be classified as well rather than adequately capitalized. To do that they must remain significantly cushioned above the 7 percent requirement.

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, as outlined by the NCUA proposal and embodied in a House introduced bill, H.R. 2317 or CURIA. It would place much greater emphasis on ensuring that there is adequate net worth in relation to the risk a particular credit union undertakes. At the same time, CUNA believes credit union PCA should incorporate a meaningful leverage requirement, comparable to that in effect for other federally insured institutions.

CUNA strongly supports the NCUA's proposed new rigorous safety and soundness regulatory regime for credit unions, which is anchored by meaningful net worth requirements. And credit unions agree that any credit union 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. Reforming PCA along these lines would preserve and strengthen the fund.

Also, the Financial Accounting Standards Board is finalizing guidance on the new accounting treatment of mergers of cooperatives that would create a new component of net worth, in addition to retained earnings, after a credit union merger. The unintended effect of the FASB rule will be to no longer permit a continuing credit union to include the merging credit union's net worth in its PCA calculations.

Senior legal staff at FASB have indicated support for a legislative approach to correct this problem, and we urge the Committee to likewise support such an effort, well in advance of the effective date so credit unions will have certainty regarding the accounting treatment of mergers.

The other issue I would like to address is the current cap on member business lending. There was no safety and soundness reason to oppose these limits as the historical record is clear that such loans are even safer than 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 20 percent suggested in CURIA. Small business is the backbone of our economy, and responsible for the vast majority of new jobs in America. Yet, a recent SBA study reveals that small businesses are having greater difficulty in getting loans in areas where bank consolidation has taken hold. The 1998 passed law severely restricts small business access to credit and impedes economic growth in America.

Furthermore, the NCUA should be given the authority to increase the current $50,000 threshold, as proposed in CURIA, up to $100,000. This would be especially helpful to smaller credit unions, as they would then be able to provide the smallest of these loans without the expense of setting up a formal program.

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, and to make sure that the provisions discussed in my testimony are part of any Congressional action taken to provide financial institutions regulatory relief.

The future of credit unions and their 86 million members will be determined by our ability to provide relief in these important areas.

Thank you.

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

Mr. Pinto.

STATEMENT OF EDWARD PINTO
PRESIDENT, COURTESY SETTLEMENT SERVICES, LLC,
ON BEHALF OF
THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. PINTO. I am Ed Pinto, President of Courtesy Settlement Services, LLC. Thank you, Chairman Crapo and Ranking Member Sarbanes, for the opportunity to testify on behalf of the National Federation of Independent Business regarding interest-bearing checking accounts for small businesses.

I am pleased to report that 86 percent of NFIB members support allowing business owners to earn interest on their business checking accounts. I am also pleased to hear the House has overwhelmingly voted in favor of H.R. 1224 by a vote of 424 to 1, indicating a strong bipartisan desire to overturn this archaic and Depression-era law that prohibits the payment of interest on business checking accounts. I was also pleased to hear earlier this morning with the panel of regulators that some of the regulators also indicated that they endorsed the repeal of this restriction.

Big banks have consistently opposed repealing this ban on interest checking, and at the same time a proposed compromise legislation that would delay the implementation of this repeal by 3 years. Their efforts to insulate themselves from the free market have hurt small businesses in this country, the acknowledged job creation engine of this country.

I view this bill as necessary consumer protection legislation, and every day it is delayed is an injustice to the over 25 million taxpayers filing business income tax returns with the IRS. Let me repeat that number, 25 million business income taxpayers in this country. That may seem like small potatoes in terms of what they might earn on interest on checking, maybe $100 or $200 per year, but multiply that by 25 million and leverage that job creation power by the ability of our Nation's business to create jobs, and the impact would be large.

The House passed bill as currently written has a 2-year delay, and that is already a compromise, and NFIB strongly urges the Committee to resist efforts to further lengthen the phase-in period. Please do not deny this much-needed legislation to tens of millions of taxpayers.

While it had been 16 years since I first started my first business, I can still vividly recall to my astonishment at being told that a business could not earn interest on a checking account. I was further astonished to find that not only did it not pay interest, but I would also be charged fees for the privilege of having that account. My banker said, "But do not worry," and then introduced me to the spellbinding concept of compensating balances. Boy, was I in for an education, and one that had nothing to do with growing my business. I remember thinking that all this seemed quite fine and not exactly consumer friendly. I had been earning interest for years in my personal checking account, which had a much smaller balance. I kept asking, "Why no interest?" And I was simply told it was against the law.

Later as my business prospered my banker suggested that 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 that is what we did. And it was very complicated. First, we analyzed my account history to determine how much to keep in the regular account so as to earn enough to avoid the fees that I had to pay on that regular account.

Next, we had to project what would be earned in interest and compare that to the additional fees that the compensating sweep account would have. Then I had to authorize an amount to be swept each night, and here I had a choice. I could either call the bank every afternoon to make arrangements, or they would do it automatically based on a preset formula. Not being a glutton for punishment I selected the automatic option. After this exercise I barely remembered why I had started my business in the first place, but that was just the beginning.

As any new business owner will tell you, there are better ways to spend your time than calling your banker every day, but small business owners, by our nature, break out in hives at the thought of money sitting in a noninterest bearing account. What I did not know was that a sweep account was really designed for a larger company, one with in-house accounting, financial staff to keep up with the flow of money on account-to-account transactions. For the small business owners with a business to run it can be a paperwork nightmare.

We soon found that the sweep account, while addressing the noninterest bearing issue, resulted in a flood of paper from the bank. Each day we got a reconciliation statement just to let us know the money had been shifted around in the previous 24 hours, and because this was done via mail, there was always a 2- to 3-day delay in the information flow, so we never really knew what was going on with the funds. Of course the mail piled up unopened at the rate of about 250 letters per year, which we then throw out periodically and add to the trash.

To add insult to injury, my so-called interest earnings were paying for all of this paperwork. Do not get me wrong, I am not arguing against sweep accounts, but they are a bookkeeping hassle for small businesses. Would these misguided resources not be better spent on tasks that help grow small businesses, rather than generating a flood of paperwork. For obvious reasons the make-work nature of the sweep account ended up significantly reducing the interest earnings, and that was really adding insult to injury.

We could have been much better off leaving the money in a noninterest bearing account, which is what many business owners do and what I now do, a fact that restricts much-needed job creation capital for those who need it most.

I know there are simpler alternatives, and that would be to allow for the payment of interest. Even banks, it does not make sense for banks to continue this prohibition because making a change would be very simple. They are already doing it on consumer accounts. The Senate has an opportunity to eliminate an archaic law that has run headlong into the creativity of the free market. The current law saddles America's small businesses with an inefficient alternative that costs them billions in annual revenue, revenue that could to create jobs.

Please give banks the choice to offer interest-bearing accounts, a choice that takes on greater urgency now that interest rates are going up and interest earned on these accounts becomes more substantial. Please consider this and resist efforts to lengthen the phase-in period, and act now.

Thank you for the opportunity to express my views.

Senator CRAPO. Thank you, Mr. Pinto.

Mr. Maloney.

STATEMENT OF EUGENE F. MALONEY

EXECUTIVE VICE PRESIDENT, FEDERATED INVESTORS, INC.

Mr. MALONEY. Senator, I appreciate the opportunity to be here this morning. My name is Eugene F. Maloney. I am Executive Vice President, Corporate Counsel, and a member of the Executive Committee of Federated Investors.

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 20 years, I have been a member of the faculty of Austin University Law School, where I teach a course entitled 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 clients of their trust departments.

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 that 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, if not evaluated in a historical context, will have the exact opposite result. This conclusion is based on my personal experience with the introduction of ceilingless deposit accounts in 1982, and the impact that it had on our client base. Friends of longstanding lost their jobs, their pensions, and their self-esteem because of the failure by Government officials and Members of Congress to fully think through the economic impact of ceiling deposit accounts on our banking system and its profitability. This failure cost every man, woman, and child in the United States $1,500.

When this matter was before Congress last year, the House Committee report included a detailed estimate of the implications for Federal tax revenues and the budgetary impact of paying interest on required reserve balances, but not on the impact on earnings or assets of banks.

During the House Committee hearings, in response to questioning as to whether the legislation would weaken any play in the market, Governor Meyer of the Federal Reserve Board replied, "No." 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, Governor Meyer replied, "No, I do not have any numbers to share with you."

In anticipation of my appearance before the Committee today, we commissioned a study by Treasury Strategies of Chicago to provide us with their views on the impact of the repeal of Regulation Q. Some key findings that we offer for your consideration today are as follows:

Companies now maintain liquid assets of approximately $5 trillion. And 57 percent of corporate liquidity is now in deposits or investments that mature in 30 days or less. As we speak, banks are adjusting their balance sheets to mitigate interest rate risk to maintain their spread revenues.

This is a volatile mix. It becomes obvious that if higher-than-market interest rates are offered to bank corporate customers, we risk a repeat of the 1980's debacle of massive amounts of money moving to institutions that are ill-prepared to rationally deploy it.

Treasury Strategies has suggested the following options to prevent this from occurring: Do not increase from 6 to 24 the number of permissible transfers per month into MMDA accounts; Cap the interest rates payable on these deregulated accounts during the phase-in period. Their suggestion is 40 percent of the 90-day Treasury bill rate; Limit the amount of interest-bearing demand deposits a bank can hold as a percentage of its capital; Limit interest payments to just uninsured deposits; Collateralize the deregulated deposits; Implement a phased approach;

Other anticipated fallout we expect to occur should the repeal go forward are as follows: Increased credit risk which will raise the banks' rate of loan charge-offs; Pressure on banks' profitability and subsequent increases in charges for discrete services. Some statistics on this point are as follows: (a) profit risk of $4 billion; (b) increased interest expense of $6 to $7.5 billion per year; and (c) for the banks studied by Treasury Strategies, it has been determined that in order to break even on their business customer base, banks will need to grow deposits or raise service charges as follows: With respect to small business, grow deposits by 80 percent or raise service charges by 34 percent. With respect to mid-size companies, grow deposits by 35 percent or raise service charges by 16 percent.

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.

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

And at this point we are going to go back to this end of the table here to Mr. Plunkett.

STATEMENT OF TRAVIS PLUNKETT LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Thank you, Mr. Chairman and Senator Sarbanes. My name is Travis Plunkett. I am the Legislative Director of the Consumer Federation of America. I appreciate the opportunity to offer the comments of CFA and a broad range of other consumer and community groups on regulatory relief proposals.

I will touch on two issues: The efforts to allow industrial loan companies to expand, and attempts to weaken reporting requirements under the Home Mortgage Disclosure Act.

A number of bills have been offered in both the House and the Senate in recent years that take the very dangerous step of allowing industrial loan companies to expand, either by offering business checking services or by branching nationwide, or both.

ILC's are State-chartered, FDIC-insured banks that were set up at the beginning of the 20th century to make small loans to industrial workers. In 1987, Congress granted an exemption to the Bank Holding Company Act for ILC's because there were few of them, they were only sporadically chartered in a small number of States, they held very few assets and they were limited in the lending and services they offered.

Since that time everything about ILC's has grown. As of 2003, one ILC owned by Merrill Lynch had more than $60 billion in assets, while 8 other large ILC's had at least a billion in assets, and a collective total of more than $13 billion in insured deposits. The five States that are allowed to charter ILC's are now aggressively encouraging new ILC's to form. They are allowing these institutions to call themselves banks, and they are giving them almost all of the powers of State-chartered commercial banks. They are also promoting the lower level of oversight they offer compared to those pesky regulators at the Federal Reserve.

ILC's now constitute what is essentially a shadow banking system that puts taxpayer-backed deposits at risk. This parallel system also siphons commercial deposits from properly regulated bank holding companies. The key problem with ILC regulation is that while the Federal Reserve 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. Regulators cannot impose capital requirements on the parent companies. Holding company regulation is also essential to ensuring that financial weaknesses, conflicts of interest, malfeasance, or incompetent leadership at the parent company will not endanger taxpayer-insured deposits at the bank.

Commercial firms and financial firms such as Merrill Lynch, American Express, and Morgan Stanley, own ILC's and want to own ILC's. We have concerns about ownership of ILC's by both types of companies, and the recent corporate scandals show the hazards of ILC membership by both types of companies.

Next, we are concerned about industry proposals to reduce the number of financial institutions required to provide disclosure under the Home Mortgage Disclosure Act. HMDA requires certain mortgage lenders with offices in metropolitan areas to collect, report, and disclose annual data about applications, originations, home purchases, and refinancings of home purchases and home improvement loans. HMDA provides the public and banking regulators with crucial data about whether lenders are serving the housing needs of the communities in which they are located.

Industry representatives have advocated that HMDA reporting thresholds for mortgage lenders be raised from $34 million in assets to $250 million in assets. While such an adjustment may seem relatively minor, it is not. Raising the threshold to $250 million would exempt about 25 percent of depository institutions and 25 percent of current HMDA filers from submitting HMDA reports. In many States, lenders in this size category represent the vast majority of all banking institutions. The elimination of loan-level HMDA reporting for these lenders would hamper enforcement of key laws such as the Equal Credit Opportunity Act, the Fair Housing Act, and the Community Reinvestment Act.

Since 1990, over 1,200 institutions with between $34 million and $250 million in assets received below satisfactory CRA ratings.

It is also important to note that because of technological advances, it has never been easier or cheaper to comply with HMDA. Software for HMDA reporting is readily available and relatively inexpensive. The Federal Financial Institutions Examination Council offers free HMDA software on its website for any institution that wants to use it.

For these reasons we urge the Committee not to make changes to HMDA reporting thresholds regarding ILC's. We urge the Committee not only to not expand ILC powers, but to also look at the ILC exemption under the Bank Holding Company Act and to plug the ILC loophole. This will prevent ILC's from becoming a separate shadow banking system that is inadequately regulated. Thank you.

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

Now we will come back over to Mr. Rock.

STATEMENT OF BRADLEY E. ROCK PRESIDENT AND CHIEF EXECUTIVE OFFICER, BANK OF SMITHTOWN AND CHAIRMAN, GOVERNMENT RELATIONS COUNCIL, AMERICAN BANKERS ASSOCIATION

Mr. ROCK. Thank you, Mr. Chairman. My name is Brad Rock. I am Chairman, President and CEO of Bank of Smithtown, a $750 million community bank founded in 1910, which is located on Long Island in Smithtown, New York.

I would like to make 3 key points. First, compliance costs drain bank resources, taking away from the needs of our customers and our communities. Every new law, regulation, or rule means two things, more expensive bank credit and less of it.

During the past decade banks have shouldered the effects of some of the most imposing legislation of the past 100 years. Compliance costs for banks today are between $38 and $42 billion per year, and these do not include costs associated with the USA PATRIOT Act, the Sarbanes-Oxley Act, the SEC, FASB, and the Public Company Accounting Oversight Board.

If we were to reduce the regulatory costs by just 20 percent, the reduction would support additional bank lending of up to $84 billion. The impact on our economy would be huge. Second, regulatory burden is significant for banks of all sizes, but small banks struggle the most. There are more than 3,200 banks with fewer than 25 employees. Nearly 1,000 banks have fewer than 10 employees. These banks simply do not have the human resources to implement the thousands of pages of regulations, policy statements, and directives they receive every year.

Countless hours are spent on compliance paperwork at all levels from bank directors and CEO's to managers and tellers. At my bank every person has major compliance responsibilities and one person has a full-time job just to coordinate all of the compliance activities. I personally spend about 1½ days per week on compliance issues. Some CEO's tell me that they are now spending nearly half their time on regulatory issues. This means that bank CEO's spend more than 5 million hours each year on compliance, time that could be better spent on ways to improve banking in their communities and to meet the changing needs of their customers.

The costs do not stop there. My bank pays more than $100,000 each year to outside firms to help us to comply with regulatory burdens. This one expense alone, if it were used as capital, would support an additional $1 million of lending in my community.

My third point is this. Only the involvement of Congress can result in a reduction of costly regulatory burdens. Bankers have seen previous relief efforts come and go without effect while the overall burden has kept rising. In my written testimony, I list some of the areas in which ABA is seeking reform. Let me briefly describe two which have been particularly costly in recent years.

Under the Bank Secrecy Act banks fill out more than 13 million cash transaction reports annually. Most of these reports are filed for companies that are traded on the public exchanges and are well-known by both the bank and the Government. These transactions have nothing to do with potentially criminal activity. The 35-year-old rules related to cash transaction reports have lost their usefulness due to several developments, including more comprehensive suspicious activity reporting, robust customer identification obligations, and mandates to match Government lists to bank accounts.

Consider a small bank that has 25 employees or less. Many banks of this size have had to hire an additional full-time employee for the sole purpose of completing reports related to the Bank Secrecy Act. The cost benefit analysis does not make sense.

Also, as a result of the Sarbanes-Oxley Act, accountants have more than doubled their fees. One community bank in New York saw its accounting fees jump from $193,000 in 2003 to more than $600,000 in 2004. New accounting standards frequently cause almost complete duplication of bank internal audits without increasing safety and soundness.

In conclusion, unnecessary paperwork and regulation erodes the ability of banks to serve customers and support the economic growth of our communities.

We look forward to working with you to find ways to bring greater balance to the regulatory process. Thank you.

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

And finally Mr. Vadala.

STATEMENT OF MICHAEL VADALA PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE SUMMIT FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. VADALA. Thank you. Good afternoon, Senator Crapo and Ranking Member Sarbanes. My name is Mike Vadala. I am the President and CEO of The Summit Federal Credit Union located in Rochester, New York. 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.

As with all credit unions, The Summit is a not-for-profit financial cooperative governed by a volunteer Board of Directors who are elected by our member-owners. The Summit was founded in 1941 and has 47,000 members and just over $340 million in assets.

America's credit unions have always remained true to our original mission of promoting thrift and providing a source of credit for provident and productive purposes. I am pleased to report to you today that America's credit unions are vibrant and healthy, and that membership in credit unions continues to grow, now serving over 86 million members.

Yet, according to data obtained from the Federal Reserve Board, credit unions have the same market share today as they did in 1980, 1.4 percent of financial assets, and as a consequence provide little competitive threat to other financial institutions.

While developing a comprehensive regulatory relief package, we hope the Committee will include the credit union provisions contained in the Financial Services Regulatory Relief Act, which passed the House last year, and also consider including additional provisions from the Credit Union Regulatory Improvements Act of 2005, CURIA, which has been introduced in the House.

NAFCU supports these bills, and I would like to talk about a few of the specific provisions in them at this time. NAFCU urges the Committee to modify the prompt corrective action system, or PCA, for federally insured credit unions to include risk assets as proposed by the NCUA and included in Title I of the CURIA bill. This would result in a more appropriate measurement to determine the relative risk of a credit union's balance sheet, and also ensure the safety and soundness of credit unions and our share insurance fund.

It is important to note this proposal would not expand the authority for NCUA to authorize secondary capital accounts. Rather, we are moving from a model where one-size-fits-all to a model that considers the specific risk posed by each individual credit union. This proposal reduces the standard net worth or leverage ratio requirements for credit unions to a level comparable to, but still greater than, what is required of FDIC-insured institutions. Strength is gained because this proposal introduces a system involving complementary leverage and risk-based standards working in tandem.

NAFCU also asks the Committee to reconsider the member business loan cap, which was established as part of the Credit Union Membership Access Act in 1998, replacing the current formula with a simple and more reasonable rate of 20 percent of the total assets of a credit union.

We support revising the definition of member business loans, giving NCUA the authority to exclude loans of $100,000 or less from counting against the cap.

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." That same study found that 86 percent of credit union member business loans are made for businesses with assets under $500,000. Many small business people feel that credit unions can fill a need in the marketplace for these loans.

Finally, we urge the Committee to make a relatively simple change that would address what could become a problem for merging credit unions when FASB changes merger accounting rules from the pooling method to the purchase method. Legislation to address this issue in the form of the Net Worth Amendment for Credit Unions Act, H.R. 1042, was passed by the House just last week. We hope that the language from this bill will also be included in any regulatory relief package introduced in the Senate.

To be clear, we are not asking you to legislate accounting rules, but rather we are asking you to change a definition so that the acquired equity of merging credit unions is properly included in total net worth for PCA purposes.

In conclusion, the cumulative safety and soundness of credit unions is unquestionable. Nevertheless, there is a need for change in today's financial services marketplace. NAFCU urges the Committee to consider the provisions we have outlined in this testimony for inclusion in any regulatory relief bill. Appropriately designed regulatory relief will ensure continued safety and soundness and allow us to better serve the 86 million members of America's credit unions.

We would like to thank you, Senator Crapo, for your leadership. We look forward to working with the Committee on this important matter, and we welcome your comments or questions.

Thank you.

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

Like I said at the outset, this is the largest panel I have ever seen. I think that it shows the breadth of interest in this kind of an issue and the number of interest groups, whether it be credit unions, community banks, independent bankers, large banks, consumers, or customers, the interest in the financial reform that we are talking about here is broad and extensive, and primarily that is because it is so important to the American consumers and the impact on the people who rely on financial services.

I just want to make a comment at the outset and then ask a couple of questions. The comment is this: As I believe everybody knows, we have taken the broad approach to this issue. We want to have all of these interests and concerns raised to the Committee so that we can evaluate them and determine how to achieve as much reform and improvement as we can possibly achieve. At the same time we do not want to make mistakes or make things worse, as has been indicated by some of the witnesses about some of the proposals. I would say the proposals, we have tried to get these proposals out there, and I think most people have notified us of their concerns about areas where they do have concern with the proposals. The testimony that we received today, both the oral testimony as well as the written testimony, has been very helpful in helping us to further identify not only areas where there is support and consensus, but also areas where there is concern and objection.

I would just encourage everybody, as soon as possible, to make sure you get your comment and concerns in to us to the extent they have not already been done in your testimony today, and that invitation goes beyond this Committee.

I was thinking about this, and in fact, Senator Sarbanes and I were talking in the hall. As you look at these recommendations, there are some of them that are obviously good ideas about which to this point we have seen no objection. There are some of them which—I will not speak for Senator Sarbanes, but which I do not like. I am sure there are some that he does not like, and there are some that you do not like. There are some that I do not like that may end up getting on the bill because everybody else likes them, or the politics of the circumstance and the dynamics make it such that they are supported well enough to move forward. There are some which I do like and which I would like to see in the bill, which the circumstances may not justify at this point if we want a bill that is going to move, and about which there is a large amount of opposition.

So this is going to be a process that requires an intense amount of analysis and work between us here on the Committee, and I would encourage you to give us as much input as you can as we seek to move forward so that we can identify the areas where there is consensus, we can identify the areas where we may need to take some further time and move in a separate piece of legislation or the like.

So anyway, I just encourage everybody to continue what you have already been doing in giving us your ideas.

With that, let me just ask a question on one of the areas in which I have a lot of interest, but which, frankly, is an area where I suspect there may be some controversy, and that is the privacy simplification issue. Mr. Bartlett, you raised that, and I think, Mr. Hayes, you indicated that you were not sure that very many people actually read these privacy notices. I have said this before in public forums, but because I serve on the Banking Committee and I am involved in a process that is evaluating these things, I try to read every one that I receive. I am not only convinced, Mr. Hayes, that most people do not read them, but I am also not sure that they can. I know that it is very difficult for me to read these and to understand exactly what rights I am being told that I have.

Now, I very strongly believe that it is a good idea for the protection of the privacy of this information, and I very strongly believe that we need to notify people of those rights.

But I guess I would start out by asking Mr. Bartlett and Mr. Hayes if maybe you could suggest what you think a properly simplified privacy notice should look like, and then I would be glad to let others who might have an opinion on this jump in.

Mr. BARTLETT. Mr. Chairman, we have had 6 years experience now, so it is clear that what we are doing now is at best nonproductive for the American consumers, and in many cases, counterproductive. Number 1 is provide a safe harbor to the regulators to draft a short form that institutions can rely on, that is the single source, largest source of the complexity is that companies have to protect themselves from various kinds of allegations they think could be leveled against them, and so that is what adds to the complexity.

Senator CRAPO. Are you telling me that lawyers write these notices?

[Laughter.]

Mr. BARTLETT. Of course, because these are legally required notices with some detail in Title 5 of Gramm-Leach-Bliley.

Senator CRAPO. I knew that by reading them, but go ahead.

[Laughter.]

By the way, I am a lawyer too.

Mr. BARTLETT. So if in fact we want to simplify them, then give the regulators the right for a safe harbor to create a simplified notice, a safe harbor, and if a company uses that then they are safe.

Second, reduce the number of notices to at a time in which there is some kind of a change in the customer relationship. You can define that in a lot of different ways. But the idea of annual notices seemed like a good idea at the time, 6 years ago, but has proved to be a pretty idea in terms of the effect of the notices.

So those are the two big changes that should be made. We support notices but they should be made usable for the consumers.

Senator CRAPO. Mr. Hayes.

Mr. HAYES. I would never insinuate that a lawyer writes those notices.

[Laughter.]

I was talking to Congressman Ford yesterday in Memphis, and we got engaged in a broader issue than this dealing with financial literacy, but I think it translates over to general literacy of a population that we have. And quite honestly, I think there is the challenge, is how do we write something that a normal, real person can understand? I mean to me it is, “We do not sell your information. We do not give your information.” You know, it has to be very succinct, written as newspapers are, on an educational level that people can understand. It cannot be written in legalese that people say, “I do not understand it,” and throw it away. I mean I think it is important. Privacy of information, no matter who you are, is very important. And to be told what happens with your information is very important to the individual, but we have to make it so that people understand.

Once we articulate that and provide that, it is really somewhat of a nuisance to continually send that out. So, I mean I think at the end of the day, we value our customers. That is what gives us revenue. That is what drives our business. That is what drives our community. I think we are trying to always be fair, but let us be real and let us write it to where people can understand what we are saying.

Senator CRAPO. Thank you.

Anybody else want to——

Mr. PLUNKETT. Senator.

Senator CRAPO. Yes.

Mr. PLUNKETT. Senator, if I could comment on this from a consumer point of view. The primary problem with the Gramm-Leach-Bliley privacy notices is that the notices are provided to consumers on an opt-out basis. That is, unless consumers respond to a notice that is often buried in an envelope with much other information, then they are not able to stop the sharing of their private financial information with third parties.

Consumers typically do not respond to opt-outs. Our recommendation at the time the Gramm-Leach-Bliley Act was put on the books was make it an opt-in. Give consumers the affirmative right to stop the sharing of information, include both affiliate information—internal sharing among financial affiliates—and third-party information. Tell the institutions that they cannot share this information unless the consumer responds affirmatively.

These institutions are very good at marketing. They would make a strong pitch as to why it is in the consumers' interest to allow the banks to share information. But the consumer would be in control of that process. That is the primary way to improve these privacy notices.

Now, assuming that Congress does not listen to my advice, it is true, it is actually the fault of both the financial institutions and the regulators that the privacy notices are written so poorly. The institutions themselves are protecting themselves from legal liability. The regulators have provided a poor starting point, a poor model for understandable privacy notices. You do not need a safe harbor to change that. We could sit down with consumers, regulators and the industry—once again, this is an industry that is extremely good at talking to consumers in an understandable fashion when they want to—and we could come up with privacy notices that everybody would be comfortable with and that you would not need a safe harbor to promote.

Senator CRAPO. Mr. Connelly, and then I will have to move to Senator Sarbanes.

Mr. CONNELLY. Thank you, Senator. At my bank we understand that sacred trust between the customer and the bank, and we do not share information with any third parties. I would suggest that the current privacy notice, we understand what privacy is, but it is pretty tough to explain it when you get one of those notices. And I think that notice is analogous to the current HIPAA notices that you might get when you go to your doctor's office or your local pharmacy. Though it is a good law, I am told by the receptionist at my doctor's office that I have to sign this. I am also told that nobody reads the notice. Maybe after the first time you got the notice you might have read it, but you sign it, and then for regulatory purposes everybody is covered, as they say.

So that we strongly support maybe a revised disclosure that takes care of all circumstances unless there is a major change, and in fact, the regulators could be empowered to delineate what constitutes a major change. Then you would have to renotice the customer.

Senator CRAPO. Thank you very much. I appreciate that. This is a very tough issue we have been working on for sometime now, but I commit to keep working on it until we get it resolved.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Connelly, I just make the observation if all banks followed the practice of your banks, there probably would not be any legislation required and we would not have the problem of privacy notices.

This notion that somehow that Congress is looking to do these things, we are prompted into them by the derelictions that take place in the workings of the marketplace. Let me give you an example right now. How many of you think there should be legislation on data breaches?

[Three witnesses raised their hands.]

Now, why do you think that? You think that because of what has happened recently. Had none of this transpired, no one would be talking about data breaches and thinking about legislation on it.

On June 17, MasterCard International reported a breach of payment card data which potentially exposed more than 40 million cards of all brands to fraud. Even the FDIC lost some records of 6,000 of their employees, current and former. The breach was discovered when employees learned that identity thieves were taking out signature loans in their names at a credit union. We know about CitiFinancial, MCI, Bank of Commerce, Bank of America, Commerce Bank, PNC Bank, and Wacovia. Bank employees may have stolen financial records of 700,000 customers of four banks. The bank employees sold the financial records to collection agencies. Time-Warner, then some of the universities, HSBC.

We are not looking for these things, but the deficiencies in the system which make this possible may require legislation. When I took over the chairmanship of this Committee I never expected to do Sarbanes-Oxley. We had an entirely different agenda. Then Enron collapsed, WorldCom collapsed. We had a panic in the markets and so forth.

Let me ask Mr. Plunkett this question. In your statement, you point out that securities firms that own ILC's have taken the lead in promoting the ILC expansions. 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 they are allowed to do under Gramm-Leach-Bliley. Instead they offer to set up a shadow banking system through the ILC. They want to be able to offer the same services and loans as commercial banks without the same regulatory oversight. Could you develop that point?

Mr. PLUNKETT. Yes, sir. To use a bad analogy, we have investment firms, all of the big ones, who either own ILC's or want to own ILC's, attempting to skirt the requirements of the Gramm-Leach-Bliley Act regarding Federal Reserve oversight of bank holding companies. They are offering in many cases banking services that are indistinguishable from other banks. So they are walking like a duck, they are quacking like a duck, but they are not regulated like a duck.

Our concern is that these firms very recently have shown themselves vulnerable to conflicts of interest that have hurt their investors. One need only have picked up the paper in the last 2 weeks to see that major fines by the SEC were handed down against Citi and one other large investment bank in the Enron case to remind us that this has been the situation. We have heard a lot of discussion about ILC's on the House side, a great deal of discussion about commercial firms owning ILC's, and there are significant reasons why that is a bad idea. But one item that seems to have escaped a lot of notice is the current ownership of ILC's by investment firms and the hazards there.

I would just like to bring that to the Committee's attention and ask that the Committee examine that concern equally with the concern about commercial firms owning ILC's.

Senator SARBANES. Mr. Bartlett, when you are in favor of that House provision for *de novo* banking, were you reading the provision to permit the ILC's to do this, or I mean had you not read it that way?

Mr. BARTLETT. Mr. Chairman, I support the entire provision. I would answer in two ways. First of all, our organization, supports ILC's and have a fundamental disagreement with what was said, but there is a disagreement about ILC's. We believe that ILC's are duly chartered, and in fact are a depository institution regulated both by State banking authorities and by the FDIC.

But more to the point for this bill, we believe that the action for this bill, particularly for interstate branching, is an issue of banking and of the issues in this bill, and so these issues should be dealt with. Interstate branching is an issue that needs to be addressed, interstate branching should be permitted for banks. The ILC issue becomes one issue that needs to be debated, perhaps some middle ground found, some kind of a resolution of it, but the core of interstate branching is interstate branching from Baltimore to Philadelphia, having nothing to do with ILC's.

Senator SARBANES. So you disagree with the Federal Reserve's position on ILC's; is that correct?

Mr. BARTLETT. I do, but I do believe the whole ILC issue is an issue that does requires some additional debate, that can find a middle ground, and that we should find a middle ground, but it should not be allowed to stop this legislation.

Senator SARBANES. Of course the more you load on this legislation, the more difficult it is to move it along. I think that is pretty obvious.

Mr. Korst, I wanted to ask you a question. I am not quite sure I understood your testimony. Is it your position or is it the implications of the position you are taking that no State would be preempted with respect to the laws that it has dealing with the rent-to-own issue?

Mr. KORST. Yes, That is correct.

Senator SARBANES. I see. So States like New Jersey, Wisconsin, and other States like that, which currently have some fairly extensive consumer protections, would be able to keep them all in place?

Mr. KORST. I think a point of clarification in a couple of those States.

Senator SARBANES. That is what I am seeking. That is why I am asking the question.

Mr. KORST. In Minnesota, Wisconsin, and New Jersey, Senator, in the absence of any defining State regulation, and additionally in the absence of any controlling Federal statute, over the past 20 years there has been a considerable amount of litigation in both State and Federal Court, and a number of conflicting decisions by those courts. What S. 603 would do would resolve the issue. And by the way, the issue that has been at play there is, are these transactions to be considered consumer credit sales under the existing State consumer credit sales laws, which by the way, were enacted well before these transactions came into existence in the marketplace, or are they something different?

And in the absence of any clear defining regulatory standard, litigation has created some murky and difficult legal circumstances in those States. S. 603 would resolve that issue by placing into the Federal consumer protection statutes a Federal definition of what constitutes a rental purchase transaction.

Senator SARBANES. Would that definition be binding on all States?

Mr. KORST. Yes, sir.

Senator SARBANES. So a State whose regulatory framework currently depended on a different definition would be preempted; is that correct?

Mr. KORST. States would not be permitted, under S. 603, if it were to be enacted, to mischaracterize the transaction as something it is not. In that respect I suggest that this proposal is consistent with Congress's direction on truth in lending and consumer leasing, wherein Congress established definitions of credit transaction and consumer lease, provided a minimum amount of consumer protections——

Senator SARBANES. You would preempt the definition on the part of all States; is that correct?

Mr. KORST. I am sorry, Senator.

Senator SARBANES. You would preempt the definition on the part of all States. You would require them all to use your definition.

Mr. KORST. That is correct.

Senator SARBANES. Even if they are now using a different definition.

Mr. KORST. To the extent there are any States that have——

Senator SARBANES. With respect to the definition, I would call that preemption.

Mr. KORST. And I think the view that we have——

Senator SARBANES. Do you have a different name for it?

Mr. KORST. Pardon me.

Senator SARBANES. Do you have a different name for it?

Mr. KORST. No. We believe, however that Congress——

Senator SARBANES. Let me ask you this question. What percent of the merchandise under rent-to-own eventually become purchases?

Mr. KORST. Just about all of it is purchased at some point in the inventory life, Senator. Some percentage of it, just under 5 percent, is actually either stolen or returned to us in an unrentable or unusable condition. But the balance of the merchandise is eventually owned by one of our customers in some form or fashion.

However, the way out transaction works, of course, consumers have the option to terminate at any time and to return the goods. In fact, most do. Twenty-five percent of our transactions result in customers acquiring ownership. The other 75 percent, the transaction is terminated and the property is returned to us. During the life of our inventory, on average it is rented by 4½ different consumers, and so when I say all of our merchandise is owned eventually by some consumer, in most cases it is after it has been rented by 3 or 4 or 5 or 6 different consumers, and then the last consumer ultimately acquires ownership of that property.

Senator SARBANES. I wanted to ask the people at the panel—and it follows up on a question I put to the previous panel. I do not know how many of you were here for that. First of all, do you feel that you have been adequately consulted by the regulators as they explore the question of what recommendations to make for the consideration of the Congress?

Ms. CARTER. Consumer groups would greatly appreciate greater involvement in this process, and not just at the initial stage when comments are given, but at the consensus development stage.

Senator SARBANES. Anyone else?

Mr. LOSETH. Yes, Senator Sarbanes. CUNA has worked close with the NCUA on different aspects of CURIA, different aspects of member business lending, and prompt corrective action, and we feel that we are working together well with the recommendations that are in the bill.

Senator SARBANES. Do any of you—sorry, go ahead.

Mr. HAYES. I feel like we have been very engaged in the process. I mean we are very close to our customers. We are very close to our banks that are throughout the country. We travel throughout the country, and we are getting that input and that input is being exchanged with the regulatory authorities, and I think the process has been very good, because we are putting things on paper. It is a tough job. As I sat here on this side, not on that side, I mean we could spend 5 days together in a room, and in some cases we may not be agreeing on every item. But I think at the end of the day we have to come to some agreement on some items to move forward or we will be sitting here 5 years from now talking about the same issues.

Senator SARBANES. Mr. Connelly.

Mr. HAYES. So there is a process that we have to figure out how to do it.

Senator SARBANES. Mr. Connelly.

Mr. CONNELLY. Sir, we have had open and continuing dialogue with both the regulator, community and consumer groups, and I would suggest that Senator Crapo has been very open about inviting consumer groups to provide more input. I think Chairman Reich will probably make additional outreaches. And I guess the answer is, now is the time. We believe that we have very adequately and continually participated with consumer groups as it relates to the needs in our community and who——

Senator SARBANES. Do you see problems—I am asking the industry people now—in the regulators having these consultation groups that would encompass both industry and consumer representatives, particularly as you are trying to see what kind of consensus can be reached?

I know on the one hand that gives you more of a challenge since you will be at a table with the people that are not of like mind. But it seems to me it is a setup a little bit if everyone at the session is essentially of the same mind when we are trying to see if we cannot work through this situation toward achieving some consensus which would then have an enhanced credibility and an enhanced legitimacy. What is the problem with sessions of that sort, other than it is a more difficult meeting to presume, may well be a more difficult meeting to work through?

Mr. ROCK. Senator, I think that increased input from all sides of the issue is always a good thing, but by the same token, it does not surprise me that on some issues that are in that matrix that there has not been much input from the consumer side because some of those issues are very technical and very specific to narrow areas of the industry. For example, if you were to ask consumer groups or consumers about the effectiveness of a 314(a) inquiry, response and inquiry practice, I do not think that many consumer groups or consumers would be familiar with that and have meaningful input on that.

So it does not surprise me that perhaps there has not been input on some of those items that are in the matrix.

Senator SARBANES. I think the question is whether there has been input on most or all of the items in the matrix, but I will ask the consumer groups to answer to that themselves.

Mr. PLUNKETT. Senator, the key idea, which you have hit on, is a meaningful dialogue, and a meaningful dialogue—your point is well taken, a meeting where the regulators can hear the pitch from the financial services people, see if consumer groups have followed the issue, have a response, ask industry representatives to address consumer concerns, get immediate feedback, have a dialogue. That allows the regulators to better understand the pros and the cons of various proposals, and it gives us, the consumer community, the opportunity to have not just input, as Carolyn Carter said, but to have meaningful input when it comes to decisionmaking.

Mr. VADALA. Senator, NCUA did a very good job of getting input on PCA in particular. They had a summit meeting which brought people together. They got written comments. They had witnesses appear at the summit, kept it open for public comment, trying to get diverse views on this issue, and have talked to other regulatory agencies. So, I really believe that they have done a great job on that particular issue and on many of the others. We are very happy with what they have done.

Mr. LOSETH. Senator, most of the changes in regulations, as they affect credit unions, directly affect the members of the credit union who own the credit union. So from what I can tell from the provisions in the bill, most all of these changes will result in putting money back in the pockets of Americans.

Mr. CONNELLY. Senator, I think that today is an example of where people from different perspectives come together and express their thoughts, and can do it collaboratively and collegially, and I would suggest that with Senator Crapo's invitation for more openness—I think maybe Chairman Reich got that sense—there is still time to be more open to the consumer advocacy perspective, and it should certainly be taken into consideration by your Committee.

Senator SARBANES. Mr. Chairman, I know the hour is late. I want to thank this panel for their contribution. I particularly want to thank—these are the statements from today's testimony, and it is obvious that many people have put a great deal of time and effort into preparing these statements. In many instance they are quite detailed. I think that is extremely helpful to us because on this issue much of the difficulty is in the details.

It is easy enough to lodge a general complaint about some requirement that the regulators now have in place. The question is, was it put there for a good reason? Does the reason still serve a purpose? Is there some way it can be done with some less onerous requirements?

But I do not see how just listening to the general complaint one can move to a decision that we just should not have this thing. I mean the general complaint reflects a sense in the industry that they are overloaded. But as you address the overload you have to take each requirement, it seems to me, and analyze it very carefully as to the purpose it serves and so forth.

Now, we are getting a lot of complaints about the Bank Secrecy Act and so forth, but of course, on the other side, we have very important questions about the financing of terrorism, the financing of criminal activities, and so forth. So we need to look at all of that.

Actually, some of the people most on the other side on that issue are people in the Department of Justice, in FinCEN at the Treasury and so forth, who think these requirements are very important to their efforts to try to deal with I think what most people would concede are serious problems. So how you work that out is an important challenge. I think the detail is extremely important. It is easy enough to make the generalized statements, but then when you come to taking action on it you have to come down into the details and take a careful look at what the pros and cons and the pluses and minuses are in terms of other interests that are involved and other objectives we are trying to achieve.

So it is obvious a lot of work went into these statements, and I want to thank the panel members for it.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you, Senator Sarbanes, and I certainly agree with that. The two hearings we have had on this issue plus the incredible amount of input that we have received outside of the hearings has been very, very helpful in our efforts to move forward on the process of trying to go from the general complaint and the general objective of getting reform to the specifics, and I appreciate the witnesses very much.

I had a bunch of other questions, but the time has gotten away from us, and we are going to have to wrap up the hearing at this point. I will submit some written questions, and I think you should all expect that you would get some written questions from some of the other Senators who did not arrive here, and we would appreciate it if you would be willing to respond to those questions.

I again want to thank all of you for your input, encourage you to move ahead. I think one of you said that the time is now. And the time is now. We want to move ahead very quickly now to try to get prepared for a markup, and start into the next phase of this process where we will be moving ahead aggressively to achieve the objectives of this bill.

With that, again, I thank all the witnesses, and this hearing will be concluded.

[Whereupon, at 1:22 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF JOHN M. REICH *

VICE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 21, 2005

Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, I very much appreciate the opportunity to testify and update you on our efforts to reduce unnecessary regulatory burden on depository institutions insured by the Federal Deposit Insurance Corporation (FDIC). I am here today as the leader of the interagency regulatory review process mandated by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). In this capacity, and as a former community banker with over 23 years of experience, I share your commitment to pursue meaningful regulatory relief legislation, while maintaining the safety and soundness of the banking industry and protecting important consumer rights. This is an important endeavor and I think our Nation's financial institutions, particularly America's smaller community banks, are counting on us to succeed in our efforts to reduce regulatory burden.

My testimony this morning will discuss the importance of balancing the relative costs and benefits of regulations, the proliferation of regulation in recent years and the high costs on the industry. It will also discuss the cumulative effect of regulations on our Nation's bank and thrift institutions, particularly smaller community banks. I will also outline our interagency efforts to review regulations and address the existing regulatory burden, as mandated by EGRPRA. I then will describe actions the FDIC has taken to reduce burdens imposed by our own regulations and operating procedures. Finally, I will outline a dozen specific legislative proposals to reduce regulatory burden that all of the Federal bank and thrift regulators have agreed to support, as well as many more that are supported by more than one regulatory agency.

The Importance of Balancing the Costs and Benefits of Regulation

Our bank regulatory system has served us quite well, often helping to restrain imprudent risk-taking, protect important consumer rights and fulfill other vital public policy objectives. Statutes and regulations help preserve confidence in the banking industry and in the financial markets by ensuring that institutions operate in a safe and sound manner, promoting transparency in financial reporting, and encouraging fair business practices. However, as more and more laws are passed, and new regulations are adopted to implement those laws, it is incumbent upon policymakers to ensure that the intended benefits justify the considerable costs. We need to take stock periodically of the cumulative effect of all regulatory requirements on the industry. No one would advocate a system where people spend more time trying to figure out how to comply with all the laws than engaging in their primary economic activity. As Federal Reserve Board Chairman Alan Greenspan said in a speech a few months ago, "to be effective regulators we must also attempt to balance the burdens imposed on banks with the regulations' success in obtaining the intended benefits and to discover permissible and more efficient ways of doing so." I could not agree more. It is all about balance, and I am afraid that the scales have now tipped too heavily to one side and need to be rebalanced.

The Proliferation and High Cost of Regulation on the Industry

In my testimony before this Committee last year, I reported that, since enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, the Federal bank and thrift regulatory agencies promulgated a total of 801 final rules. Since I testified in June of last year, the agencies adopted an additional 50 final rules, which means that there have been a total of 851 final rules adopted since FIRREA—an average of about 50 new or amended rules promulgated every year. This does not include the rules adopted by the Securities and Exchange Commission (SEC), Financial Accounting Standards Board (FASB), Public Company Accounting Oversight Board (PCAOB), American Institute of Certified Public Accountants (AICPA) and a whole host of State regulatory authorities nor regulations that apply to companies in general (such as tax and environmental rules).

It is a challenge for bankers to maintain the capacity to respond to the steady stream of new regulations while continuing to comply with existing ones. Recently enacted 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 un-

* Appendix held in Committee files.

necessarily increasing regulatory burden on the industry as we implement new requirements mandated by legislation.

Rule changes, particularly for smaller community banks with limited staff, can be 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. The 4,094 insured institutions with less than $100 million in assets last year have, on average, fewer than 20 employees and the 1,000 smallest community banks and thrifts in the country average fewer than 10 employees. It is hard to imagine how those institutions can continue to serve their customers' needs and also meet myriad new regulatory requirements.

The cost of all of our regulatory requirements is hard to measure because it tends to become indivisible, if not invisible, from a bank's other activities. While there are no definitive studies, 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 $38 billion in 2004 (The Cost of Bank Regulation: A Review of the Evidence," Gregory Elliehausen, *Federal Reserve Bulletin,* April 1998). Regulatory burden is an issue for all banks, but I believe that the burden falls heaviest on America's smaller community banks, as explained in the next section.

The Impact of Regulatory Burden on Community Banks

New regulations have a greater impact on community banks, especially smaller 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. The magnified impact of regulatory burden on small banks is a significant concern to me. Community banks play a vital role in the economic well-being of countless individuals, neighborhoods, businesses, and organizations throughout our country, serving as the very lifeblood of their communities. These banks are found in all communities—urban, suburban, rural, and small towns. They are a major source of local credit. Data from the June 2004 Call Reports indicates that over 90 percent of commercial loans at small community banks were made to small businesses. In addition, the data indicates that community banks with less than $1 billion in assets, which hold only 14 percent of industry assets, account for 45 percent of all loans to small businesses and farms.

Community banks 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 in civic leadership, charitable contributions, and local investment in school and other municipal debt. I have a real concern that the volume and complexity of existing banking regulations, coupled with new laws and regulations, are increasingly posing a threat to the survival of our community banks.

Over the last 20 years, there has been substantial consolidation in the banking industry. This can be seen most dramatically in the numbers of small community banks. At the end of 1984, there were 11,705 small community banks with assets of less than $100 million in today's dollars. At year-end 2004, the number of small community banks dropped by 65 percent to just 4,094 (see Chart 1). For institutions with assets of $1 billion or less in 2004 dollars, there has been a decline of 8,761 institutions, or 51 percent over the 20-year period. This chart underscores the point that the rate of contraction in the number of community banks increases with decreasing asset size. The smaller the institutions, the greater the rate of contraction—even when we adjust size for inflation.

The decline in the number of community banks has three main components: Mergers; growth out of the community bank category; and failures. These factors were only partially offset by the creation of more than 2,500 new banks during 1985–2005. (In the above calculations, bank asset size is adjusted for inflation. Thus, a bank with $100 million in assets today is compared with one having about $63 million in assets in 1985.) A number of other market forces, such as interstate banking and changes to State branching laws impacted the consolidation of the banking industry. The bank and thrift crisis of the 1980's 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 regulatory burden plays a significant role in shaping the industry, including the number and viability of community banks. While many new banks have been chartered 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 needs are met, especially as bank mergers continue to reduce choices in some local markets.

More dramatic than the decline in numbers of institutions has been the decline in market share of community banks. As Chart 2 indicates, the asset share of small community banks decreased from 9 percent to 2 percent in the past 20 years, while the share of institutions with less than $1 billion in assets fell from 33 percent to 14 percent. This chart understates the real loss of market share for these institutions, since it does not reflect the growing importance of asset management activities that generate revenues but do not create assets on institutions' balance sheets. Chart 3, which presents community banks' share of industry earnings, shows a greater loss of share, from 12 percent to 2 percent for small community banks, and from 44 percent to 13 percent for institutions with less than $1 billion in assets.

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 $122.9 billion, surpassing the previous annual record of $120.5 billion set in 2003. 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 117 largest banks in the country (those with assets over $10 billion), which represent 1.3 percent of the total number of insured institutions, earned $89.3 billion or about 73 percent of total industry earnings. This is in contrast to the 4,094 banks with assets under $100 million, which represent 46 percent of the total number of insured institutions and earned about $2.1 billion or only 1.7 percent of total industry earnings (see Chart 3). Moreover, when the data is examined further, you find that banks with assets over $1 billion had an average return on assets (ROA) of 1.31 percent, while those with assets under $1 billion had an average ROA of 1.16 percent (see Chart 4).

The ROA comparisons understate the actual disparity in performance between community banks and their larger counterparts. The 15 basis-point difference in nominal ROA last year increases to a 43 basis-point gap when the data is adjusted for the accounting effects of large-bank mergers and different tax treatment of Subchapter S corporations. One of the main causes of the growing difference is the greater ability of large institutions to spread their overhead costs across a larger and more diverse base of revenues. Chart 5 illustrates the growing efficiency gap separating large and small institutions. It shows the extent to which noninterest expenses absorb operating revenues. Throughout the early 1990's, both large and small institutions were able to control expense growth and increase revenues so that their efficiency ratios improved (declined) in tandem. During the past 6 years, however, larger institutions have been able to continue to improve their efficiency, whereas community banks have not. The regressive burden of regulation, which increased considerably during this period, contributed to this divergence in performance. Last year, more than one out of every 10 small community banks was unprofitable. That was more than four times the proportion of larger institutions that were unprofitable. 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.

Community bankers are 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. 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. While we have only anecdotal evidence on this point, conversations concerning merger or sale of institutions are likely occurring today in many community bank boardrooms all over the United States.

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 that, in many cases, have evolved from small niche players to full-service retail depository institutions. In the past 10 years, the number of credit unions with assets exceeding $1 billion increased almost five-fold, from 20 institutions in 1994 to 99 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.

Interagency Effort to Reduce Regulatory Burden

In 1996, Congress passed the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). EGRPRA requires the Federal Financial Institutions Examination Council (FFIEC) and each of its member agencies to review their regulations at least once every 10 years, in an effort to eliminate any regulatory requirements that are outdated, unnecessary or unduly burdensome. For the past 2 years, I have been leading the interagency effort and am pleased to report that we are making progress.

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 agencies have already jointly published four separate requests for comment in the *Federal Register*. The first notice, published on June 16, 2003, sought comment on our overall regulatory review plan as well as the initial three categories of regulations: Applications and Reporting; Powers and Activities; and International Operations. The second interagency notice, published on January 20, 2004, 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 third notice, published on July 20, 2004, sought public comment on remaining consumer protection regulations (which relate primarily to deposit accounts/relationships). The fourth notice, published on February 3, 2005, sought public comment on our antimoney laundering, safety and soundness and securities regulations.

These four requests for comments have covered a total of 99 separate regulations. In response to these requests, the agencies received a total of 846 comment letters from bankers, consumer and community groups, trade associations and other interested parties. Each of the recommendations is being carefully reviewed and analyzed by the agency staffs. Based on these reviews, the appropriate agency or agencies may bring forward, and request public comment on, proposals to change specific regulations.

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 be informed about the EGRPRA project and to let us know what 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, with direct links to the actual text of each regulation. Comments submitted through the website are automatically transmitted to all of the financial institution regulatory agencies and posted on the EGRPRA website. 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, it also is important to have face-to-face meetings with bankers and consumer group representatives so they have an opportunity to communicate their views on the issues directly. Over the past 2 years, the agencies sponsored a total of nine banker outreach meetings in different cities around the country to heighten industry awareness of the EGRPRA project. Two additional meetings are scheduled for tomorrow in New Orleans and September 21 in Boston. The meetings provide an opportunity for the agencies to listen to bankers' regulatory burden concerns, explore comments and suggestions, and identify possible solutions. To date, more than 450 bankers (mostly CEO's) and representatives from the national and State trade associations participated in these meetings with representatives from FDIC, FRB, OCC, OTS, CSBS, and the State regulatory agencies. Summaries of the issues raised during the meetings are posted on the EGRPRA website.

We also held three outreach meetings for consumer and community groups. Representatives from a number of consumer and community groups participated in the meetings, along with representatives from the FDIC, FRB, OCC, OTS, NCUA, and CSBS. The meetings provided a useful perspective on the effectiveness of many existing regulations. We will hold one additional meeting with consumer and community groups on September 22 in Boston, Massachusetts, and we are willing to hold additional meetings if there is sufficient interest among consumer and community groups.

Response by the Regulatory Agencies

The tremendous regulatory burden that exists was not created overnight and unfortunately, from my perspective, cannot be eradicated overnight. It is a slow and arduous process, but I believe that we are making some headway. In fact, the banking and thrift regulatory agencies are working together closely and harmoniously on a number of projects to address unnecessary burdens affirmatively. In addition to eliminating outdated and unnecessary regulations, the agencies have identified more efficient ways of achieving important public policy goals of existing statutes. Although we have much work ahead of us, there has been significant progress to date. Here are some notable examples:

Community Reinvestment Act Regulations

On February 22, 2005, the FDIC, along with the OCC, issued a proposal to amend the Community Reinvestment Act (CRA) regulations. The Federal Reserve Board issued a very similar proposal shortly thereafter. The agencies' proposal would raise the "small bank" threshold in the CRA regulations to $1 billion in assets, without regard to holding company assets. This would represent a significant increase in the small bank threshold from the current level of $250 million which was established in 1995. Under the proposal, just over 1,566 additional banks (those with assets between $250 and $1 billion) would be subject to small bank reporting and streamlined examination standards.

This proposal does not exempt any 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. The proposal includes a "community development test" for banks between $250 million and $1 billion in assets which would be separately rated in CRA examinations. This community development test would provide eligible banks with greater flexibility to meet CRA requirements than the large bank test under which they are currently evaluated. Another effect of the proposal would be the elimination of certain collection and reporting requirements that currently apply to banks between $250 million and $1 billion in assets.

These changes to the regulation, if adopted as proposed, would result in significant regulatory burden reduction for a number of institutions. 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—and I remain receptive to all points of view. The comment period for this proposal closed on May 10, 2005, and the FDIC received approximately 3,800 comment letters. It is my hope that, after carefully considering all comments, the agencies will agree on a final rule before the end of this year.

Privacy Notices

On December 30, 2003, the Federal bank, thrift and credit union regulatory agencies, in conjunction with the Federal Trade Commission, SEC, 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 solicited comment 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 conducting consumer research and testing that will be used to develop privacy notices that meet these goals. As they do so, it is important for the agencies to continue to be mindful that changes to privacy notices and the requirements for their distribution may themselves create new costs for the banking industry.

Consumer Disclosures

In recent speeches, Acting Comptroller Julie Williams called for a comprehensive review of existing consumer disclosures to make them more useful and understandable for consumers as well as less burdensome for banks. I applaud her efforts to highlight this issue and agree that we should take a careful look at the large number and actual content of all consumer disclosures required by law. Consumers may in fact be experiencing "information overload." Beginning with the Truth in Lending Act 35 years ago, through the privacy provisions of the Gramm-Leach-Bliley Act and culminating with the recently enacted FACT Act, there are now dozens of consumer laws and regulations, any number of which might apply, depending on the transaction. Chart 6 graphically depicts some of the laws and regulations that a bank must be concerned with under different mortgage lending scenarios.

The sheer number of potential disclosures raises several questions: (1) Are the numbers of disclosures too many for banks and consumers to deal with effectively; (2) do consumers find the disclosures too complicated, conflicting, and duplicative; and (3) are these disclosures failing to achieve their designated purpose in helping consumers become informed customers of financial services? I think we need to look at the whole panoply of disclosures and find ways to eliminate the existing overlap, duplication, and confusion. We may have reached a point where we have "nondisclosure by over-disclosure." I look forward to working with my fellow regulators to improve the current situation with respect to consumer disclosures.

BSA and USA PATRIOT Act Guidance

There is no question that financial institutions and the regulators must be extremely vigilant in their efforts to implement the Bank Secrecy Act (BSA) in order to thwart terrorist financing efforts and money-laundering. Last year, bankers filed over 13 million Currency Transaction Reports (CTR's) and over 300,000 Suspicious Activity Reports (SAR's) with the Financial Crimes Enforcement Network (FinCEN). Although FinCEN is providing more information to bankers than previously, bankers still believe they are filing millions of CTR's and SAR's that are not utilized for any law enforcement purpose. Consequently, bankers believe that a costly burden is being carried by the industry 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 CTR's and SAR's and make the reports that are filed more useful for law enforcement and to communicate with bankers more effectively.

In the next week or so, the bank and thrift regulatory agencies are expected to issue detailed BSA examination procedures that will address many of the questions bankers have about BSA compliance. To further assist banks, the agencies and FinCEN issued interpretive guidance designed to clarify the requirements for appropriately assessing and minimizing risks posed when providing banking services to Money Services Businesses. Bankers understand the vital importance of knowing their customers and thus generally do not object to taking additional steps necessary to verify the identity of their customers. However, bankers wanted guidance from the regulators on how to establish appropriate customer identification requirements under the USA PATRIOT Act. In response, the bank and thrift regulatory agencies, the Treasury Department and FinCEN issued interpretive guidance to all financial institutions to assist them in developing a Customer Identification Program (CIP). The interagency guidance answered the most frequently asked questions about the requirements of the CIP rule. Finally, with respect to the requirements of the Office of Foreign Assets Control (OFAC), the agencies are working to develop examination procedures and guidance for OFAC compliance.

I have met on several occasions with FinCEN's Director, William Fox, and pledged to work with him to make reporting under the BSA more effective and efficient, while still meeting the important crime-fighting objectives of antiterrorism and antimoney-laundering laws. I am convinced that we can find ways to make this system more effective for law enforcement, while at the same time make it more cost efficient and less burdensome for bankers.

FDIC Efforts to Relieve Regulatory Burden

In addition to the above-noted interagency efforts to reduce regulatory burden, the FDIC, under the leadership of Chairman Powell, has undertaken a number of initiatives to improve the efficiency of our operations and reduce regulatory burden, without compromising safety and soundness or undermining important consumer protections. Over the last several years, we have 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 initiatives to reduce regulatory burden include the following:

(1) Raised the threshold for well-rated, well-capitalized banks to qualify for streamlined safety and soundness examinations under the FDIC MERIT examination program 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, trust, and IT specialty examinations, placing greater emphasis on an institution's administration of its compliance and fiduciary responsibilities and less on transaction testing;

(3) Initiated electronic filing of branch applications through "FDIC Connect" and began exploring alternatives for further streamlining the deposit insurance application process in connection with new charters and mergers;
(4) Simplified the deposit insurance coverage rules for living trust accounts so that the rules are easier to understand and administer;
(5) Simplified the assessment process by providing institutions with electronic invoices and eliminating most of the paperwork associated with paying assessments;
(6) Amended our international banking regulations to expand the availability of general consent authority for foreign branching and investments in certain circumstances and replaced the fixed asset pledge with a risk-based pledge requirement;
(7) Reviewed existing Financial Institution Letters (FIL's) to eliminate outdated or unnecessary directives and completely changed the basic format of the FIL's to make them easier to read.
(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 making available 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 decisionmaking out to the field level to expedite decisionmaking 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.
(13) Amended the FDIC's securities disclosure regulations for banks subject to the registration and disclosure requirements of the Securities Exchange Act of 1934 so that the reporting requirements remain substantially similar to those required of all publicly traded companies by the Sarbanes-Oxley Act of 2002.
(14) Adopted revised guidelines for supervisory and assessment appeals to provide more transparency and independence in the appeals process.

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.

Legislative Proposals to Reduce Regulatory Burden

Mr. Chairman, I wish to commend you, Senator Crapo, and the other distinguished Members of your Committee for your efforts to develop legislation to remove unnecessary regulatory burden from the banking industry. Since most of our regulations are mandated by statute, I believe 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. In fact, the EGRPRA statute requires us to identify and address unnecessary regulatory burdens that must be addressed by legislative action.

Almost a year ago, I testified on regulatory burden relief before this Committee, along with 18 other witnesses. At the end of the hearing, Senator Crapo asked me, as the leader of the interagency EGRPRA task force, to review the testimony presented at the hearing and extract the various regulatory burden reduction proposals. The result was a matrix with a total of 136 burden reduction proposals.

Thereafter, I convened a meeting of banking industry representatives from the American Bankers Association, America's Community Bankers, the Independent Community Bankers of America, and the Financial Services Roundtable, who together reviewed the matrix of 136 proposals in an effort to determine which of these proposals they could all support as industry consensus items. This process yielded a list of 78 banking industry consensus items.

The FDIC reviewed the 78 banking industry consensus proposals for safety and soundness, consumer protection and other public policy concerns and determined that we could affirmatively support 58 of the 78 industry consensus proposals. There are other proposals that, after review, the FDIC determined we have "no objection" to or we take "no position" on, since the proposals do not affect either the FDIC or the institutions we regulate. There are only five of the banking industry consensus proposals that the FDIC opposes.

The next step in the consensus building process was to share our positions with the other Federal banking agencies in an effort to reach interagency consensus. After much work, negotiation, and compromise, the FRB, OCC, OTS, and the FDIC agreed to support twelve of the banking industry consensus proposals. This "bankers' dozen" includes the following specific proposals for regulatory burden relief, which are described in greater detail in the testimony's Appendix:

Authorize the Federal Reserve to Pay Interest on Reserves

This amendment gives the Federal Reserve express authority to pay interest on balances that depository institutions are required to maintain at the Federal Reserve Banks. By law, depository institutions are required to hold funds against transaction accounts held by customers of those institutions. These funds must be held in cash or on reserve at Federal Reserve Banks. Over the years, institutions have tried to minimize their reserve requirements. Allowing the Federal Reserve Banks to pay interest on those reserves should put an end to economically wasteful efforts by banks to circumvent the reserve requirements. Moreover, it could be helpful in ensuring that the Federal Reserve will be able to continue to implement monetary policy with its existing procedures.

Increase Flexibility for the Federal Reserve Board to Establish Reserve Requirements

This proposal gives the Federal Reserve Board greater discretion in setting reserve requirements for transaction accounts below the ranges established in the Monetary Control Act of 1980. The provision eliminates current statutory minimum reserve requirements for transaction accounts, thereby allowing the Board to set lower reserve requirements, to the extent such action is consistent with the effective implementation of monetary policy.

Repeal Certain Reporting Requirements Relating to Insider Lending

These amendments repeal certain reporting requirements related to insider lending imposed on banks and savings associations, their executive officers, and their principal shareholders. The reports recommended for elimination are: (1) reports by executive officers to the board of directors whenever an executive officer obtains a loan from another bank in an amount more than he or she could obtain from his or her own bank; (2) quarterly reports from banks regarding any loans the bank has made to its executive officers; and (3) annual reports from bank executive officers and principal shareholders to the bank's board of directors regarding their outstanding loans from a correspondent bank.

Federal banking agencies have found that these particular reports do not contribute significantly to the monitoring of insider lending or the prevention of insider abuse. Identifying insider lending is part of the normal examination and supervision process. The proposed amendments would not alter the restrictions on insider loans or limit the authority of the Federal banking agencies to take enforcement action against a bank or its insiders for violations of those restrictions.

Streamline Depository Institution Merger Application Requirements

This proposal streamlines merger application requirements by eliminating the requirement that each Federal banking agency must request a competitive factors report from the other three Federal banking agencies, in addition to requesting a report from the Attorney General. Instead, the agency reviewing the application would be required to request a report only from the Attorney General and give notice to the FDIC as insurer.

Shorten Post-Approval Waiting Period on Bank Mergers and Acquisitions Where There Are No Adverse Effects on Competition

The proposed amendments to the Banking Holding Company Act and the Federal Deposit Insurance Act shortens the current 15-day minimum post-approval waiting period for certain bank acquisitions and mergers when the appropriate Federal banking agency and the Attorney General agree that the transaction would not have significant adverse effects on competition. Under those circumstances, the waiting period could be shortened to 5 days. However, these amendments do not shorten the time period for private parties to challenge the transaction under the Community Reinvestment Act.

Improve Information Sharing with Foreign Supervisors

This proposal amends Section 15 of the International Banking Act of 1978 to add a provision to ensure that the Federal Reserve, OCC, FDIC, and OTS cannot be compelled to disclose information obtained from a foreign supervisor in certain circumstances. Disclosure could not be compelled if public disclosure of the information would be a violation of the applicable foreign law and the U.S. banking agency obtained the information under an information sharing arrangement or other procedure established to administer and enforce the banking laws. This amendment provides assurance to foreign supervisors that may otherwise be reluctant to enter into information sharing agreements with U.S. banking agencies because of concerns that those agencies could not keep the information confidential and public disclosure could subject the foreign supervisor to a violation of its home country law. It also facilitates information sharing necessary to supervise institutions operating internationally, lessening duplicative data collection by individual national regulators. 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 United States or the agency.

Provide an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act

This amendment increases the threshold for the small depository institution exception under the Depository Institution Management Interlocks Act. Under current law, a management official generally may not serve as a management official for another nonaffiliated depository institution or depository institution holding company if their offices are located, or they have an affiliate located, in the same metropolitan statistical area (MSA). For institutions with less than $20 million in assets, this MSA restriction does not apply. The proposal increases the MSA threshold, which dates back to 1978, to $100 million.

Exempt Merger Transactions Between an Insured Depository Institution and One or More of its Affiliates from Competitive Factors Review and Post-Approval Waiting Periods

This proposal amends the Bank Merger Act (12 U.S.C. 1828(c)) to exempt certain merger transactions from both the competitive factors review and post-approval waiting periods. It applies only to merger transactions between an insured depository institution and one or more of its affiliates, as this type of merger is generally considered to have no affect on competition.

Increase Flexibility for Flood Insurance

These amendments make a number of changes to the Flood Disaster Protection Act of 1973 to: (1) increase the maximum dollar amount qualifying for the "small loan" exception to the requirement to purchase flood insurance and adjust that maximum loan amount periodically based on the Consumer Price Index; (2) eliminate the 15-day gap between the 30-day grace period during which flood insurance coverage continues after policy expiration and the 45-day period required after policy expiration before a lender can purchase insurance on the borrower's behalf; and (3) replace the current mandatory system for imposing civil monetary penalties in response to significant violations of the flood insurance requirements with a discretionary system for doing so. These amendments would both reduce burden on lenders and give the Federal supervisory agencies greater discretion to tailor their responses to violations more closely to the facts of individual cases.

Enhance Examination Flexibility

This proposal raises the total asset threshold for small institutions to qualify for an 18-month examination cycle from $250 million to $500 million, thus potentially permitting more institutions to qualify for less frequent examinations. The FDI Act requires the banking agencies to conduct a full-scale, on-site examination of the insured depository institutions under their jurisdiction at least once every 12 months. The Act provides an exception for small institutions—that is, institutions with total assets of less than $250 million—that are well-capitalized and well-managed, and meet other criteria. Examinations of these qualifying smaller institutions are required at least once every 18 months. The proposal would reduce regulatory burden on low-risk, smaller institutions and permit the banking agencies to focus their resources on the highest-risk institutions.

Call Report Streamlining

This proposal requires the Federal banking agencies to review information and schedules required to be filed in Reports of Condition (Call Reports) every 5 years to determine if some of the required information and schedules can be eliminated.

Preparing the Call Report has become a significant burden for many banks. A bank must report a substantial amount of financial and statistical information with its Call Report schedules that appears to be unnecessary to assessing the financial health of the institution and determining the amount of insured deposits it holds. This amendment requires the agencies to review the real need for information routinely so as to reduce that burden.

Authorize Member Bank to Use Pass-Through Reserve Accounts

This amendment allows banks that are members of the Federal Reserve System to count as reserves their deposits in affiliated or correspondent banks that are in turn "passed through" by those banks to the Federal Reserve Banks as required reserve balances. It extends to these member banks a privilege that was granted to nonmember institutions at the time of the Depository Institutions Deregulation and Monetary Control Act of 1980.

Additional Proposals

The above-noted, industry-backed proposals have the unanimous support of all the Federal bank and thrift regulatory agencies. However, they are not the only legislative proposals to reduce regulatory burden that are supported by one or more of the regulatory agencies. In fact, many of the other banking industry consensus items have support from multiple Federal banking agencies. In a matrix of legislative proposals prepared by Senate staff, there are dozens of proposals with multiple agency support, no objection, or no position. (It is important to note that the indication of "no position" by some agencies does not indicate that the agency has decided not to object to a particular proposal.) These proposals may yet yield a number of industry consensus regulatory burden relief proposals agreeable to all of the Federal banking agencies. We are continuing to work toward this goal within the context of the Interagency EGRPRA Task Force.

The EGRPRA process has produced a wealth of proposals. The synergism that has resulted from the EGRPRA process makes me believe that there is real momentum behind the effort to reduce regulatory burden on the industry. I 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 stated at the outset, the EGRPRA process addresses the problem of regulatory burden for every federally insured financial institution. Banks and thrifts, both large and small, labor under the cumulative weight of our regulations. 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 it the most. That is why 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 remain personally committed to accomplishing that objective, no matter how difficult it may be to achieve.

Now is the time to take action to address the unnecessary regulations that face the banking industry every day. There seems to be a real consensus building to address this issue. I remain 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 diluting important consumer protections.

Thank you for providing me with this opportunity to testify.

PREPARED STATEMENT OF JULIE L. WILLIAMS*

ACTING COMPTROLLER OF THE CURRENCY

OFFICE OF THE COMPTROLLER OF THE CURRENCY

JUNE 21, 2005

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I appreciate this opportunity to appear before you today to discuss the challenge of reducing unnecessary regulatory burden on America's banks. I also want to take

*Appendix held in Committee files.

this opportunity to express appreciation to Senator Crapo for his commitment and dedication to this issue.

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 national banks and the national banking system. We appreciate your efforts to pursue regulatory burden relief legislation, as evidenced by this hearing today.

Unnecessary burdens are not simply a matter 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. Over-regulation neither encourages greater competition nor improved allocation of resources; to the contrary, it can shackle competition and lead to inefficient use of resources.

The regulatory burdens imposed on our banks arise from several sources. One source is regulations promulgated by the Federal banking agencies. Thus, when we review the regulations we already have on the books and consider new ones, we have a responsibility to ensure that our regulations effectively protect safety and soundness, foster the integrity of bank operations, and safeguard the interests of consumers, and do not impose regulatory burdens that exceed what is necessary to achieve those goals, and thereby act as a drag on our banks' efficiency and competitiveness.

We also need to recognize that not all the regulatory burdens imposed on banks today come from regulations promulgated by *bank* regulators. Thus, we welcome the interest of the Committee in issues such as regulatory implementation of the Bank Secrecy Act and anti-money laundering standards, and the ongoing efforts by the Securities and Exchange Commission (SEC) to implement the so-called "push-out" provisions of the Gramm-Leach-Bliley Act (GLBA) in a manner that is faithful to GLBA's intent and not so burdensome as to drive established banking functions out of banks.

Another source of regulatory burden is mandates of Federal legislation. Thus, relief from some manifestations of unnecessary regulatory burden requires action by Congress. My testimony contains a number of recommendations for legislative changes to reduce unnecessary regulatory burden by adding provisions to law to provide new flexibilities, modify requirements to be less burdensome, and in some cases, eliminate certain requirements currently in the law. This hearing today is a crucial stage in that process.

In summary, my testimony will:

- First, summarize how the Federal banking agencies are working together under the able leadership of Federal Deposit Insurance Corporation (FDIC) Vice Chairman Reich through the process required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) to identify unnecessary regulatory burdens;
- Second, summarize some important regulatory initiatives that the OCC is pursuing with the other Federal banking agencies to reduce burden;
- Third, summarize several of the OCC's priority legislative items for regulatory burden relief;
- Fourth, in the area of consumer protection, explain how we can both reduce unnecessary regulatory burden and more effectively use disclosures to provide information to consumers in a more meaningful way;
- Fifth, provide an overview of some other legislative items that the OCC supports that are included in a regulator/industry consensus package; and
- Sixth, provide some additional comments about other legislative proposals.

Regulatory Initiatives to Address Regulatory Burden

EGRPRA Process

The OCC is an active participant in and supporter of the regulatory burden reduction initiative being led by FDIC Vice Chairman Reich. Under Vice Chairman Reich's capable and dedicated leadership, the Federal banking agencies are working together to conduct the regulatory review required under Section 2222 of EGRPRA. Section 2222 requires the Federal Financial Institutions Examination Council and each Federal banking agency to identify outdated, unnecessary regulatory requirements and, in a report to Congress, to address whether such regulatory burdens can be changed through regulation or require legislative action. The current review period ends in September 2006.

The Federal banking agencies—the OCC, the Board of Governors of the Federal Reserve System (Fed), the FDIC, and the Office of Thrift Supervision (OTS)—have divided their regulations into thirteen categories for purposes of publishing those regulations for review as part of the EGRPRA process. Since the first joint notice was published in mid-2003, the agencies have issued a total of four joint notices for public comment and are about to put out a fifth. To date, we have received over 700 comments on our notices. We anticipate that a sixth and final joint notice will be published in the first half of 2006. Every comment received will be considered in formulating the agencies' recommendations for specific regulatory changes as well as legislative recommendations.

Moreover, in addition to soliciting written comments, the Federal banking agencies, in conjunction with the Conference of State Bank Supervisors and State regulatory agencies, have held nine banker outreach meetings in different cities and regions throughout the country to hear firsthand the bankers' concerns and suggestions to reduce burden. Additional outreach meetings may be scheduled. The agencies also are making every effort to ensure that there is ample opportunity for consumers and the industry to participate in this process, and we have held three consumer and community outreach meetings, including one in the Washington, DC area.

Other Burden Reduction Regulatory Initiatives

The OCC constantly reviews its regulations to identify opportunities to streamline regulations or regulatory processes, while ensuring that the goals of protecting safety and soundness, maintaining the integrity of bank operations, and safeguarding the interests of consumers are met. In the mid-1990's, pursuant to our comprehensive "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. The following are several significant regulatory projects we are pursuing to identify and reduce unnecessary regulatory burdens.

Improving the Value and Reducing the Burden of Privacy Notices. The OCC, together with the other Federal banking agencies, the Federal Trade Commission, the SEC, and the Commodity Futures Trading Commission, have undertaken an unprecedented initiative to simplify the privacy notices required under GLBA. Over a year ago, the agencies asked for comments on whether to consider amending their respective 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 understandable and useful for consumers and less burdensome for banks to provide. 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.

The OCC and the other agencies then engaged experts in plain language disclosures and consumer testing to assist in conducting a series of focus groups and consumer interviews to find out what information consumers find most meaningful, and the most effective way to disclose that information to them. We expect that this consumer testing will be completed by the end of the year and will form the basis for a proposal to revise the current privacy notice rules. Personally, I believe 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 that produce and distribute privacy notices.

Reducing CRA Burden on Small Banks. Recently, the OCC, the Fed, and the FDIC proposed amendments to our Community Reinvestment Act (CRA) regulations. The comment period closed a little over a month ago—on May 10. Current CRA rules define a "small bank" as a bank with assets of up to $250 million. Banks above that asset threshold are categorized as "large" banks for CRA purposes and are subject to a three-part test that separately assesses their lending, services, and investments in their assessment areas.

The proposal would create a new class of "intermediate" small banks, namely those with assets between $250 million and $1 billion. "Intermediate" small banks would be subject to the streamlined small bank lending test and a flexible new community development test that would look to the mix of community development lending, investment, and services that a bank provides, particularly in light of the bank's resources and capacities, and the needs of the communities it serves. "Intermediate" small banks also would no longer be subject to certain data collection and reporting requirements.

The OCC, the Fed, and the FDIC joined in this proposal, which we thought was an effort to carefully balance the goals of reducing unnecessary regulatory reporting burdens with achieving the goals of the CRA. We are now reviewing the comments we received in response to the proposal and hope to conclude the rulemaking process in the near future.

OCC Support for Regulatory Burden Relief Legislation

The OCC also has recommended a package of legislative amendments that we believe will help reduce unnecessary regulatory burden on national banks and other depository institutions. I am pleased to present those items to you today for your consideration. In addition, the banking agencies have been discussing jointly recommending certain legislative changes to reduce burdens that have been identified as part of the EGRPRA process. The consensus items supported by the four Federal banking agencies and the industry also are discussed below in my testimony.[1] As the legislative process moves forward, we may jointly support additional items.

My testimony highlights some of the important items that the OCC believes will reduce regulatory burden on our banking system and 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 Appendix #1 to my testimony.[2]

National Bank-Related Provisions

Repealing State Opt-In Requirements for De Novo Branching. Repeal of the State opt-in requirement that applies to banks that choose to expand interstate by establishing branches *de novo* would remove a significant unnecessary burden imposed on both national and State banks that seek to establish new interstate branch facilities to enhance service to customers. 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. Interstate bank *mergers* are now permissible in all 50 states. *De novo* branching, however, is permissible only in those approximately 23 States that have affirmatively opted-in to allow the establishment of new branches in the State. Approximately 17 of these 23 States impose a reciprocity requirement.

In many cases, in order to serve customers in multistate metropolitan areas or regional markets, banks must 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 both national and State banks.

Resolving Issues About Federal Court Diversity Jurisdiction. Another high priority item is an amendment that would resolve the differing interpretations of the State citizenship rule for national banks (and Federal thrifts) for purposes of determining Federal court diversity jurisdiction. This issue has significant practical consequences in terms of unnecessary legal costs and operational uncertainties for both national banks and Federal thrifts. We are cooperating with the OTS on this issue and we would be pleased to work with your staff on a legislative proposal.

The controversy has taken on increased importance for national banks in light of a recent Federal appeals court decision by the Fourth Circuit in November 2004 that created a split in the circuits by finding that, for purposes of determining diversity jurisdiction, a national bank is a citizen of *every* State in which it has a branch or potentially any other type of permanent office.[3] Under the Fourth Circuit's diversity jurisdiction interpretation, federally chartered national banks would be denied access to Federal court any time any opposing party is a citizen of a State in which the bank has a branch. While a national bank with just one interstate branch would be affected by this decision, the consequences are most severe for national banks that have established interstate branches in multiple States.

The Fourth Circuit's opinion has created uncertain standards on this issue since every other Federal Circuit Court has reached a contrary conclusion. In October 2004, the Fifth Circuit held that, in determining citizenship for purposes of Federal court diversity jurisdiction, a national bank is *not* located at its interstate branch locations.[4] Similarly, in 2001, the Seventh Circuit found that a national bank is a citizen of only the State of its principal place of business and the State listed in its organization certificate.[5] Indeed, over 60 years ago, the Ninth Circuit considered

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[1] It is important to point out that, while a particular item recommended by the OCC, for example, may not be on the consensus list, this does not necessarily mean that a particular trade group or another Federal agency would oppose the item. In most cases, it simply means that an industry group or a Federal banking agency has not taken a position on the item.

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

[3] See *Wachovia Bank* v. *Schmidt,* 388 F.3d 414 (4th Cir. 2004).

[4] See *Horton* v. *Bank One, N.A.,* 387 F.3d 426 (5th Cir. 2004).

[5] See *Firstar Bank, N.A.* v. *Faul,* 253 F.3d 982 (7th Cir. 2001).

this issue and concluded that a national bank is a citizen only of the State where it maintains its principal place of business.[6]

Although the Supreme Court has recently agreed to review the Fourth Circuit's decision, this review does not supplant the need for a uniform rule that would apply to national banks and Federal savings associations to ensure that all federally chartered depository institutions are treated in the same manner with respect to access to Federal court in diversity cases.[7] Providing more certainty on this issue would reduce burden on national banks and Federal thrifts, including the substantial costs associated with repeatedly litigating this issue.

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 100-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)[8] need the approval of the Comptroller (or the Fed 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 2 years. The amendment would ensure that the OCC (and the Fed 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 toward 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.

Modernizing Corporate Governance. The OCC also supports an amendment that would eliminate a requirement 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 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, responsibilities, and enforcement authority.

For example, organization as a limited liability national association 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

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[6] See *American Surety Co.* v. *Bank of California,* 133 F.2d 160 (9th Cir. 1943).

[7] Federal thrifts are subject to similar uncertainty as national banks because Federal law does not currently specify their citizenship for purposes of diversity jurisdiction. Thus, courts have concluded that a Federal thrift generally is not a citizen of any State. See, for example, *First Nationwide Bank* v. *Gelt Funding, Inc.,* No. 92 Civ. 0790, 1992 U.S. Dist. LEXIS 18278, at 30 (S.D.N.Y. Nov. 30, 1992).

[8] See 12 U.S.C. § 324 and 12 CFR § 208.5 generally applying the national bank dividend approval requirements to state member banks.

limited liability companies (LLC's) 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 LLC's and the FDIC adopted a rule allowing certain state bank LLC's 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.[9] 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 applicable 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.

Giving National Banks More Flexibility in Main Office Relocations. The OCC supports an amendment to national banking law that will reduce unnecessary burdens on a national bank seeking to relocate its main office *within* its home State. The amendment would provide that a national bank that is merging or consolidating with another bank *in the same State* pursuant to national banking law, rather than the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) which applies only to interstate mergers and consolidations, has the same opportunity to retain certain offices that it would have if the merger or consolidation were an interstate merger subject to Riegle-Neal. The amendment would allow a national bank, with the Comptroller's approval, to retain and operate as its main office any main office or branch of any bank involved in the transaction in the same manner that it could do if this were a Riegle-Neal transaction. This would give a national bank more flexibility when making the business decision to relocate its main office to a branch location within the same State.

Enhancing National Banks' Community Development Investments. The OCC supports an amendment that would increase the maximum amount of a national bank's investments that are designed primarily to promote the public welfare either directly or by purchasing interests in an entity primarily engaged in making these investments, such as a community development corporation. We recommend increasing the maximum permissible amount of such investments from 10 percent to 15 percent of the bank's capital and surplus. The maximum limit only applies if the bank is adequately capitalized and only if the OCC determines that this higher limit will not pose a significant risk to the deposit insurance fund. Today, more than 90 percent of national banks investments under this authority are in low-income housing tax credit projects and losses associated with such projects are minimal. Allowing certain adequately capitalized national banks to modestly increase their community development investments subject to the requirements of the statute will enable them to expand investments that have been profitable, relatively low-risk, and beneficial to their communities.

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. 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 United States 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 in this regard is an amendment to the 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 ap-

[9] This provision was included in H.R. 1224, the Business Checking Freedom Act of 2005, as recently reported by the House Financial Services Committee and as passed by the House on May 24, 2005.

proach would closely resemble the risk-based capital framework that applies to both national and State banks.

OCC Operations

Improving Ability to Obtain Information from Regulated Entities. The OCC supports an amendment that would permit all of the Federal banking agencies—the OCC, FDIC, OTS, and the Fed—to establish and use advisory committees in the same manner. Under current law, only the Fed is exempt from the disclosure requirements under the Federal Advisory Committee Act (FACA). Yet, all types of insured institutions and their regulators have a need to share information and to conduct open and frank discussions that may involve nonpublic information about the impact of supervisory or policy issues. Because of the potentially sensitive nature of this type of information, the public meeting and disclosure requirements under FACA may inhibit the supervised institutions from providing the agencies their candid views. Importantly, this is information that any one bank could provide to its regulator and discuss on a confidential basis. It is only when several banks simultaneously do so in a collective discussion and offer suggestions to regulators that issues are raised under FACA. Our amendment would cure this anomaly and enhance the dialogue between all depository institutions and their Federal bank regulators.

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 bank situations.

Enforcing Written Agreements and Commitments. The OCC supports an amendment that would expressly authorize the Federal banking agencies to enforce written agreements and conditions imposed in writing in connection with an application or when the agency imposes conditions as part of its decision not to disapprove a notice, for example, a Change in Bank Control Act (CBCA) notice.

This amendment would rectify the results of certain Federal court decisions that conditioned the agencies' authority to enforce such conditions or agreements with respect to a nonbank party to the agreement on a showing that the nonbank party was "unjustly enriched." We believe that this amendment will enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses.

Barring Convicted Felons From Participating in the Affairs of Depository Institutions. The OCC also supports an amendment to the banking laws that would 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. Thus, for example, it would be harder to prevent an individual convicted of such crimes from serving as an official of an uninsured trust bank whose operations are subject to the highest fiduciary standards, then to keep that individual from an administrative position at an insured bank.

Strengthening the Supervision of "Stripped-Charter" Institutions. The OCC supports an amendment to the CBCA to address issues that have arisen when a stripped-charter institution (that is, 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 route 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 current 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.

Reducing Burdens and Enhancing Effectiveness of Consumer Compliance Disclosures

Many of the areas that are often identified as prospects for regulatory burden reduction involve requirements designed for the protection of consumers. Over the years, those requirements—mandated by Congress and initiated by regulators—have accreted, and in the disclosure area, in particular, consumers today receive disclosures so voluminous and so technical that many simply do not read them—or when they do, do not understand them.

No matter how well-intentioned, the current disclosures being provided to consumers in many respects are *not* delivering the information that consumers need to make informed decisions about their rights and responsibilities, but they *are* imposing significant costs on the industry and consuming precious resources.

In recent years, bank regulators and Congress have mandated that more and more information be provided to consumers in the financial services area. New disclosures have been added on top of old ones. The result today is a mass of *disclosure requirements* that generally do not *effectively communicate* to consumers, and impose excessive burden on the institutions required to provide those disclosures.

There are two arenas—legislative and regulatory—in which we can make changes to produce better, more effective, and less burdensome approaches to consumer disclosures.

With respect to legislation to improve disclosures, we can learn much from the experience of the Food and Drug Administration (FDA) in developing the "Nutrition Facts" label. This well-recognized—and easily understood disclosure is on virtually every food product we buy.

The effort that led to the FDA's nutrition labeling began with a clear statement from Congress that the FDA was directed to accomplish certain *objectives.* While Congress specified that certain nutrition facts were to be disclosed, it gave the FDA the flexibility to delete or add to these requirements in the interest of assisting consumers in "maintaining healthy dietary practices." The current disclosure is the result of several years of hard work and extensive input from consumers. The "Nutrition Facts" box disclosure was developed based on *goals* set out by Congress and then extensive research and consumer testing was used to determine what really worked to achieve those goals.

This experience teaches important lessons that we need to apply to information provided to consumers about financial services products:

- First, financial services legislation should articulate the goals to be achieved through a particular consumer protection disclosure regime, rather than directing the precise content or wording of the disclosure.
- Second, the legislation should provide adequate time for the bank regulators to include consumer testing as part of their rulemaking processes.
- Third, Congress should require that the regulators must consider both the burden associated with implementing any new standards, as well as the effectiveness of the disclosures.

With respect to the regulatory efforts to improve disclosures, as discussed above, we are today using consumer testing—through focus groups and consumer interviews—to identify the content and format of privacy notices that consumers find the most helpful and easy to comprehend. We are hopeful that this initiative will pave the way for better integration of consumer testing as a standard element of developing consumer disclosure regulations.

On another front, the OCC also took the unusual step several months ago of submitting a comment letter to the Federal Reserve Board on its Advance Notice of Proposed Rulemaking related to credit card disclosures, discussing both the development of the FDA's "Nutrition Facts" label and the efforts of the Financial Services Authority (FSA) in the United Kingdom to develop revised disclosures for a variety of financial products. Our comments highlighted some of the lessons learned from the FDA's and FSA's efforts and urged the Fed to take guidance from this experience:

- Focus on key information that is central to the consumer's decisionmaking (provide supplementary information separately in a fair and clear manner);
- Ensure that key information is highlighted in such a way that consumers will notice it and understand its significance;
- Employ a standardized disclosure format that consumers can readily navigate; and
- Use simple language and an otherwise user-friendly manner of disclosure.

Banking Agency and Industry Consensus Items

As a result of the dialogue between the Federal banking agencies—the OCC, the Fed, the FDIC, and the OTS—and the banking industry [10] as part of the EGRPRA process and other discussions over the last several years on regulatory burden relief legislation, it has become apparent that there are a number of items that we all support. These consensus items are discussed in more detail in Appendix #2. Several of the items on the consensus list also were included in H.R. 1375 as passed by the House in the last Congress.

In brief, the banking industry groups and the four Federal banking agencies all support amendments to Federal law that would:

- Authorize the Fed to pay interest on reserve accounts under the Federal Reserve Act (FRA); [11]
- Provide that member banks may satisfy the reserve requirements under the FRA through pass-through deposits;
- Provide the Fed with more flexibility to set reserve requirements under the FRA;
- Repeal certain reporting requirements relating to insider lending under the FRA;
- Streamline depository institutions' requirements under the Bank Merger Act (BMA) to eliminate the requirement that the agency acting on the application must request competitive factor reports from all of the other Federal banking agencies;
- Shorten the post-approval waiting period under the BMA in cases where there is no adverse effect on competition;
- Exempt mergers between depository institutions and affiliates from the competitive factors review and post-approval waiting periods under the BMA;
- Improve information sharing with foreign supervisors under the IBA;
- Provide an inflation adjustment for the small depository institution exception under the Depository Institution Management Interlocks Act;
- Amend the Flood Disaster Protection Act of 1973 to:
  (1) increase the "small loan" exception from the flood insurance requirements from $5,000 to $20,000 and allow for future increases based on the Consumer Price Index;
  (2) allow lenders to force-place new flood insurance coverage if a borrower's coverage lapses or is inadequate so that the new coverage is effective at approximately the same time that the 30-day grace period expires on the lapsed policy; and
  (3) repeal the rigid requirement that the Federal supervisor of a lending institution must impose civil money penalties if the institution has a pattern or practice of committing certain violations and give the supervisor more flexibility to take other appropriate actions;
- Enhance examination flexibility under the Federal Deposit Insurance Act (FDIA) by increasing the small bank threshold from $250 million to $500 million so that more small banks may qualify to be examined on an 18-month rather than an annual cycle; [12] and
- Provide that the Federal banking agencies will review the requirements for banks' reports of condition under the FDIA every 5 years and reduce or eliminate any requirements that are no longer necessary or appropriate.

Comments on other Legislative Proposals

We would like to take this opportunity to also make you aware of our views on some other legislative proposals that we understand may be under consideration.

Maintaining Parity Between Permissible Securities and Stock Investments of National Banks and State Member Banks. The OCC understands that it has been suggested that the Federal Reserve Act (12 U.S.C. § 335) [13] be amended in a way that

[10] Banking industry groups participating include the American Bankers Association, America's Community Bankers, the Independent Community Bankers of America, and the Financial Services Roundtable.

[11] This amendment was included in H.R. 1224, the Business Checking Freedom Act of 2005, as recently reported by the House Financial Services Committee and as passed by the House on May 24, 2005.

[12] A's discussed in Appendix #1, the OCC also supports enhancing examination flexibility under the FDIA by giving the Federal banking agencies the discretion to adjust the examination cycle for an insured depository institution (for a period of time not to exceed 6 months) if necessary for safety and soundness and the effective examination and supervision of insured depository institutions.

[13] 12 U.S.C. § 335 states:

"State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are apwould undo the long-standing parity between national banks' and State member banks' permissible direct and indirect investments. This parity dates back to the 1933 Glass-Steagall Act and was carefully maintained when GLBA was enacted in 1999. The OCC would oppose any changes to § 335 that remove restrictions on State member banks' investments unless corresponding changes are made for national banks. National banks are also member banks. If Congress determines that such restrictions are no longer necessary for the safety and soundness of State member banks, then, as a matter of competitive equity and reducing unnecessary regulatory burden, these restrictions should no longer be applied to national banks.

The second sentence in § 335 was enacted in 1999 as part of the GLBA compromise relating to financial subsidiary activities. Consistent with the parity framework, this sentence provides that the restrictions in the first sentence do not apply to any interest held by a State member bank in accordance with the amendments made by GLBA that permit national banks to have financial subsidiaries, subject to the same conditions and limitations that apply to national banks. Thus, State member banks' financial subsidiaries are subject to the same limitations and prudential safeguards that apply to national banks' financial subsidiaries. This sentence was the result of a carefully crafted compromise to ensure that parallel firewalls, safeguards, and rules were applied to financial subsidiaries of national and State member banks.

Enhancing Investments in Bank and Thrift Service Companies. The OCC generally supports proposals that would permit banks to invest in thrift service companies and would permit savings associations to invest in bank service companies. Moreover, the OCC would not object to removing the geographic restrictions on the operations of thrift service corporations as long as the Bank Service Company Act is similarly amended to remove the geographic restrictions on bank service companies.

Conclusion

Mr. Chairman, on behalf of the OCC, I thank you for your leadership in holding these hearings. The OCC strongly supports initiatives that will reduce unnecessary burden on the industry in a responsible, safe and sound manner. We would be pleased to work with you and your staff to make that goal a reality.

I would be happy to answer any questions you may have.

PREPARED STATEMENT OF MARK W. OLSON*

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 21, 2005

Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for the opportunity to testify on issues related to regulatory relief. The Board is aware of the current and growing regulatory burden that is imposed on this Nation's banking organizations. Often this burden falls particularly hard on small institutions, which have fewer resources than their larger brethren. The Board strongly supports the efforts of Congress to review periodically the Federal banking laws to determine whether they can be streamlined without compromising the safety and soundness of banking organizations, consumer protections, or other important objectives that Congress has established for the financial system. In 2003, at Chairman Shelby's request, the Board provided the Committee with a number of legislative proposals that we believe are consistent with this goal. Since then, the Board has continued to work with the other Federal banking agencies and your staffs on regulatory relief matters and the Board recently agreed to support several additional regulatory relief proposals. A summary of the proposals supported by the Board is included in the appendix to my testimony.

In my remarks, I will highlight the Board's three highest priority proposals. These three proposals would allow the Federal Reserve to pay interest on balances held by depository institutions at Reserve Banks, provide the Board greater flexibility in setting reserve requirements, and permit depository institutions to pay interest on demand deposits. These amendments would improve efficiency in the financial sec-

plicable in the case of national banks under paragraph 'Seventh' of Section 5136 of the Revised Statutes, as amended [12 U.S.C. § 24(Seventh)]. This paragraph shall not apply to an interest held by a State member bank in accordance with section 5136A of the Revised Statutes of the United States [12 U.S.C. § 24a] and subject to the same conditions and limitations provided in such section."

*Appendix held in Committee files.

tor, assist small banks and small businesses, and enhance the Federal Reserve's toolkit for efficiently conducting monetary policy. I also will mention a few additional proposals that the Board supports and that would provide meaningful regulatory relief to banking organizations. The Board looks forward to working with Congress, our fellow banking agencies, and other interested parties in developing and analyzing other potential regulatory relief proposals as the legislative process moves forward.

For its part, the Board strives to review each of our regulations at least once every 5 years to identify those provisions that are out of date or otherwise unnecessary. The Board also has been an active participant in the ongoing regulatory review process being conducted by the Federal banking agencies pursuant to the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). EGRPRA requires the Federal banking agencies, at least once every 10 years, to review and seek public comment on the burden associated with the full range of the agencies' regulations that affect insured depository institutions. The Board and the other banking agencies are in the midst of the first 10-year review cycle, and I am pleased to report that we are on track to complete this process by the 2006 deadline. The agencies already have solicited comments on four broad categories of regulations—including those governing applications, activities, money laundering, and consumer protection in lending transactions—and have conducted outreach meetings throughout the country to encourage public participation in the EGRPRA process. In response to these efforts, the agencies have received comments from more than 1,000 entities and individuals on ways to reduce the regulatory burden on banking organizations. The Board will consider and incorporate the comments relevant to our regulations as we move forward with our own regulation review efforts.

While the banking agencies can achieve some burden reductions through administrative action, Congress plays a critical role in the regulatory relief process. Many proposals to reduce regulatory burden require Congressional action to implement. Moreover, the Congress has ultimate responsibility for establishing the overall regulatory framework for banking organizations, and through its actions Congress can ensure that regulatory relief is consistent with the framework it has established to maintain the safety and soundness of banking organizations and promote other important public policy goals.

Interest on Reserves and Reserve Requirement Flexibility

For the purpose of implementing monetary policy, the Board is obliged by law to establish reserve requirements on certain deposits held at depository institutions. By law, the Board currently must set the ratio of required reserves on transaction deposits above a certain threshold at between 8 and 14 percent. Because the Federal Reserve does not pay interest on the balances held at Reserve Banks to meet reserve requirements, depositories have an incentive to reduce their reserve balances 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 deposits and money market investments that are not. These sweep programs and similar activities absorb real resources and therefore diminish the efficiency of our banking system. The Board's proposed amendment would authorize the Federal Reserve to pay depository institutions interest on their required reserve balances. Paying interest on these required reserve balances would remove a substantial portion of the incentive for depositories to engage in reserve avoidance measures, and the resulting improvements in efficiency should eventually be passed through to bank borrowers and depositors.

Besides required reserve balances, depository institutions also voluntarily hold two other types of balances in their Reserve Bank accounts—contractual clearing balances and excess reserve balances. 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 in the form of credits that may be used to pay for Federal Reserve services, such as check clearing. Excess reserve balances are funds held by depository institutions in their accounts at Reserve Banks in excess of their required reserve and contractual clearing balances. Excess reserve balances currently do not earn explicit or implicit interest.

The Board's proposed amendment would authorize the Federal Reserve to pay explicit interest on contractual clearing balances and excess reserve balances, as well as required reserve balances. This authority would enhance the Federal Reserve's ability to efficiently conduct monetary policy, and would complement another of the Board's proposed amendments, which would give the Board greater flexibility in setting reserve requirements for depository institutions.

In order for the Federal Open Market Committee (FOMC) to conduct monetary policy effectively, it is important that a sufficient and predictable demand for balances at the Reserve Banks exist so that the System knows the volume of reserves to supply (or remove) through open market operations to achieve the FOMC's target Federal funds rate. Authorizing the Federal Reserve to pay explicit interest on contractual clearing balances and excess reserve balances, in addition to required reserve balances, could potentially provide a demand for voluntary balances that would be stable enough for monetary policy to be implemented effectively through existing procedures without the need for required reserve balances. In these circumstances, the Board, if authorized, could consider reducing—or even eliminating—reserve requirements, thereby reducing a regulatory burden for all depository institutions, without adversely affecting the Federal Reserve's ability to conduct monetary policy.

Having the authority to pay interest on excess reserves also could help mitigate potential volatility in overnight interest rates. If the Federal Reserve was authorized to pay interest on excess reserves, and did so, the rate paid 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 a Reserve Bank. Although the Board sees no need to pay interest on excess reserves in the near future, and any movement in this direction would need further study, the ability to do so would be a potentially useful addition to the monetary toolkit of the Federal Reserve.

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.

Interest on Demand Deposits

The Board also strongly supports repealing the statutory restrictions that currently prohibit depository institutions from paying interest on demand deposits. The Board's proposed amendment would allow all depository institutions that have the legal authority to offer demand deposits to pay interest on those deposits. As I will explain a little later, however, the Board opposes amendments that would separately authorize industrial loan companies that operate outside the supervisory and regulatory framework established for other insured banks to offer, for the first time, interest bearing transaction accounts to business customers.

Repealing the prohibition of interest on demand deposits would improve the overall efficiency of our financial sector and, in particular, should assist small banks in attracting and retaining business deposits. 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 and they spend resources—and charge fees—for sweeping the excess demand deposits of businesses into money market investments on a nightly basis. Small banks, however, often do not have the resources to develop the sweep or other programs that are needed to compete for the deposits of business customers. Moreover, from the standpoint of the overall economy, the expenses incurred by institutions of all sizes to implement these programs are a waste of resources and would be unnecessary if institutions were permitted to pay interest on demand deposits directly.

The costs incurred by banks in operating these programs are passed on, directly or indirectly, to their large and small business customers. Authorizing banks to pay interest on demand deposits would eliminate the need for these customers to pay for more costly sweep and compensating balance arrangements to earn a return on their demand 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.

Some proposals, such as H.R. 1224—the Business Checking Freedom Act of 2005—which recently passed the House, would delay the effectiveness of the authorization of interest on demand deposits for 2 years. The Board believes that a short implementation delay of 1 year, or even less, would be in the best interest of the public and the efficiency of our financial sector. A separate provision of H.R. 1224 would, in effect, allow implicit interest to be paid on demand deposits without any delay through a new type of sweep arrangement, but this provision would not promote efficiency. It would allow banks to offer a reservable money market deposit account (MMDA) from which twenty-four transfers a month could be made to other accounts of the same depositor. Banks would be able to sweep balances from demand deposits into these MMDA's each night, pay interest on them, and then sweep them back into demand deposits the next day. This type of account would likely permit banks to pay interest on demand deposits more selectively than with direct interest payments. The twenty-four-transfer MMDA, which would be useful only during the transition period before direct interest payments were allowed, could be implemented at lower cost by banks already having sweep programs. However, other banks would face a competitive disadvantage and pressures to incur the cost of setting up this new program during the transition for the 1 year interim period. Moreover, some businesses would not benefit from this MMDA. Hence, the Board does not advocate this twenty-four-transfer account.

Small Bank Examination Flexibility

The Board also supports an amendment that would expand the number of small institutions that qualify for an extended examination cycle. Federal law currently mandates that the appropriate Federal banking agency conduct an on-site examination of each insured depository institution at least once every 12 months. The statute, however, permits institutions that have $250 million or less in assets and that meet certain capital, managerial, and other criteria to be examined on an 18-month cycle. As the primary Federal supervisors for State-chartered banks, the Board and Federal Deposit Insurance Corporation (FDIC) may alternate responsibility for conducting these examinations with the appropriate State supervisory authority if the Board or FDIC determines that the State examination carries out the purposes of the statute.

The $250 million asset cutoff for an 18-month examination cycle has not been raised since 1994. The Board's proposed amendment would raise this asset cap from $250 million to $500 million, thus potentially allowing approximately an additional 1,100 insured depository institutions to qualify for an 18-month examination cycle.

The proposed amendment would provide meaningful relief to small institutions without jeopardizing the safety and soundness of insured depository institutions. Under the proposed amendment, an institution with less than $500 million in assets would qualify for the 18-month examination cycle only if the institution was well-capitalized, well-managed, and met the other criteria established by Congress in the Federal Deposit Insurance Corporation Improvement Act of 1991. The amendment also would continue to require that all insured depository institutions undergo a full-scope, on-site examination at least once every 12 or 18 months. Importantly, the agencies would continue to have the ability to examine any institution more frequently and at any time if the agency determines an examination is necessary or appropriate.

Despite advances in off-site monitoring, the Board continues to believe that regular on-site examinations play a critical role in helping bank supervisors detect and correct asset, risk-management, or internal control problems at an institution before these problems result in claims on the deposit insurance funds. The mandatory 12- or 18-month on-site examination cycle imposes important discipline on the Federal banking agencies, ensures that insured depository institutions do not go unexamined for extended periods, and has contributed significantly to the safety and soundness of insured depository institutions. For these reasons, the Board opposes alternative amendments that would allow an agency to indefinitely lengthen the exam cycle for any institution in order to allocate and conserve the agency's examination resources.

Permit the Board to Grant Exceptions to Attribution Rule

The Board has proposed another amendment that we believe will help banking organizations maintain attractive benefits programs for their employees. The Bank Holding Company Act (BHC Act) generally prohibits a bank holding company from owning, in the aggregate, more than 5 percent of the voting shares of any company without the Board's approval. The BHC Act also provides that any shares held by a trust for the benefit of a bank holding company's shareholders or employees are deemed to be controlled by the bank holding company itself. This attribution rule was intended to prevent a bank holding company from using a trust established for the benefit of its management, shareholders, or employees to evade the BHC Act's restrictions on the acquisition of shares of banks and nonbanking companies.

While this attribution rule has proved to be a useful tool in preventing evasions of the BHC Act, it does not always provide an appropriate result. For example, it may not be appropriate to apply the attribution rule when the shares in question are acquired by a 401(k) plan that is widely held by, and operated for the benefit of, the employees of the bank holding company. In these situations, the bank holding company may not have the ability to influence the purchase or sale decisions of the employees or otherwise control the shares that are held by the plan in trust for its employees. The suggested amendment would allow the Board to address these situations by authorizing the Board to grant exceptions from the attribution rule where appropriate.

Reduce Cross-Marketing Restrictions

Another amendment proposed by the Board would modify the cross-marketing restrictions imposed by the Gramm-Leach-Bliley Act (GLB Act) on the merchant banking and insurance company investments of financial holding companies. The GLB Act generally prohibits a depository institution controlled by a financial holding company from engaging in cross-marketing activities with a nonfinancial company that is owned by the same financial holding company under the GLB Act's merchant banking or insurance company investment authorities. However, the GLB Act currently permits a depository institution subsidiary of a financial holding company, with Board approval, to engage in limited cross-marketing activities through statement stuffers and Internet websites with nonfinancial companies that are held under the Act's insurance company investment authority (but not the act's merchant banking authority).

The Board's proposed amendment would allow depository institutions controlled by a financial holding company to engage in cross-marketing activities with companies held under the merchant banking authority to the same extent, and subject to the same restrictions, as companies held under the insurance company investment authority. We believe that this parity of treatment is appropriate, and see no reason to treat the merchant banking and insurance investments of financial holding companies differently for purposes of the cross-marketing restrictions of the GLB Act.

A second aspect of the amendment would liberalize the cross-marketing restrictions that apply to both merchant banking and insurance company investments. This aspect of the amendment would permit a depository institution subsidiary of a financial holding company to engage in cross-marketing activities with a nonfinancial company held under either the merchant banking or insurance company investment authority if the nonfinancial 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 the nonfinancial portfolio company and the financial holding company's depository institution subsidiaries.

Industrial Loan Companies

As I noted earlier, the Board strongly supports allowing depository institutions to pay interest on demand deposits. The Board, however, opposes proposals that would allow industrial loan companies (ILC's) to offer interest-bearing, negotiable order of withdrawal (NOW) accounts to business customers if the corporate owner of the ILC takes advantage of the special exemption in current law that allows the owner to operate outside the prudential framework that Congress has established for the corporate owners of other types of insured banks.

ILC's are State-chartered, FDIC-insured banks that were first established early in the 20th century to make small loans to industrial workers. As insured banks, ILC's are supervised by the FDIC as well as by the chartering State. However, under a special exemption in current law, any type of company, including a commercial or retail firm, may acquire an ILC in a handful of States—principally Utah, California, and Nevada—and avoid the activity restrictions and supervisory requirements imposed on bank holding companies under the Federal BHC Act.

When the special exemption for ILC's was initially granted in 1987, ILC's were mostly small, local institutions that did not offer demand deposits or other types of checking accounts. In light of these facts, Congress conditioned the exemption on a requirement that any ILC's chartered after 1987 remain small (below $100 million in assets) *or* refrain from offering demand deposits that are withdrawable by check or similar means.

This special exemption has been aggressively exploited since 1987. Some grandfathered States have allowed their ILC's to exercise many of the same powers as commercial banks and have begun to charter new ILC's. Today, several ILC's are owned by large, internationally active financial or commercial firms. In addition, a number of ILC's themselves have grown large, with one holding more than $50 billion in deposits and an additional six holding more than $1 billion in deposits.

Affirmatively granting ILC's the ability to offer business NOW accounts would permit ILC's to become the functional equivalent of full-service insured banks. This result would be inconsistent with both the historical functions of ILC's and the terms of their special exemption in current law.

Because the parent companies of exempt ILC's are not subject to the BHC Act, authorizing ILC's to operate essentially as full-service banks would create an unlevel competitive playing field among banking organizations and undermine the framework Congress has established for the corporate owners of full-service banks. It would allow firms that are not subject to the consolidated supervisory framework of the BHC Act—including consolidated capital, examination, and reporting requirements—to own and control the functional equivalent of a full-service bank. It also would allow a foreign bank to acquire control of the equivalent of a full-service insured bank without meeting the requirement under the BHC Act that the foreign bank be subject to comprehensive supervision on a consolidated basis in its home country. In addition, it would allow financial firms to acquire the equivalent of a full-service bank without complying with the capital, managerial, and Community Reinvestment Act (CRA) requirements established by Congress in the GLB Act.

Congress has established consolidated supervision as a fundamental component of bank supervision in the United States because consolidated supervision provides important protection to the insured banks that are part of a larger organization and to the Federal safety net that supports those banks. Financial trouble in one part of an organization can spread rapidly to other parts. To protect an insured bank that is part of a larger organization, a supervisor needs to have the authority and tools to understand the risks that exist within the parent organization and its affiliates and, if necessary, address any significant capital, managerial, or other deficiencies before they pose a danger to the bank. This is particularly true today, as holding companies increasingly manage their operations—and the risks that arise from these operations—in a centralized manner that cuts across legal entities. Risks that cross legal entities and that are managed on a consolidated basis simply cannot be monitored properly through supervision directed at one, or even several, of the legal entities within the overall organization. For these reasons, Congress since 1956 has required that the parent companies of full-service insured banks be subject to consolidated supervision under the BHC Act. In addition, following the collapse of Bank of Commerce and Credit International (BCCI), Congress has required that foreign banks seeking to acquire control of a U.S. bank under the BHC Act be subject to comprehensive supervision on a consolidated basis in the foreign bank's home country.

Authorizing exempt ILC's to operate as essentially full-service banks also would undermine the framework that Congress has established—and recently reaffirmed in the GLB Act—to limit the affiliation of banks and commercial entities. This is because any type of company, including a commercial firm, may own an exempt ILC without regard to the activity restrictions in the BHC Act that are designed to maintain the separation of banking and commerce.

H.R. 1224 attempts to address the banking and commerce concerns raised by allowing ILC's to offer business NOW accounts by placing certain limits on the types of ILC's that may engage in these new activities. However, as Governor Kohn recently testified in the House on behalf of the Board, the limits contained in H.R. 1224 do not adequately address these concerns. Moreover, H.R. 1224 fails to address the supervisory issues associated with allowing domestic firms and foreign banks that are not subject to consolidated supervision to control the functional equivalent of a full-service insured bank.

Let me be clear. The Board does not oppose granting ILC's the ability to offer business NOW accounts if the corporate owners of ILC's engaged in these expanded activities are covered by the same supervisory and regulatory framework that applies to the owners of other full-service insured banks. Stated simply, if ILC's want to benefit from expanded powers and become functionally indistinguishable from other insured banks, then they and their corporate parents should be subject to the same rules that apply to the owners of other full-service insured banks. For the same reasons discussed above, the Board opposes amendments that would allow exempt ILC's to open *de novo* branches throughout the United States.

Affirmatively granting exempt ILC's the authority to offer business NOW accounts also is *not* necessary to ensure or provide parity among insured banks. The Board's proposed amendment would allow *all* depository institutions that have the authority to offer demand deposits the ability to pay interest on those deposits. Thus, the Board's proposed amendment would treat all depository institutions equally. Separately granting exempt ILC's the ability to offer the functional equivalent of a corporate demand deposit, on the other hand, would grant new and expanded powers to institutions that already benefit from a special exemption in current law. Far from promoting competitive equity, these proposals would promote competitive *inequality* in the financial marketplace.

The Board believes that important principles governing the structure of the Nation's banking system—such as consolidated supervision, the separation of banking and commerce, and the maintenance of a level playing field for all competitors in the financial services marketplace—should not be abandoned without careful consideration by the Congress. In the Board's view, legislation concerning the payment of interest on demand deposits is unlikely to provide an appropriate vehicle for the thorough consideration of the consequences of altering these key principles.

Conclusion

I appreciate the opportunity to discuss the Board's legislative suggestions and priorities concerning regulatory relief. The Board would be pleased to work with the Committee and your staffs as you seek to develop and advance meaningful regulatory relief legislation that is consistent with the Nation's public policy objectives.

Testimony on Regulatory Burden Relief
before the
Senate Committee on Banking, Housing and Urban Affairs

June 21, 2005

Richard M. Riccobono, Acting Director
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, including efforts pursuant to the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), of the Office of Thrift Supervision (OTS).

Removing unnecessary regulatory obstacles that hinder profitability, innovation, and competition in our financial services industry, and that also impede job creation and economic growth in the general economy, is an important and continuing objective of OTS. Although we have accomplished much in recent years to streamline and eliminate some of the burdens faced by the thrift industry, there remain many other areas for improvement. We are fully committed to work with you, Mr. Chairman, and the Members of the Committee to address these issues.

Before proceeding to my testimony, Mr. Chairman, I want to recognize the tireless efforts of Senator Crapo and his staff on pursuing regulatory burden reduction legislation, as well as Federal Deposit Insurance Corporation (FDIC) Vice Chairman John Reich, who has spearheaded the interagency EGRPRA regulatory burden reduction effort. As you know, Vice Chairman Reich has been nominated to serve as the OTS Director. We look forward to working with him on these and the numerous other issues and challenges facing OTS and the thrift industry.

OTS's highest priority items for regulatory burden relief legislation are:

- Removing the continuing duplicative oversight burden and disparate treatment of savings associations under the federal securities laws by providing savings associations the same exemptions as banks with respect to investment adviser and broker-dealer activities that each conducts on otherwise equal terms and under substantially similar authority.

- Eliminating the existing arbitrary limits on thrift consumer lending activities.

- Updating commercial lending limits for federal savings associations to enhance their ability to diversify and to provide small and medium-sized businesses greater choice and flexibility in meeting their credit needs.

- Establishing statutory succession authority within the Home Owners' Loan Act (HOLA) for the position of the OTS Director.

I will explain each of these items in more detail and describe several other initiatives that we are recommending for enactment. All of these items are included in the Matrix of Financial Services Regulatory Relief Proposals, which has been included in the record. For your convenience, the items are identified by their Matrix number below.

Before addressing these issues, it is important to note that there are two areas not addressed in this statement that many of our institutions have identified as unduly burdensome—the Bank Secrecy Act requirements and the rules under the Sarbanes Oxley Act. Virtually all institutions raise these two issues as regulatory relief priorities. While we recognize the need for relief in these areas, I do not believe we are at a point right now to be able to make sound recommendations on where to make effective reforms without compromising the underlying purposes of these laws, but we are working with the other federal banking agencies (FBAs) and others to develop recommendations for reform.

II. Revising the Federal Securities Laws to Eliminate Duplicative Regulatory Burdens for Savings Associations [Matrix # 52]

OTS's most important regulatory burden reduction legislative priority is revising the federal securities laws so that savings associations are relieved of a duplicative burden imposed on them with respect to their investment adviser and broker-dealer activities. This is easily accomplished by revising the federal securities laws so that savings associations and banks are treated equally. As described more fully below, this involves exempting savings associations from the investment adviser and broker-dealer registration requirements to the same extent that banks are exempt under the Investment Advisers Act (IAA) and the Securities Exchange Act of 1934 (1934 Act).

Although the Securities and Exchange Commission (SEC) has issued several proposals purportedly to address the duplicative burden imposed on savings associations, the application of the federal securities laws in these two areas remains a needless additional burden with no additional supervisory benefit for savings associations. Significant disparities remain under the IAA, with savings associations subject to an entirely duplicative SEC oversight regime. Equally significant, it remains uncertain how the SEC will ultimately treat savings associations for purposes of the broker-dealer exemption. In the SEC's most recent iteration on this issue, it indicated that it would roll back an interim rule that had extended equal treatment to savings associations vis-à-vis banks for purposes of the broker-dealer exemption.[1] While these issues remain in flux, there has been nothing to indicate that we are heading in the direction of reducing needless duplicative oversight for savings associations under the federal securities laws.

Underscoring the case for eliminating these duplicative requirements is the fact that banks and savings associations 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 savings associations 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 savings association and bank customers equally well-protected.

To avoid the regulatory burden and substantial costs of this duplicative regulatory structure, some OTS-regulated savings associations have converted to

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1. SEC Proposed Rule: Regulation B, Release No. 34-49879, approved by the Commission on June 2, 2004, released to the public on June 17, 2004, and published in the Federal Register on June 30, 2004.

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 unrelated and extraneous factors such as SEC 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 savings associations 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 savings associations—enjoyed a blanket exemption under the IAA.

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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).

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 savings associations that limit their investment management and advisory services to a limited range of accounts. Under the proposal, savings association fiduciary accounts are segregated into two categories. Savings associations that provide services to accounts that include only traditional trust, estate, and guardianship accounts would be exempt from registration. Savings associations 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 would be required to register as an investment adviser.[3]

The practical effect of this approach is that it provides an extremely limited exemption that does not provide meaningful regulatory relief for savings associations. This fact was made clear to the SEC Commissioners at a meeting last year when the SEC staff advised the Commissioners that none of the savings associations currently registered under the IAA—there are 42 savings associations currently registered (and 3 registered operating subsidiaries)—would be able to take advantage of the proposed exemption since all provide investment management and advisory services for both account categories.

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3. A more detailed description and comparison of bank and savings association activities, and applicability of the IAA to each, is set forth in an attachment to this statement.

While the SEC wants to apply the federal securities laws in two different manners depending on the business operations of a savings association, there is no distinction between these two categories of accounts under the HOLA and OTS regulations applicable to savings associations. 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 savings associations, 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.

Savings associations registered 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 savings associations shows aggregate annual costs ranging from $75,000 to $518,200.

Limiting the types of accounts for which a savings association may provide investment management and advisory services to avoid IAA registration, as the SEC has proposed, 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. Savings associations providing investment management and advisory services should be encouraged to provide competitive products and services 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 savings association for engaging in exactly the same activities.

Ironically, many of these same themes were cited as the basis for the SEC's recent rule exempting certain broker-dealers from the IAA registration requirements. Minimizing duplicative regulation, changes reflecting developments and advances in industry practices, acknowledging underlying Congressional intent to carve out certain types of entities from IAA registration because of parallel federal oversight, and ensuring and maintaining consistent consumer protections are all reasons supporting the SEC's exemption for broker-dealers under the IAA. These same reasons support an IAA exemption for savings associations.

Duplicative registration and oversight without any additional supervisory or regulatory benefit is, as we all recognize, regulatory burden in its truest form. For the same reasons that SEC registered broker-dealers should not be subject to registration under the IAA, OTS-licensed savings associations should not be subject to IAA registration.

In addressing this issue, it is important to recall that in July 2000 an amendment was offered by Senator Bayh (on regulatory burden reduction legislation then pending before the Committee) to extend the IAA exemption to savings associations so that savings associations and banks could compete equally in the provision of investment management and advisory services. As the Senator and others on the Committee at the time may recall, during consideration of the amendment, 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.[4] Five years later the issue remains unresolved with virtually no likelihood of this changing given that the SEC's May 2004 proposal offers no relief to existing IAA-registered savings associations. This fact, alone, underscores why nothing short of a legislative solution is adequate to resolve this issue going forward.

While OTS submitted a comment letter to the SEC discussing why the proposed IAA rule is flawed, we are not optimistic that it will change anything given the history of this issue. After much discussion for several years between OTS and the SEC staff, we have not made any 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.

B. Broker-Dealer Registration

A similar duplicative burden exists for savings associations under the broker-dealer provisions of the 1934 Act. Extending the current bank broker-dealer exemption to savings associations would eliminate this duplicative burden. Banks—but not savings associations—enjoyed a blanket exemption from broker-

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4. 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 savings associations. 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.

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 savings associations within the bank exemption. This treated savings associations 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 savings associations 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 savings associations the same exemptions as banks. On June 30, 2004, the SEC published in the Federal Register a new proposed rule governing when a bank or savings association must register as a broker.

Unlike the SEC's final dealer rule and interim broker rule, under the new broker proposal savings associations would no longer be treated the same as banks in all respects. Although savings associations 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 savings associations. 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 savings associations are engaged in the exempted securities activities and will only extend relief for savings associations to the securities activities they are currently performing. A separate analysis conducted by OTS, however, indicates that savings associations currently engage in all of the securities activities covered by the three additional exemptions. This information was forwarded to the SEC staff pursuant to their request. 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. OTS has strongly urged the SEC to remove this new disparity and the additional duplicative burden it imposes on savings associations.

As was the case in the SEC's investment adviser proposal, in issuing its proposed broker rule, the SEC passed on the opportunity to streamline its overlapping oversight of savings association broker-dealer activities by providing the equivalent treatment to savings associations as banks receive. In both instances, the SEC has proposed to treat savings associations differently than banks in fundamentally important respects. Both of these actions impose duplicative regulatory burdens and demonstrate the continuing, immediate need for legislation to provide relief to savings associations under the federal securities laws.

III. Removing Disparate Standards in Savings Association Consumer Lending Authority [Matrix # 82]

Another important regulatory burden legislative proposal for OTS is eliminating an anomaly that exists under HOLA relating to the consumer lending authority for savings associations. Currently, consumer loans are subject to a 35 percent of assets limitation, while there is no limit on loans a savings association 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 savings association investment limit—are not secured. Removing the 35 percent cap on consumer lending will permit savings associations to engage in secured lending activities to the same extent that they may make unsecured credit card loans. Our hope is that this will increase savings association secured lending activities relative to unsecured credit card lending, thereby improving the overall safety and soundness of savings association loan portfolios, as well as providing regulatory burden relief.

A related amendment would address a similar anomaly that exists with how savings associations compute so-called "qualified thrift investments" (QTI) under the qualified thrift lender (QTL) test. Currently, a savings association may count 100 percent of its credit card loans as QTI, but other consumer loans count as QTI only to the extent that these and other categories of loans do not exceed 20 percent of the savings association'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 savings associations to perform more effectively as the retail institutions their customers need and expect, without impairing safety and soundness.

IV. Eliminating Obstacles to Small Business Lending by Federal Savings Associations [Matrix # 53]

Another OTS legislative priority is reducing statutory limitations on the ability of federal savings associations 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 savings association's assets. Commercial loans in excess of 10 percent of assets must be in small business loans. OTS supports legislative provisions that remove the current limit on small business lending and increase the cap on other commercial lending from 10 percent to 20 percent of assets.

In addition to being good for small business job creation and the economy, there are several reasons why we have concluded that these changes make sense for savings associations from a policy perspective. First, this will give savings associations greater flexibility to promote safety and soundness through diversification. Additional flexibility, particularly in small business lending, will provide opportunities to counter the undulations of a cyclical mortgage market. This will enable savings association 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 savings associations are at or near the current statutory limits and must curtail otherwise safe and sound business lending programs. Finally, this proposal will enable savings associations that have a retail lending focus to be able to achieve the economies of scale necessary to engage in this activity safely and profitably.

Small business lending is an integral component of job growth and employment in the United States.[5] This proposal would increase competition for,

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5. There are currently 23 million small businesses in the United States, representing 99.7 percent of U.S. employers. These firms employ more than half of all private sector employees, accounting for 44 percent of the U.S. private sector payroll. Small businesses generate between 60 to 80 percent of all net new jobs annually, and are responsible for over 50 percent of the U.S.

and the availability of, small business and other commercial loans now and in the future as savings associations 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.[6] Finally, the proposal will also assist businesses that prefer borrowing from entities like savings associations that meet the needs of borrowers with personal service.

V. Agency Continuity – Creating Statutory Succession Authority and Modernizing Appointment Authority for the OTS Director [Matrix # 59]

OTS urges Congress to authorize the Treasury Secretary to appoint one or more individuals within OTS to serve as OTS Acting Director in order to assure agency continuity. Similarly, it is important to modernize the existing statutory appointment authority for the OTS Director by permitting an appointee a new five-year term.

The first proposal would revise the current procedure of relying on the Vacancies Act to fill any vacancy that occurs during or after the term of an OTS Director or Acting Director. This would eliminate potential concerns and time constraints imposed by the Vacancies Act process under which OTS currently operates. The latter proposal would eliminate reliance on an antiquated

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private gross domestic product. U.S. Small Business Administration, Frequently Asked Questions (March 2004).

6. See "The Effects of Mergers and Acquisitions on Small Business Lending by Large Banks." Small Business Administration Office of Advocacy (March 2005).

appointment process that currently requires a new OTS Director to fill out the expiring term of a predecessor, rather than receiving a new five-year term.

We believe that both of these revisions are important given our continuing focus on the stability of the financial system and the regulatory oversight agencies in the event of a national emergency. For example, existing uncertainty about succession authority for an OTS Acting Director could impair the ability of OTS to act effectively and decisively in a crisis if an existing OTS Director or an Acting Director, such as me, suddenly was incapacitated as a result of an event arising from a national emergency.

The OCC has long-standing authority for appointing Deputy Comptrollers,[7] and both the FDIC and Federal Reserve Board have succession authority built into their operative authorizing statutes. One approach to ensure OTS continuity would be to amend HOLA to permit the Treasury Secretary to make the OTS appointments so each potential OTS Acting 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 FBAs. 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 greater, delays, it is important to promote stability and continuity within OTS by encouraging

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7. 12 U.S.C. § 4.

longevity within the position of the OTS Director, as well as to establish a statutory chain of command within OTS. Implementing these suggested changes will avoid the possibility of gaps in authority to regulate and supervise savings associations, eliminate uncertainty for the savings associations OTS regulates, and avoid potential litigation over whether the acts of OTS staff are valid.

The vacancy issue is of particular concern to OTS because we are the only financial services sector regulator that could be readily exposed to a vacancy problem. During a vacancy, OTS succession now occurs through the process of the Vacancies Act, which has inherent uncertainty regarding 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.

VI. Other Regulatory Burden Reduction 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 benefit the thrift industry.

A. Authorizing Federal Savings Associations to Merge and Consolidate with Nondepository Affiliates [Matrix # 57]

OTS favors giving federal savings associations 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.[8] The Bank Merger Act would still apply, and the new authority does not give savings associations the power to engage in new activities.

Under current law, a federal savings association may only merge with another depository institution. This proposal reduces regulatory burden on savings associations by permitting mergers with nondepository affiliates where appropriate for sound business reasons and if otherwise permitted by law. Today, if a savings association 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 savings association. Structuring a transaction in this way can be costly and unduly burdensome. We support permitting savings associations to merge with affiliates, along with the existing authority to merge with other depository institutions.

B. Amending the International Lending Supervision Act (ILSA) to Support Consistency and Equal Representation [Matrix # 66 & 67]

Two amendments to ILSA that we previously proposed would promote greater consistency among U.S. regulators in supervising the foreign activities of insured depository institutions.

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8. Section 6 of the National Bank Consolidation and Merger Act (12 U.S.C. § 215a-3).

1. Applying ILSA to Savings Associations

OTS recommends making federal and state savings associations (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 FBAs, but savings associations 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 savings associations because these institutions were not active in international finance in 1983. While savings associations maintain a domestic focus—providing credit for housing and other consumer needs within the United States—some savings associations 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 savings and loan holding companies (SLHCs) have international operations (including several foreign-based holding companies) that provide opportunities for expanded international operations by the subsidiary savings association.

While OTS has broad supervisory powers under HOLA to oversee all activities of savings associations, their subsidiaries, and their affiliates, making savings associations 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.

2. OTS Representation on the Basel Committee on Bank Supervision

Amending ILSA to support equal representation for OTS on the Basel Committee will enable OTS to share its expertise with respect to consolidated supervision of diverse, internationally active holding companies, one-to-four family and multifamily residential lending, consumer lending, and interest rate risk management. SLHCs operate in more than 130 countries, control over $6 trillion in assets, and their savings association subsidiaries originate almost one in every four residential mortgage loans in the United States. At $2.6 trillion in one-to-four family residential mortgage loan originations in 2004, this market stands as the largest credit market in the world, with over $9 trillion in currently outstanding loans.[9]

OTS currently participates in numerous Basel Committee working groups and subcommittees. Giving OTS a recognized voice on Basel will help assure that

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9. See Mortgage Bankers Association Mortgage Finance Forecast (June 6, 2005).

international bank supervision policies do not inadvertently harm savings associations or the numerous internationally active SLHCs.

C. Clarification of Citizenship of Federal Savings Associations for Federal Diversity Jurisdiction [Matrix # 58]

Pursuant to federal diversity jurisdiction, a federal savings association may sue or be sued in federal court if the claim exceeds $75,000 and the parties are citizens of different states. OTS previously proposed an amendment clarifying that, for purposes of determining diversity jurisdiction, a federal savings association is a citizen only of the state where it has its home office. We would also support a similar proposal, however, that designates that a federal savings association is a citizen for diversity jurisdiction purposes of either its home state or the state in which its principal place of business is located.

Some courts have determined that if a savings association 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. Either of the pending diversity jurisdiction proposals would avoid this result. Both would also avoid a potential similar problem with respect to mutual savings associations. 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 savings associations, those operating regionally or nationally with depositors across the country would find it difficult or impossible to establish diversity jurisdiction. Both versions of the diversity jurisdiction proposal would establish a uniform rule governing federal jurisdiction when a savings association is involved and, accordingly, reduce confusion and uncertainty.

D. Enhancing Examination Flexibility [Matrix # 68]

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 support the position endorsed by all of the FBAs that consideration of a $500 million cap for well-capitalized, well-managed institutions is appropriate.

This proposal would reduce regulatory burden on low-risk, small institutions and permit the FBAs to more effectively focus their resources on the highest risk institutions.

E. Removal of Qualified Thrift Lender Requirements with Respect to Out-of-State Branches of Federal Savings Associations [Matrix # 54]

OTS also supports removing the requirement that federal savings associations meet the QTL test on a state-by-state basis. This requirement is a superfluous regulatory burden because interstate savings associations may currently structure their activities to assure compliance with the state-by-state requirement. Thus, there is no meaningful purpose for maintaining this requirement. The QTL test should, of course, continue to apply to the institution as a whole.

F. Authority for a Savings and Loan Holding Company to Own a Separate Credit Card Savings Association [Matrix # 99]

Another unnecessary and burdensome statutory provision is a limitation imposed on existing SLHCs that limits their activities (to those permissible for a multiple SLHC) for the acquisition or chartering of a limited purpose credit card savings association, but permits acquiring or chartering (without any activities limitations) of a substantially similar limited purpose credit card bank. This restriction arises out of the fact that a SLHC generally cannot own more than one savings association (unless acquired in a supervisory transaction), without being subject to the activities restrictions imposed on SLHCs owning multiple savings associations. Under the HOLA, a SLHC cannot charter or acquire a limited purpose credit card savings association, but can charter or acquire a limited purpose credit card bank without triggering the multiple SLHC restrictions or being treated as a bank holding company under the Bank Holding Company Act.

From a regulatory burden perspective, it makes no sense to subject a SLHC structure to an additional bank regulator, i.e., supervising a limited purpose credit card bank, simply because of a statutory activities limitation that provides the SLHC cannot own an otherwise permissible limited purpose credit card savings association that it can own if the entity is a bank. This result is illogical and excessive regulatory burden with no additional supervisory or regulatory benefit attached. An amendment providing that a limited purpose credit card savings association is not deemed a savings association, or is excluded from consideration, in applying the activities restrictions imposed on multiple SLHCs under the HOLA would fix this problem.

G. Modernizing the Community Development Investment Authority of Savings Associations [Matrix # 55]

OTS previously proposed and continues to support updating HOLA to give savings associations the same authority as national banks and state member banks to make investments to promote the public welfare. This proposal enhances the ability of savings associations 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, investment opportunities that meet the technical requirements of savings associations' current statutory community development authority are rare. As a result, OTS has found it cumbersome to promote the spirit and intent of Congress's determination to allow savings associations to make such community development investments. Currently, using its administrative authority, OTS may issue a "no action" letter when a savings association 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, lacks certainty, and is clearly burdensome.

The proposal closely tracks the existing authority for banks. Under the proposal, savings associations 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 savings association's capital and surplus, or up to 10 percent on an exception basis.

H. Eliminating Geographic and Ownership Limits on Thrift Service Companies [Matrix # 56 & 94]

OTS supports legislation authorizing federal savings associations to invest in service companies without regard to the current geographic and ownership restrictions. Current law permits a federal savings association to invest in a service company only if (i) the service company is chartered in the savings association's home state, and (ii) the service company's stock is available for purchase only by savings associations chartered by that state and other federal savings associations 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 savings associations, which often operate in more than one state, to join with savings associations and banks to obtain services at lower costs due to economies of scale or to engage in other approved activities.

Today, a savings association 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 savings association'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 savings associations and banks, and discourages otherwise worthwhile investments. While this proposal simplifies the ability of banks and savings associations to invest together in service companies, it does not expand the powers of savings associations or banks. The activities of the service company must be permissible investments under the rules applicable to the savings association or bank.

I. Streamlining Agency Action under the Bank Merger Act [Matrix # 69]

OTS supports streamlining Bank Merger Act application requirements by eliminating the requirement that each FBA 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 savings association 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 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.

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, and without undue impact on existing consumer protections. 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.

PREPARED STATEMENT OF JOANN M. JOHNSON *

CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

JUNE 21, 2005

Chairman Shelby, Ranking Member Sarbanes, Senator Crapo, and Members of the Committee, on behalf of the National Credit Union Administration (NCUA) I am pleased to be here today to present our agency's views on regulatory efficiency and reform initiatives being considered by Congress. Enacting legislation that will directly and indirectly benefit the consumer and the economy by assisting all financial intermediaries and their regulators perform the role and functions required of them is prudent.

Regulatory Relief and Efficiency

In June 2004, I testified before this Committee and presented several legislative proposals NCUA recommended for your consideration. NCUA continues to recommend these provisions as desirable components of regulatory reform:

- Permit Federal credit unions to cash checks and money transfer services for individuals in their field of membership but not yet members. 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. The House of Representatives has taken this up as H.R. 749, amended it to include international remittances and passed the bill. Section 3 of S. 31, introduced by Senator Sarbanes and other Members of the Committee includes a similar provision;
- Increase the allowable maturity on Federal credit union loans from 12 to 15 years. 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;
- Increase the investment limit in credit union service organizations (CUSO's) from 1 percent to 3 percent. The 1 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;
- Safely increase options for credit unions to invest their funds by expanding authority beyond loans, government securities, deposits in other financial institutions and certain other very limited investments. The recommendation is to permit additional investments in corporate debt securities (as opposed to equity) and further establish specific percentage limitations and investment grade standards;
- Alleviate NCUA from the process now required that it consider a spin-off of any group of over 3,000 members in the merging credit union when two credit unions merge voluntarily. A spin-off would most likely undermine financial services to the affected group and may create safety and soundness concerns;
- Provide relief for credit unions from a requirement that they register with the SEC as broker-dealers when engaging in certain de minimums securities activities. The principle established by the present bank exemption, and a similar exemption sought by thrifts, is that securities activities of an incidental nature to the financial institutions do not have to be placed into a separate affiliate;
- Make needed technical corrections to the Federal Credit Union Act.

These NCUA recommendations are more fully described on the following pages.

NCUA has also reviewed the following additional credit union provisions included in the matrix circulated by Senator Crapo in anticipation of this hearing. 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 ensure: Leases of land on Federal facilities for credit unions; exclusion of member business loans to nonprofit religious organizations; criteria for continued membership of certain member groups in community charter conversions; credit union governance provisions; providing NCUA with greater flexibility to adjust the Federal usury ceiling for Federal credit unions; and an exemption from the premerger notification requirements of the Clayton Act.

Preserving the Net Worth of Credit Unions in Mergers

NCUA anticipates that the Financial Accounting Standards Board (FASB) will act in 2005 or 2006 to lift the current deferral of the acquisition method of accounting

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* Appendix held in Committee files.

for mergers by credit unions thereby eliminating the pooling method and requiring the acquisition method beginning in 2007.[1] When this change to accounting rules is implemented it will require that, in a merger, the net assets on a fair value basis of the merging credit union as a whole, rather than retained earnings, be carried over as "acquired equity," a term not recognized by the "Federal Credit Union Act" (FCUA).

This FASB policy has been in place since mid-2001 for most business combinations and the delay by FASB in implementing it for credit unions has allowed all of us to explore how credit unions could conform to the new financial reporting standards.

Without the changes to the "Federal Credit Union Act," only "retained earnings" of the continuing credit union will count as net worth after a merger. This result would seriously reduce the post-merger net worth ratio of a fFederally insured credit union, because this ratio is the retained earnings of only the continuing credit union stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has adverse implications under the statutory "prompt corrective action" (PCA) regulation. This result will discourage voluntary mergers and on occasion make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF). Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost.

NCUA encourages this Committee to include language in legislation to allow NCUA to continue to recognize the "net worth" of the merging credit union for purposes of prompt corrective action. A solution has been referred to this Committee as H.R. 1042, the "Net Worth Amendment for Credit Unions Act."

Reform of Prompt Corrective Action System for Federally Insured Credit Unions

The guiding principle behind PCA is to resolve problems in federally insured credit unions at the least long-term cost to the NCUSIF. This mandate is good public policy and consistent with NCUA's fiduciary responsibility to the insurance fund. While NCUA supports a statutorily mandated PCA system, the current statutory requirements for credit unions are too inflexible and establish a structure based primarily on a "one-size-fits all" approach, relying largely on a high leverage requirement of net worth to total assets. This creates inequities for credit unions with low-risk balance sheets and limits NCUA's ability to design a meaningful risk-based system.

Reform of capital standards is vital for credit unions as the other Federal banking regulators explore implementation of BASEL II and other capital reforms for banks in the United States. While maintaining a leverage ratio, NCUA's PCA reform proposal incorporates a more risk-based approach to credit union capital standards consistent with BASEL I and II. In recognition of the inherent limitations in any risk-based capital system, our proposal incorporates leverage and risk-based standards working in tandem. The risk-based portion of the proposed tandem system uses risk portfolios and weights based on the BASEL II standard approach.

For the leverage requirement, NCUA supports a reduction in the standard net worth (that is, leverage) ratio requirement for credit unions to a level comparable to what is required of FDIC insured institutions. The minimum leverage ratio for a well-capitalized credit union is currently set by statute at 7 percent, compared to the threshold of 5 percent for FDIC-insured institutions. Our proposed new leverage requirement, while comparable, accounts for the 1 percent method of capitalizing the NCUSIF, and its effect on the overall capital in the Insurance Fund and the credit union system. The result is a leverage requirement for credit unions that averages 5.7 percent under our proposal, as compared to the 5 percent requirement in the banking system. There are important reasons why the leverage ratio for credit unions ratio should be lowered to work in tandem with a risk-based requirement.

First, credit unions should not be placed at a competitive disadvantage by being held to higher capital standards when they are not warranted to protect the insurance fund. For FDIC insured institutions, a 5 percent leverage requirement coupled with a risk-based system has provided adequate protection for their insurance fund. In comparison, the credit union industry has a relatively low-risk profile, as evi-

[1] 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 (that is, 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).

denced by our low loss history. This is largely due both to the greater restrictions on powers of credit unions relative to other financial institutions and credit unions' conservative nature given their member-owned structure. In fact, our experience has shown that given economic needs and their conservative nature, the vast majority of credit unions will operate with net worth levels well above whatever is established as the regulatory minimum.

In addition, the current 7 percent leverage requirement is excessive for low risk institutions and overshadows any risk-based system we design, especially if you consider that under BASEL the risk-based capital requirement is 8 percent of risk assets. A meaningful risk-based system working in tandem with a lower leverage requirement provides incentives for financial institutions to manage the risk they take in relation to their capital levels, and gives them the ability to do so by reflecting the composition of their balance sheets in their risk-based PCA requirements. The current high leverage requirement provides no such ability or incentive and, in fact, it can be argued could actually contribute to riskier behavior to meet these levels given the extra risk isn't factored into the dominant leverage requirement.

As mentioned above, we recognize that achieving comparability between the Federal insurance funds does require us to factor in the NCUSIF's deposit-based funding mechanism. Thus, our reform proposal incorporates a revised method for calculating the net worth ratio for PCA purposes by adjusting for the deposit credit unions maintain in the share insurance fund. However, our proposed treatment of the NCUSIF deposit for purposes of regulatory capital standards in no way alters its treatment as an asset under generally accepted accounting principles, or NCUA's steadfast support of the mutual, deposit-based nature of the NCUSIF.

As for capitalization investments in corporate credit unions, these are not uniformly held by all credit unions. Indeed, not all credit unions even belong to a corporate credit union. Thus, these investments are appropriately addressed under the risk-based portion of PCA. Our reform proposal addresses capitalization investments in corporate credit unions consistent with BASEL and the FDIC's rules applicable to capital investments in other financial institutions.

For the risk-based requirement, our proposal tailors the risk-asset categories and weights of BASEL II's standard approach, as well as related aspects of the FDIC's PCA system, to the operation of credit unions. The internal ratings-based approach of BASEL II for the largest internationally active banks is not applicable to credit unions. However, it is our intention to maintain comparability with FDIC's PCA requirements for all other insured institutions and keep our risk based requirement relevant and up-to-date with emerging trends in credit unions and the marketplace.

As there are limitations in any regulatory capital scheme, NCUA's reform proposal also includes recommendations to address these other forms of risk under the second pillar of the supervisory framework, a robust supervisory review process. Through our examination and supervision process, NCUA will continue to analyze each credit union's capital position in relation to the overall risk of the institution, which may at times reflect a need for capital levels higher than regulatory minimums.

I would also point out that our reform proposal addresses an important technical amendment needed to the statutory definition of net worth. As mentioned earlier, NCUA anticipates that the Financial Accounting Standards Board (FASB) will act soon to lift the current deferral of the acquisition method of accounting for mergers by credit unions, thereby eliminating the pooling method and requiring the acquisition method. NCUA's PCA proposal includes a legislative solution to this problem, but if the issue is considered separately in Senate regulatory relief legislation before the expected FASB implementation date, that is a favorable outcome.

Enabling NCUA to adopt a PCA system that remains relevant and up-to-date with emerging trends in credit unions and the marketplace provides safety, efficiency, and benefits to the credit union consumer. I believe our reform proposal achieves a much needed balance between enabling credit unions to utilize capital more efficiently to better serve their members while maintaining safety and soundness and protecting the share insurance fund. 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 more fully risk-based would better achieve the objectives of PCA and is consistent with sound risk management principles.

Net Worth Category Comparison - Current vs. Proposed PCA System
Number of Federally Insured Credit Unions (Excluding "New" Credit Unions)
December 31, 2004 Data

		Proposed System					
	PCA Classification	Well-capitalized	Adequately capitalized	Under-capitalized	Significantly under-capitalized	Critically under-capitalized	Total
Current System	Well-capitalized	8,753	0	12	0	0	8,765
Current System	Adequately capitalized	89	0	17	0	0	106
Current System	Undercapitalized	1	17	14	9	0	41
Current System	Significantly undercapitalized	0	0	0	5	3	8
Current System	Critically undercapitalized	0	0	0	0	7	7
	Total	8,843	17	43	14	10	8,927

The red fields represent a reduction in PCA category, the yellow fields represent no change in PCA category, and the green fields represent an increase in PCA category.

As the above table illustrates, the PCA category for the vast majority of credit unions, reflecting their already strong net worth levels, would remain unchanged. However, 107 credit unions would improve into a higher PCA category given their relatively low-risk profiles. At the same time 41 credit unions would experience a reduction in their net worth category, thus accelerating corrective action for these inadequately capitalized credit unions. In fact, almost all of the 29 downgrades from well or adequately capitalized to undercapitalized under the new system are due to the proposed new risk-based requirement, indicating the new system is better recognizing risk in relation to net worth levels. I would also point out that the proposed new tandem system is rigorous in respect to thinly capitalized credit unions as no significantly or critically undercapitalized credit unions are upgraded under the proposed system, and the overall level of critically, significantly, and undercapitalized credit unions increases.

Explanation of NCUA Recommended Provisions for Consideration by the Committee on Banking, Housing, and Urban Affairs

CHECK CASHING AND MONEY TRANSFER SERVICES OFFERED WITHIN THE FIELD OF MEMBERSHIP OF THE CREDIT UNION

Current Law

Section 107 of the Federal Credit Union Act authorizes Federal credit unions to provide check cashing and money transfer services to members.

Proposed Amendment

This amendment permits Federal credit unions to offer these same services to persons eligible to be members of the credit union, defined as those that fall within the field of membership of the credit union.

Reasons for Change

- Congress and the Administration are asking financial institutions to do more to reach the "unbanked."
- Credit unions are constrained from extending the most basic financial transaction (check cashing) to those who have avoided traditional financial institutions.
- Expanding check cashing, wire transfer, and similar services to nonmembers within a credit union's field of membership would provide an introduction to reliable low-cost financial services which can provide a viable alternative to less savory practices while at the same time increase confidence in traditional financial organizations.
- With more and more credit unions adopting underserved areas, these services become especially important in reaching out to the underserved.

ELIMINATE THE 12-YEAR LIMIT ON TERM OF FEDERAL CREDIT UNION LOANS

Current Law

The Federal Credit Union Act imposes a 12-year loan maturity limit on most credit union loans. Principal residence loans have maturities up to 30 years, and principal mobile home loans have maturities of 15 years.

Proposed Amendment

The proposed amendment permits the NCUA Board to provide for maturity limits up to 15 years, or longer, as the NCUA Board may allow by regulation.

Reasons for Change

- The current restriction placed on Federal credit unions is outdated and unnecessarily restricts a credit union's lending terms to its members.
- Members of Federal credit unions should be able to obtain loans for second homes, recreational vehicles, and other purposes in accordance with conventional maturities that are commonly accepted in the market today.

INCREASE IN 1 PERCENT INVESTMENT LIMIT IN CUSO'S

Current Law

The Federal Credit Union Act permits Federal credit unions to invest in Credit Union Service Organizations (CUSO's)—organizations providing services to credit unions and credit union members. An individual credit union, however, may invest in aggregate no more than 1 percent of its shares and undivided earning in these organizations.

Proposed Amendment

The provision increases the permissible credit union investment in CUSO's from 1 percent to 3 percent of its shares and undivided earnings.

Reasons for Change

- CUSO's are frequently established by several credit unions to provide important services to credit unions, such as check clearing and data processing, which can be done more efficiently for a group.
- When these services are provided through a CUSO, any financial risks are isolated from the credit union while allowing the credit unions to retain quality control over the services offered and the prices paid by the credit unions or their members.
- An increase in the CUSO investment to 3 percent allows the CUSO to continue servicing its credit union members without having to bring services back in-house or engage outside providers. This controls risk and expense to the credit union.
- The 1 percent limit has not been updated since its inception in 1977.

INVESTMENTS IN SECURITIES BY FEDERAL CREDIT UNIONS

Current Law

The Federal Credit Union Act authorizes Federal credit unions to invest in loans, obligations of the United States, or securities fully guaranteed as to principal and interest by the U.S. Government, deposits in other financial institutions, and certain other limited investments, such as obligations of Federal Home Loan Banks, wholly owned government corporations, or in obligations, participations or other instruments issued by, or fully guaranteed by FNMA, GNMA, or FHLMC.

Proposed Amendment

This amendment would provide authority for Federal credit unions to purchase and hold for their own account "investment securities" if they are in one of the four highest investment rating categories—subject to further definition and qualification by NCUA rulemaking.

The amendment limits Federal credit unions' investments in investment securities in two ways. First, a statutory "single obligor" percentage limitation is established, such that the total amount of investment securities of any single obligor or maker held by the Federal credit union for the credit union's own account cannot exceed 10 percent of the net worth of the credit union. Second, the aggregate amount of investments held by the Federal credit union for its own account cannot exceed 10 percent of the assets of the credit union.

Reasons for Change

- A number of private debt instruments such as highly rated commercial paper, corporate notes, and asset-backed securities would be appropriate investments for Federal credit unions.

- Other federally regulated and State regulated financial institutions have a proven track record with these limited investments.
- Allowing such investments would give credit unions more asset liability management options.
- NCUA implementing regulations will further address appropriate investment gradings, possible minimum credit union net worth requirements, and other safety and soundness requirements.
- With a percentage limitation of 10 percent of net worth per single obligor, this modest increase in investment flexibility will not subject credit unions to undue risk.
- The 10 percent limitation language parallels the limitation applicable to national banks when applied to the "net worth" measurement for credit unions.
- The prohibition against investment in equity securities is maintained.

VOLUNTARY MERGER AUTHORITY

Current Law

Section 109 of the Federal Credit Union Act requires NCUA to engage in an analysis of every voluntary merger of healthy Federal credit unions to determine whether a spin-off of any select employee group (SEG) of over 3,000 members in the merging credit union can be effectively accomplished.

Proposed Amendment

The recommendation is to eliminate the requirement that NCUA engage in an analysis of every voluntary merger to determine whether a select employee group over 3,000 can be spun-off into a separate credit union.

Reasons for Change

- Requiring NCUA to engage in an analysis of every voluntary merger of healthy Federal credit unions to consider a spin-off from the merging credit union of any select employee group (SEG) of over 3,000 is cumbersome and provides little practical benefit or purpose. There are about 300 a year.
- When two healthy multiple bond credit unions pursue a merger, it increases their financial strength and member service is enhanced, as well as their long-term safety and soundness.
- Member employee (or other) groups over 3,000 are already included in a multiple group credit union in accordance with statutory standards.

TREATMENT OF CREDIT UNIONS AS DEPOSITORY INSTITUTIONS UNDER SECURITIES LAWS

Current Law

Section 201 and 202 of the Gramm-Leach-Bliley Act, enacted in 1999, created specific exemptions from broker-dealer registration requirements of the Bank Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisors Act of 1940. The principle established in these laws is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate and functionally regulated.

Proposed Amendment

This provision would provide a statutory exemption for credit unions similar to that already provided banks and allow credit unions, like banks, to avoid complicated filings with the Securities and Exchange Commission for incidental activities.

Reasons for Change

- Federal credit unions are empowered to engage in specific activities enumerated in the FCUA and any other activities incidental to the enumerated activities. Among the specific broker-related activities currently authorized are third-party brokerage arrangements, sweep accounts, safekeeping and custodial activities. Among the dealer-related activities are the purchase and sale of particular securities, including but not limited to municipal securities and "Identified Banking Products" for the credit union's own account.
- These incidental activities might trigger SEC registration if not exempted by law.
- This important regulatory relief and efficiency provision would reduce the cost and complication to credit unions having to approach the SEC on a case-by-case basis or through regulation—the only avenues now available to them for relief.
- While a Federal or State chartered credit union might be granted authority to engage in otherwise lawful activities, the credit union might have to abandon the

activity or outsource it to a third party at increased expense if this exemption is not provided.

- This exemption would not expand the types of securities activities that credit unions are authorized to engage in. It simply serves to provide parity with banks and thrifts regarding an exemption from SEC registration for the limited securities activities credit unions are authorized to engage in.

TECHNICAL CORRECTIONS TO THE FEDERAL CREDIT UNION ACT

Explanation of Proposed Amendment

Twenty-eight purely technical and clerical corrections to the Federal Credit Union Act have been identified as needed.

Reasons for Change

To make the Federal Credit Union Act accurate and correct.

Conclusion

Thank you, Mr. Chairman, Senator Sarbanes, and Senator Crapo for the opportunity to appear before you today on behalf of NCUA to discuss the public benefits of regulatory efficiency for NCUA, credit unions and 84 million credit union members. I am pleased to respond to any questions the Committee may have or to be a source of any additional information you may require.

PREPARED STATEMENT OF ERIC McCLURE

COMMISSIONER, MISSOURI DIVISION OF FINANCE

ON BEHALF OF THE

CONFERENCE OF STATE BANK SUPERVISORS

JUNE 21, 2005

Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am Eric McClure, Commissioner of the Missouri Division of Finance, and I am pleased to be here today on behalf of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to be here today to discuss strategies for reducing unnecessary regulatory burden on our Nation's financial institutions.

CSBS is the professional association of State officials who charter, regulate, and supervise the Nation's approximately 6,240 State-chartered commercial banks and savings institutions, and nearly 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. We especially appreciate this opportunity to discuss our views in our capacity as the chartering authority and primary regulator of the vast majority of our Nation's community banks.

Chairman Shelby, we applaud your longstanding commitment to ensuring that regulation serves the public interest without imposing unnecessary or duplicative compliance burdens on financial institutions. At the State level, we are constantly balancing the need for oversight and consumer protections with the need to encourage competition and entrepreneurship. We believe that a diverse, healthy financial services system serves the public best.

CSBS and the State banking departments have been working closely with the Federal banking agencies, through the Federal Financial Institutions Examination Council, to implement the Economic Growth and Regulatory Paperwork Reduction Act of 1996. While this legislation made necessary and beneficial changes, we see continuing opportunities for Congress to streamline and rationalize regulatory burden, especially for community banks.

Principles for Regulatory Burden Relief

The Conference of State Bank Supervisors has developed a set of principles to guide a comprehensive approach to regulatory burden relief, and we ask Congress to consider each proposal carefully against these principles.

First, a bank's most important tool against regulatory burden is its ability to make meaningful choices about its regulatory and operating structures. The State charter has been and continues to be the charter of choice for community-based institutions because the State-level supervisory environment—locally oriented, relevant, responsive, meaningful, and flexible—matches the way these banks do business.

A bank's ability to choose its charter encourages regulators to operate more efficiently, more effectively, and in a more measured fashion. A monolithic regulatory regime would have no incentive for efficiency. The emergence of a nationwide financial market made it necessary to create a Federal regulatory structure, but the State system remains as a structural balance to curb potentially excessive Federal regulatory measures, and as a means of promoting a wide diversity of financial institutions.

Second, our current regulatory structure and statutory framework may recognize some differences between financial institutions, but too often mandate overarching "one-size-its-all" requirements for any financial institution that can be described by the word "bank." These requirements are often unduly burdensome on smaller or community-based institutions.

Regulatory burden always falls hardest on smaller institutions. Although 48 of the Nation's 100 largest banks hold State charters, State charters make up the vast majority of these smaller institutions. We see this impact on earnings every day among the institutions we supervise. In a May 27 letter to American Banker, FDIC Vice Chairman John Reich noted the disproportionate impact of compliance costs on institutions with less than $1 billion in assets. Community banks represent a shrinking percentage of the assets of our Nation's banking system, and we cannot doubt that compliance costs are in part driving mergers. Even where laws officially exempt small, privately held banks, as in the case of Sarbanes-Oxley, the principles behind these laws hold all institutions to increasingly more expensive compliance standards.

This is a crucial time for Congress to take the next step in reviewing the impact that these Federal statutes have had on the economy of this great country. My colleagues and I see growing disparity in our Nation's financial services industry. The industry is bifurcated, and becoming more so. A line exists—although it is not a clear line at this time—that divides our country's banking industry into larger and smaller institutions. Congress must recognize this reality, and the impact this bifurcation has on our economy.

The Nation's community banking industry is the fuel for the economic engine of small business in the United States. Although I speak as a State bank supervisor, I recognize that federally chartered community banks are also important to small business.

Small business is a critical component of the U.S. economy. According to the Small Business Administration, small business in the United States accounts for 99 percent of all employers, produces 13 times more patents per employee than large firms, generates 60 to 80 percent of new jobs, and employs 50 percent of the private sector. Small businesses must be served, and community banks are the primary source of that service. They can often more readily provide customized products that fit the unique needs of small businesses. Regulatory burden relief will help community banks provide the service that fuels this economic engine.

Stifling economic incentives for community banks with excessive statutory burdens slows this economic engine of small business in the United States. Regulatory burden relief for community banks would be a booster shot for the nation's economic well-being.

We suggest that Congress and the regulatory agencies seek creative ways to tailor regulatory requirements for institutions that focus not only on size, but also on a wider range of factors that might include geographic location, structure, management performance and lines of business. As the largest banks are pushing for a purely national set of rules for their evolving multistate 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.

Third, while technology continues to be an invaluable tool of regulatory burden relief, it is not a panacea.

Technology has helped reduce regulatory burden in countless ways. State banking departments, like their Federal counterparts, now collect information from their financial institutions electronically as well as through on-site examinations. Most State banking departments now accept a wide range of forms online, and allow institutions to pay their supervisory fees online as well. Many state banking departments allow institutions online access to maintain their own structural information, such as addresses, branch locations, and key officer changes.

At least 25 State banking agencies allow banks to file data and/or applications electronically, through secure areas of the agencies' websites. Nearly all of the States have adopted or are in the process of accepting an interagency Federal application that allows would-be bankers to apply simultaneously for a State charter and for Federal deposit insurance.

Shared technology allows the State and Federal banking agencies to work together constantly to improve the examination process, while making the process less intrusive for financial institutions. Technology helps examiners target their examinations through better analysis, makes their time in financial institutions more effective, and expedites the creation of examination reports.

The fact that technology makes it so much easier to gather information, however, should not keep us from asking whether it is necessary to gather all of this information, or what we intend to do with this information once we have it. Information-gathering is not cost-free.

Our Bankers Advisory Board members have expressed particular concern about Bank Secrecy Act requirements, Currency Transaction Reports, and Suspicious Activity Reports. These collection requirements have become far more extensive in the past 3 years, representing the new importance of financial information to our national security. Industry representatives, however, estimate that CTR's cost banks at least $25 per filing. Although they understood the importance of gathering this data, our Bankers Advisory Board members reported widespread frustration at the perception that law enforcement agencies do little, if anything, with this costly information. CSBS has worked diligently with FinCEN and the Federal banking agencies to develop clear, risk-based BSA examination procedures. We hope these procedures will alleviate some of the financial industry's concerns in this area. Federal law enforcement agencies need to work with State and Federal regulators to ensure clear guidance is provided to the industry with regard to prosecution. We also urge Congress, FinCEN, and the Federal banking regulators to simplify the BSA reporting forms and look carefully at potential changes to threshold levels.

Finally, although regulators constantly review regulations for their continued relevance and usefulness, many regulations and supervisory procedures still endure past the time that anyone remembers their original purpose.

Many regulations implement laws that were passed to address a specific issue; these regulations often stay on the books after the crisis that spurred new legislation has passed. Recognizing this, many State banking statutes include automatic sunset provisions. These sunset provisions require legislators and regulators to review their laws at regular intervals to determine whether they are still necessary or meaningful.

We could hardly do that with the entire Federal banking code, but the passage of the Fair Credit Reporting Act amendments showed how valuable this review process can be. We urge Congress to apply this approach to as wide a range of banking statutes as possible.

The Conference of State Bank Supervisors endorses approaches, such as the Communities First Act (H.R. 2061 introduced in the House of Representatives by Congressman Jim Ryun (R–KS)), that recognize and encourage the benefits of diversity within our banking system. CSBS supports the great majority of regulatory burden reductions proposed in the Communities First Act, believing that they will alleviate the burden on community banks without sacrificing either safety and soundness or community responsiveness and responsibility. Our dual banking system exists because one size is not appropriate for every customer, and one system is not appropriate for every institution. We ask that Congress include some type of targeted relief for community banks in any regulatory relief legislation.

Through extensive discussions among ourselves and with State-chartered banks, and in addition to the concepts and ideas expressed in the Communities First Act, we recommend seven specific changes to Federal law that will help reduce regulatory burden on financial institutions, without undue risk to safety and soundness. We ask that the Committee include these provisions in any legislation it approves.

Extended Examination Cycles for Well-Managed Banks under $1 Billion

We believe that advances in off-site monitoring techniques and technology, and the health of the banking industry, make annual on-site examinations unnecessary for the vast majority of healthy financial institutions. Therefore, we ask that Congress extend the mandatory Federal examination cycle from 12 months to 18 months for healthy, well-managed banks with assets of up to $1 billion.

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 that was included in the House passed version of a regulatory relief bill in the 108th Congress (H.R. 1375 section 616) intended to improve the State system for multistate 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 multistate 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.

Regulatory Flexibility for the Federal Reserve

CSBS also favors a provision that would give the Federal Reserve the necessary flexibility to allow State-chartered member banks to exercise the powers granted by their charters, as long as these activities pose no significant risk to the deposit insurance fund.

A major benefit of our dual banking system has always been the ability of each State to authorize new products, services, and activities for their State-chartered banks. Current law limits the activities of State-chartered, Fed member banks to those activities allowed for national banks. This restriction stifles innovation within the industry, and eliminates a key dynamic of the dual banking system.

We endorse an amendment to remove this unnecessary limitation on State member banks as it has no basis in promoting safety and soundness. Congress has consistently reaffirmed State authority to design banking charters that fit their unique market needs. FDICIA, in 1991, allowed States to continue to authorize powers beyond those of national banks. Removing this restriction on State member banks would be a welcome regulatory relief.

Limited Liability Corporations

States have been the traditional source of innovations and new structures within our banking system, and CSBS promotes initiatives that offer new opportunities for banks and their customers without jeopardizing safety and soundness.

In this tradition, CSBS strongly supports an FDIC proposal to make Federal deposit insurance available to State-chartered banks that organize as limited liability corporations (LLC's). An LLC is a business entity that combines the limited liability of a corporation with the pass-through tax treatment of a partnership.

The FDIC has determined that State banks organized as LLC's 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 handful of States now allow banks to organize as LLC's, including Maine, Nevada, Texas, Vermont, and, most recently, Utah. More States may consider this option, however, because the structure offers the same tax advantages as Subchapter S corporations but with greater flexibility. Unlike Subchapter S corporations, LLC's are not subject to limits on the number and type of shareholders.

It is not clear, however, that Federal law allows pass-through taxation status for State banks organized as LLC's. An Internal Revenue Service regulation currently blocks pass-through tax treatment for State-chartered banks. We ask the Committee to encourage the IRS to reconsider its interpretation of the tax treatment of State-chartered LLC's.

Federal Financial Institutions Examination Council

CSBS believes that a State banking regulator should have a vote on the Federal Financial Institutions Examination Council (FFIEC), the coordinating body of Federal banking agencies.

The FFIEC's State Liaison Committee includes State bank, credit union, and savings bank regulators. The chairman of this Committee has input at FFIEC meetings, but is not able to vote on policy or examination procedures that affect the institutions we charter and supervise.

Improving coordination and communication among regulators is one of the most important regulatory burden relief initiatives. To that end, we recommend that Congress change the State position in FFIEC from one of observer to that of full voting member.

State bank supervisors are the primary regulators of approximately 74 percent of the Nation's banks, and thus are vitally concerned with changes in Federal regulatory policy and procedures.

De Novo Interstate Branching

CSBS seeks changes to Federal law that would allow all banks to cross State lines by opening new branches. While Riegle-Neal intended to leave this decision in the hands of the States, inconsistencies in Federal law have created a patchwork of contradictory rules about how financial institutions can branch across State lines.

These contradictions affect State-chartered banks disproportionately. Federally chartered savings institutions are not subject to *de novo* interstate branching restrictions, and creative interpretations from the Comptroller of the Currency have exempted most national banks, as well.

Therefore, we ask Congress to restore competitive equity by allowing *de novo* interstate branching for all federally insured depository institutions.

Deposit Insurance for Branches of International Banks Licensed to do Business in the United States

Finally, CSBS urges the Committee to review the statutory prohibition on the establishment of additional FDIC-insured branches of international banks.

Since Congress enacted this prohibition in 1991, cooperation and information sharing between the United States and home country regulators have improved substantially. An international bank wishing to establish a branch in the United States must obtain approval from the Federal Reserve as well as from the licensing authority, and the Federal Reserve must find the bank to be subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. These supervisory changes eliminate many of the concerns about establishing additional FDIC-insured branches that led to the statutory prohibition.

International banks operating in the United States benefit the U.S. economy through job creation, operating expenditures, capital investments, and taxes. The vast majority of international bank branches are licensed by the States, and are assets to the states' economies. The Committee should review and remove this prohibition, and allow international banks the option of offering insured accounts.

Challenges to Regulatory Burden Relief

The current trend toward greater, more sweeping Federal preemption of State banking laws threatens all of the regulatory burden relief issues described above.

Federal preemption can be appropriate, even necessary, when genuinely required for consumer protection and competitive opportunity. The extension of the Fair Credit Reporting Act amendments met this high standard.

We appreciate that the largest financial services providers want more coordinated regulation that helps them create a nationwide financial marketplace. We share these goals, but not at the expense of distorting our marketplace, denying our citizens the protection of State law and the opportunity to seek redress close to home, or eliminating the diversity that makes our financial system great. The Comptroller's regulations may reduce burden for our largest, federally chartered institutions and their minority-owned operating subsidiaries, but they do so at the cost of laying a disproportionate burden on State-chartered institutions and even on smaller national banks.

We ask the Committee and Congress to review the disparity in the application of State laws to State and nationally chartered banks and their subsidiaries. Because expansive interpretations of Federal law created this issue, a Federal solution is necessary in order to preserve the viability of the State banking system.

Conclusion

Mr. Chairman, Members of the Committee, the regulatory environment for our Nation's banks has improved significantly over the past 10 years, in large part because of your vigilance.

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, and among community-based institutions as well as among the largest providers.

Diversity in our financial system is not inevitable. Community banking is not inevitable. This diversity is the product of a consciously developed State-Federal system, and any initiative to relieve regulatory burden must recognize this system's value. A responsive and innovative State banking system that encourages community banking is essential to creating diverse local economic opportunities.

State bank examiners are often the first to identify and address economic problems, including cases of consumer abuse. We are the first responders to almost any problem in the financial system, from downturns in local industry or real estate markets to the emergence of scams that prey on senior citizens and other consumers. We can and do respond to these problems much more quickly than the Federal Government, often bringing these issues to the attention of our Federal counterparts and acting in concert with them.

State supervisors are sensitive to regulatory burden, and constantly look for ways to simplify and streamline compliance. We believe in, and strive for, smart, focused, and reasonable regulation. Your own efforts in this area, Chairman Shelby, have greatly reduced unnecessary regulatory burden on financial institutions regardless of their charter.

The industry's record earnings levels suggest that whatever regulatory burdens remain, they are not interfering with larger institutions' ability to do business profitably. The growing gap between large and small institutions, however, suggests a trend that is not healthy for the industry or for the economy.

The continuing effort to streamline our regulatory process while preserving the safety and soundness of our Nation's financial system is critical to our economic well-being, as well as to the health of our financial institutions. State bank supervisors continue to work with each other, with our legislators and with our Federal counterparts to balance the public benefits of regulatory actions against their direct and indirect costs.

We commend you, Mr. Chairman, Senator Crapo, and the Members of this Committee for your efforts in this area. We thank you for this opportunity to testify, and look forward to any questions that you and the Members of the Committee might have.

PREPARED STATEMENT OF STEVE BARTLETT*

PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE FINANCIAL SERVICES ROUNDTABLE

JUNE 21, 2005

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is Steve Bartlett and I am President & CEO of The Financial Services Roundtable.

The Roundtable represents 100 of the Nation's largest integrated financial services companies. Our members provide banking, insurance, and investment products and services to millions of American consumers. Roundtable member companies account for $17.1 trillion in managed assets, $888 billion in revenue, and 2 million jobs.

The Roundtable appreciates the opportunity to share its views on the topic of regulatory relief for financial services firms. We strongly support efforts to reduce the regulatory burden confronting the financial services industry. Outdated laws and regulations impose significant, and unnecessary, burdens on financial services firms,

*Appendix held in Committee files.

and these burdens not only make our firms less efficient, but also increase the cost of financial products and services to consumers.

I recognize that in some respects I am "preaching to the choir" when I cite the burdens of regulation on financial services firms. This Committee, and Senator Crapo in particular, have been in the forefront of efforts to eliminate unnecessary and overly burdensome laws and regulations applicable to financial services firms. The Roundtable appreciates these efforts, and hopes that they will be fully realized with the enactment of a regulatory burden relief bill in this Congress.

Recently, the Roundtable has undertaken its own initiative aimed at regulatory burden relief. Based upon input from our members, we have identified four major regulatory problems in need of reform. We have undertaken a dialogue with the appropriate Federal financial regulatory agencies about these problems, and, in some instances, have recommended specific remedies. I will begin by addressing these four key issues. I also have highlighted a number of other regulatory reforms sought by the Roundtable, many of which were incorporated in H.R. 1375, the Financial Services Regulatory Relief Act, which was approved by the House of Representatives in the last Congress. Please find attached to my testimony an addendum of regulatory relief proposals offered for consideration by The Financial Services Roundtable.*

The Roundtable's Regulatory Oversight Coalition

Recently, The Roundtable initiated its own effort to reduce excessive regulation. This effort is focused on four regulatory problem areas:

- Suspicious Activity Report (SAR) filing requirements;
- SEC enforcement policies and practices;
- The confidentiality of information that is shared with Federal financial regulators; and
- Compliance with Section 404 of the Sarbanes-Oxley Act.

SAR's

Roundtable member companies strongly support the Government's efforts to combat money laundering and terrorist financing. However, we believe that the current system of reporting suspicious activities is not working properly. The best evidence of this is the dramatic increase in SAR filings in recent years. For example, since 1996, national SAR reporting has increased 453 percent. Similarly, FinCEN reported 81,197 filings in 1997 versus 288,343 filings in 2003. As of October 28, 2004, depository institutions had filed a total of 297,753 SAR's, and the total number of SAR filings is projected to double this year.

There are several reasons for this dramatic increase in SAR filings. First, the failure to file SAR's has become a criminal issue. The U.S. Justice Department has aggressively pursued actions against financial institutions for failing to file SAR's. This criminalization of the filing process has created a huge reputational risk for financial institutions, and has caused institutions to file an increasing number of SAR's in order to avoid any potential for prosecution. Second, there are no clear standards for when SAR's should be filed. Although guidelines are in place, examiners neither clearly nor consistently apply them. In addition, financial institutions do not receive feedback from law enforcement on the type of information that should be included in the SAR. Third, Roundtable member companies have encountered a "zero tolerance" policy among the Federal financial regulatory agencies. Under this policy, institutions are held accountable for every single transaction.

Finally, there is a lack of coordination among the various agencies and examiners responsible for SAR filings. This lack of coordination often results in duplicate requests and multiple filings.

To address these problems, The Roundtable has urged the Federal financial regulatory agencies to take the following actions:

- Develop clear, simple guidelines on SAR's, which include safe harbor protections for institutions and individuals who file the SAR;
- Draft regulations and/or guidelines that focus on an institution's anti-money laundering program and policies, not individual transactions;
- Coordinate with each other on all examination procedures, and provide consistent interpretations of the Bank Secrecy Act;
- Consider raising the Currency Transaction Report (CTR) threshold above the current $10,000.00 level; and
- Provide additional guidance on Customer Identification Programs, including tailoring the regulations to individual businesses versus a one-size-fits-all approach.

* Held in Committee files.

Additionally, the Roundtable recommends that any decision to pursue a criminal charge against a financial institution for failure to file a SAR, or other report required by the Bank Secrecy Act, should be made by the main Justice Department, not a field office, and that such decisions be made in consultation with the appropriate Federal financial regulator for the institution.

SEC Enforcement

Roundtable member companies are increasingly concerned about the enforcement policies and practices of the Securities and Exchange Commission (SEC). Just as the Roundtable supports compliance with Federal anti-money laundering laws and regulations, the Roundtable supports compliance with our Nation's securities laws. Nonetheless, we believe that compliance is being hindered by certain SEC enforcement policies and practices.

Specifically, the Roundtable believes that there should be a "firewall" between the SEC's examination staff and the Division of Enforcement. A firewall would give institutions a chance to more freely discuss compliance issues and other practices outside of a potential enforcement context. This is the model that has been successfully followed by the Federal banking agencies, and we believe that it would enhance, not reduce, compliance with securities laws.

Second, we believe that the SEC should provide a notice to institutions when an investigation is complete. Currently, no such notices are provided, and this practice can have an unnecessary chilling effect on business operations.

Third, as discussed further below, we believe the SEC should drop its policy of "forcing" companies to waive attorney-client privilege in the course of an investigation. This policy is impairing the attorney-client privilege, and this threatens to undermine internal discussion and investigations.

Finally, we believe the SEC should give financial institutions adequate time to respond to broad document requests.

The SEC has said that it will not tolerate unreasonable delays in response to inquiries. The Roundtable does not endorse unreasonable delays, but has found that the SEC's definition of what constitutes an unreasonable delay is often very limited. This has created problems for institutions that are trying to determine what information is relevant and what is protected by the attorney-client privilege.

Confidentiality of Information Shared with Regulators

Financial institutions are required to share an increasing amount of information with Federal financial regulators. Reporting and filing requirements imposed by Federal law and regulators are a major source of this burden. For example, since the enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, Federal banking and thrift regulators have promulgated over 801 final rules, most of which impose various types of reporting and filing requirements. Additionally, financial institutions are asked to provide a wide-range of documents and information to regulators in the course of examinations and investigations.

Unfortunately, this information sharing is threatened by two developments. First, there is the potential for confidential information that is shared with a Federal financial regulator to become accessible by third parties. Needless to say, this potential can have significant chilling effects on the nature and type of information an institution is willing to share with its regulator.

Second, the Justice Department, the SEC, and the other Federal financial regulators have adopted policies that effectively undermine the attorney-client privilege. Under these policies, the wavier of the attorney-client privilege is a condition for being deemed "cooperative" with the agency, and the failure to waive the privilege can adversely affect the nature of the charges that may be brought in an enforcement case or the size of any civil money penalty that may be assessed against an institution. Such policies can have significant unintended consequences:

- They have a chilling effect on the communications between management, boards of directors, and their attorneys because of the uncertainty over what conversations and work-product is protected:
- They discourage internal investigations. The current regulatory environment, including reforms brought about by the Sarbanes-Oxley Act, encourages companies to conduct thorough internal investigations and, to the extent necessary, communicate the results of those investigations to the appropriate Federal regulators. Yet, the likelihood that such communications will result in a waiver of the attorney-client privilege creates a disincentive to conducting investigations. Thus, the current waiver policy is directly counter to the goals of Sarbanes-Oxley and similar regulatory reforms. Furthermore, the policies place employees in a difficult position during the course of investigations. If employees cooperate in an investigation, their statements may have to be provided to the investigation agency. If an

employee decided not to cooperate and withholds information, the employee risks termination or other action against them.

To protect the confidentiality of information given to a Federal financial regulator, the Roundtable urges the enactment of legislation similar to The Financial Services Antifraud Network Act of 2001 (also known as the Bank Examination Report Privilege Act or BERPA), which was proposed in the 107th Congress,[1] and the Securities Fraud Deterrence and Investor Restitution Act, which was proposed in the 108th Congress.[2] These proposals would protect the integrity and effectiveness of the information shared with Federal financial regulators. For example, BERPA would clarify that information voluntarily disclosed to an examining agency continues to be protected by the institution's own privileges. BERPA also would codify and strengthen the bank supervisory privilege by defining confidential supervisory information, affirming that such information is the property of the agency that created or requested it, and protecting this information from unwarranted disclosure to third parties. Furthermore, BERPA would reaffirm the agencies' powers to establish procedures governing the production of confidential supervisory information to third parties.

The Roundtable also recommends that such legislation be expanded to cover information shared with an institution's auditors. The Sarbanes-Oxley Act protects privileged documents provided to the Public Company Accounting Oversight Board (PCAOB) in connection with the inspections and investigations of registered audit firms.

This protection, however, does not extend to information obtained by the auditors themselves. Ensuring that information shared with auditors can remain subject to confidentiality will help to ensure the flow of information between an institution and its auditors.

With respect to the governmental policies that have the effect of undermining the attorney-client privilege, The Roundtable recommends that Congress make it clear to the Justice Department and the Federal financial regulators that the waiver of the privilege should not be a matter of policy in all investigations.

Section 404 of the Sarbanes-Oxley Act

Section 404 of the Sarbanes-Oxley Act requires SEC-reporting firms to conduct annual assessments of the effectiveness of their internal controls, and to have their auditors independently attest to and report on this assessment. The Roundtable supports the goals of this section. Strong corporate governance and transparency of management structure and internal controls are important. Nonetheless, the Roundtable has identified a certain substantial concern with the implementation of Section 404.

Most notably, Section 404 has changed the role of auditors. It has made auditors hesitant to provide advice to clients, caused auditors to impose excessive testing and documentation requirements on clients, and significantly increased the cost of outside audits.

Additionally, Section 404 has imposed significant initial and on-going costs on companies. A recent survey by Financial Executives International found that the total cost of compliance per company is approximately $4.36 million. These costs include large increases in external costs for consulting, software and other vendors, additional personnel, and, as noted above, additional fees by external auditors.

Furthermore, Roundtable members have encountered confusion over the standards in Section 404. For example, we find a need for clarity on the meaning of terms such as "material weakness" and "significant controls."

Other Needed Regulatory Reforms

There are a number of other needed regulatory reforms that the Roundtable urges the Committee to consider as it crafts regulatory relief legislation. I will start by highlighting provisions from H.R. 1375, and then list some other recommended changes to Federal law.

Interstate Banking

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.

[1] H.R. 1408, Financial Services Antifraud Network Act of 2001, U.S. House of Representatives, 107th Congress (November 7, 2001).

[2] H.R. 2179, Securities Fraud Deterrence and Investor Restitution Act, U.S. House of Representatives, 108th Congress (May 21, 2003).

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.

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 from H.R. 1375 in its version of regulatory relief legislation.

Section 401 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 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 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 Exams

A second provision related to interstate banking that we would urge the Committee to incorporate in its version of regulatory relief legislation 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 banking 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 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 three 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.[3] As a result, the securities activities of banks have been subject to regulation by banking regulators, not the Securities and Exchange Commission. 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 commercial banks.[4] As a result, the securities activities of thrifts have been subject to regulation by both the Securities and Exchange Commission (SEC) and the Office of Thrift Supervision (OTS).

[3] The scope of this exemption was narrowed in the Gramm-Leach-Bliley Act.

[4] In 1999, Congress did amend the Investment Company Act to treat thrifts the same as banks.

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 regulatory relief legislation.

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 current 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 regulatory par with commercial banks, by eliminating the costs associated with registration with the SEC.

Auto Loans

The Roundtable urges the Committee to incorporate Section 208 of H.R. 1375 in its version of regulatory relief legislation. Current law limits the amount of automobile loans by a thrift to no more than 35 percent 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 Section 204 of H.R. 1375. 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.

Cross Marketing

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 antitying 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. The Roundtable urges the Committee to amend the BHCA and establish parity of treatment between financial holding companies that own insurance affiliates and those that own merchant banking affiliates.

We also urge that the Committee permit a depository institution subsidiary of a financial holding company to engage in cross-marketing activities with a nonfinancial company held by a merchant banking affiliate if the nonfinancial 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 noncontrol situations, the separation of banking and commerce is maintained by the other restrictions contained in the BHCA 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.

These proposed modifications to the BHCA were incorporated in Section 501 of H.R. 1375.

SEC Regulation of Broker-Dealers

Sections 201 and 202 of the Gramm-Leach-Bliley Act were intended to provide for SEC regulation of certain new securities activities, but permit banks to continue to engage directly in traditional trust and accommodation activities, that have long been regulated by the banking agencies. The Gramm-Leach-Bliley Act never envisioned that banks would be forced to "push out" traditional trust activities into SEC regulated companies. Despite this clear Congressional intent, the SEC has issued proposed regulations that would do exactly that—it would force banks to divest historic business lines and push them out to registered broker-dealers. The Federal Reserve and the OCC have objected to these proposed regulations, and their comment letter to the SEC emphasizes the importance of issuing a regulation that conforms to Congressional intent.

Nevertheless, the SEC appears adamant in going forward with a far-reaching regulation that would effectively require banks to cease engaging in many traditional banking activities. The Committee should amend the Gramm-Leach-Bliley Act to strike Sections 201 and 202 to ensure that banks may continue to engage in traditional banking functions without the threat of having to push these activities out into a nonbanking company.

Diversity Jurisdiction

Under the law, citizens of two different States may avail themselves of the Federal courts if certain jurisdictional thresholds are met. Every corporation is deemed to be a citizen of two States: (1) the State of incorporation; and (2) the State in which it has its principal place of business, if different. Thus a company with offices in every State will still be able to use the Federal courts, as long as the other party is not a citizen of the company's "home" State.

National banks and Federal savings associations are treated differently. The statute provides that a national bank is a citizen in the State in which it is located, and at least one court has held that this means every State in which the bank has a branch. For Federal savings associations, there is no provision governing their citizenship, and this issue has to be litigated over and over.

We urge the Committee to amend the law to clarify that both a national bank and a Federal savings association are citizens of the State in which the institution's main or home office is located and the State in which they maintain their principal place of business, if different. This would put national banks and Federal thrift associations under the same rules that apply to every other corporation in America.

Anti-Tying

We urge the Committee to repeal the price variance feature of the existing antitying rule so that a banking institution can give a price break to commercial customers if that commercial customer decides to purchase other products and services from the institution. Banks should have the ability to offer a commercial customer a price break on a product or service if the commercial customer decides to buy another product or service. This change would not encourage antitrust activities. Unlike the classic tying case, the customer could not be forced into buying a product. If the customer thinks the price break is good enough, he or she can buy the product. If the customer does not think the price break is good enough, he or she is under no obligation to buy the product. Furthermore, our proposed change would apply only to commercial customers, not individuals or small businesses.

Simplified Privacy Notice

Like many consumers, the Roundtable member companies have found that the privacy notice required by the 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 version of regulatory relief legislation that directs the relevant Federal agencies to finalize a simplified privacy notice for purposes of GLBA, and provides that such a notice supersede 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.

Real Estate Brokerage

The Financial Services Roundtable strongly supports the authorization of financial services holding companies to engage in real estate brokerage activities. We believe that the Gramm-Leach-Bliley Act of 1999 clearly contemplated this would be a permissible "financial activity" for financial services holding companies, and thus can be authorized by a joint rulemaking of the Treasury Department and the Federal Reserve Board. We also strongly support legislation, such as H.R. 2660 sponsored by Chairman Oxley and Ranking Member Frank in the House, that would define this activity as "financial" without the need for a rulemaking proceeding.

Conclusion

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. The costs savings that will result from this regulatory relief legislation will benefit the consumers of financial products and services. We look forward to working with the Committee on this important legislation.

Testimony

before the

Senate Committee on

BANKING, HOUSING AND URBAN AFFAIRS

June 21, 2005

regarding

Current Proposals Considered for Regulatory Relief Legislation

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on behalf of their organizations and clients as well as:

ACORN
Center for Responsible Lending
Consumers Union
National Association of Consumer Advocates
National Community Reinvestment Coalition
U.S. Public Interest Research Group

Chairman Shelby, Senator Sarbanes, and Members of the Committee, this written testimony accompanies the verbal comments provided to you today by both Travis Plunkett of the **Consumer Federation of America**[1] and Carolyn Carter 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 that may arise as you consider proposals for financial services reform. This testimony is also provided to you on behalf of **ACORN**[3], the **Center for Responsible Lending**[4], **Consumers Union,**[5] the **National Association of Consumer Advocates**[6]**,** the **National Community Reinvestment Coalition**[7] and the **U.S. Public Interest Research Group.**[8]

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[1]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 research, advocacy and education.

[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]**ACORN** is the nation's largest community organization of low- and moderate-income families, with over 175,000 member families organized into 800 neighborhood chapters in 80 cities across the country.

[4] The **Center for Responsible Lending** (CRL) is a non profit, nonpartisan organization focused on policy research and advocacy to stop predatory lending practices. CRL is an affiliate of Self-Help, one of the nation's largest nonprofit community development lenders, whose mission is to create and protect homeownership opportunities for low-wealth families through home and small business ownership.

[5]**Consumers Union**, 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.

[6] **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.

[7]**National Community Reinvestment Coalition** (NCRC) is the nation's trade association for economic justice whose members consist of local community based organizations. Since its inception in 1990, NCRC has spearheaded the economic justice movement. NCRC's mission is to build wealth in traditionally underserved communities and bring low- and moderate-income populations across the country into the financial mainstream. NCRC members have constituents in every state in America, in both rural and urban areas.

[8]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.

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 we believe 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 have missed some.*

I. Harmful Proposals to Consumers

A. Expansion of **industrial loan companies** is dangerous to the banking system and to taxpayers.

B. Diluting the protections provided through the **disclosures and the right of rescission in the Truth in Lending Act** would be very harmful to consumers.

C. Reducing the number of financial institutions required to provide **HMDA disclosures** would be a serious mistake at this critical juncture.

D. Preemption of the voter-mandated Constitutional **interest rate ceilings in the state of Arkansas** is terribly unfair to Arkansas voters, as it would completely remove the state's ability to impose *any limits* on *any loans* in the state.

E. The proposed **mortgage servicers' exemption from a requirement in the Fair Debt Collection Practices Act** is bad public policy and will undermine efforts to rein in foreclosure inducing practices of some mortgage servicers.

F. Allowing virtually unlimited **diversity jurisdiction** in federal courts for national banks and federal thrifts is a bad idea.

G. S. 603, entitled, "The Consumer Rental-Purchase Agreement Act of 2005" is *not* a consumer protection bill -- it is solely designed to protect the **rent to own industry from having to provide meaningful consumer protections.**

H. We urge you to resist the efforts of **check diversion companies** to obtain an exemption from the Fair Debt Collections Practices Act ("FDCPA").

I. Congressional oversight is critical to ensure that **CRA regulations** are not weakened.

II. Important Proposals to Update Federal Laws to Protect Consumers

J. The application of the Truth in Lending Act to **bounce loans** should be clarified.

K. All banks, including state chartered banks, should be prohibited from providing exorbitantly priced **payday loans** in violation of state laws.

L. The jurisdiction limits and statutory penalties of the **Truth in Lending Act** and the Consumer Leasing Act need to be brought up to 21st Century standards.

M. **Credit unions** should be permitted to provide check cashing and remittance services to anyone in their field of membership.

N. The **Electronic Fund Transfer Act** should be expanded 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.

A number of pieces of legislation have been offered in the last few years that take 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. They are state-chartered banks insured by the Federal Deposit Insurance Corporation that were established at the beginning of the 20th century to make small loans to industrial workers. ILCs now seek to emulate the powers of big commercial banks without the oversight these banks receive. Allowing them to offer business checking or to branch nationwide would be a mistake.

A bill passed by the House last month (H.R. 1224) would allow many ILCs to offer interest on business checking accounts. Legislation passed by the House last year (H.R. 1375) 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. Under these two proposals, 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.

One requirement of both bills could prevent some large commercial firms from offering interest on business checking accounts or branching de novo into some states in the future. Regarding ILCs established in the future, the states would be permitted to deny the establishment, acquisition or operation of an ILC branch – or, in the case of H.R. 1224, to deny the establishment of business checking accounts that pay interest -- if the states 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. However, 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 cannot impose capital requirements on the parent companies.

We should also note that proposals to allow the expansion of ILCs have not been restricted to the House. A Senate bill introduced in 2003 (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 two years after the date of enactment, but the authority goes into effect after two years whether the joint regulations are issued or not. This bill is a straightforward expansion of the authorities of industrial loan companies that we strongly oppose.

Our organizations have several specific concerns with both the House and Senate proposals:

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 has trumpeted its "positive regulatory environment" and declares 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, General Electric, 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. They might be tempted to skirt the "15 percent rule" to allow a large retail firm, for example, to purchase an ILC and set up branches in each of its stores.

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 tying the hands of states that wish to protect their residents from under-regulated ILCs.

B. Diluting the protections provided through the disclosures and the right of rescission in the Truth in Lending Act would be very harmful to consumers.

There has been considerable discussion by both regulators and the financial services industry in the context of Regulatory Relief about consumer disclosures and the right of rescission. The Acting Comptroller of the Currency has talked about the need to revisit the purpose of disclosures, and streamline them to avoid information overload.[9] She has compared credit card disclosure rules under the Truth in Lending Act to the nutritional disclosure developed by the Food and Drug Administration, and concluded that the TILA disclosures come up short.

[9] See Testimony of Julie L. Williams, Acting Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, May 17, 2005.

There is much in the Acting Comptroller's testimony with which we agree:

- Credit disclosure requirements should not be developed hastily, and their design should involve consumer testing.
- Credit disclosures should be made in a standardized disclosure format that consumers can readily navigate.
- Key information should be highlighted, with other information provided in a fair and clear manner.
- Simple language should be required.
- Credit card issuers should be required to disclose several additional important terms that the Truth in Lending Act regulations currently do not require. The Acting Comptroller listed, among other things, the circumstances under which a promotional rate can be terminated, the specific circumstances under which a penalty rate can be imposed, the duration of a penalty rate, and the lender's reservation of a unilateral right to increase the interest rate or fees or change the other terms of the account.

We strongly *disagree*, however, with the Acting Comptroller's suggestion that there should not be detailed, prescriptive rules specifying the content of the disclosures to be made to consumers. Indeed, this suggestion is at odds with the Acting Comptroller's own recommendation that credit disclosures should be made in a standardized format so that consumers can easily find the information that is important to them. The use of a standardized format and uniform terms is essential if consumers are to be able to find and absorb information. While there is clearly legitimate room for debate about whether *Congress* or an *agency* should establish the detailed, prescriptive rules for the content and format of credit disclosures, there should be no debate that such rules are necessary.

Second, we strongly disagree with any implication that, in the name of "streamlining," consumers should be deprived of disclosures that are currently required. Making credit disclosures more effective should involve improving their format and language, not reducing the amount of information given to consumers. It may be true that a buyer or borrower can absorb only a few bits of information at one time. While we would never rule out the possibility of eliminating required disclosures that are completely worthless to consumers, different buyers are looking for different pieces of information. To use the nutritional label analogy, one buyer may be shopping for low sodium foods, so will look for the sodium content and ignore everything else on the nutritional label. The next person may be looking for low cholesterol foods, so will look just for that. A majority of people may pay no attention to the sodium disclosure, but as long as there are some who do, it should not be eliminated. The same is true with credit disclosures. One consumer may plan to carry a balance on a credit card, and so will be concerned with the interest rate, while the next consumer may plan not to carry a balance and will be most concerned with the grace period. Providing both of these bits of information in a uniform, easily navigated format, enables these two consumers to pick out the information they need. When a large array of information is disclosed clearly and in a uniform format, people can pick out the information that concerns them most.

For example, in comments to the Federal Reserve Board on Regulation Z, many of our groups recommended moving the required disclosure for calculating credit card balances from the "Schumer Box" on applications and solicitations to a less prominent location. This is because many consumers do not understand balance calculation methods and because there is other key information – such the cost of late and over-limit fees that may be assessed – that should be disclosed in the Schumer Box instead. But our groups did not recommend eliminating the balance calculation disclosure entirely, because some consumers will in fact use it in making a determination about whether to sign up for a particular credit card.

In evaluating credit disclosures, it must be stressed that they serve not just an immediate function but also a long-term function. For example, many consumers will gather several credit card solicitations, and then sit down and compare them side-by-side. Having a complete set of disclosures makes this possible, even though a consumer might not be able to absorb all of the information when first seeing a credit card solicitation. Similarly, with home-secured credit, there is a three-day rescission window. The consumer cannot be expected to absorb all the important terms of the transaction at closing. But after closing, the consumer can make a more careful, detailed review of the disclosures and evaluate whether the loan is a good idea and whether unexpected terms were slipped in at closing. Again, having a few key terms presented prominently is helpful, but all the important terms should be disclosed in a clear format so that the consumer can review everything after closing.

In this respect, the analogy to nutritional labeling breaks down. A person who checks a nutritional label and buys a candy bar will probably eat the candy bar and throw the wrapper away without ever referring to the label again. With consumer credit terms, the consumer is likely to keep the disclosure statement and refer to it from time to time over the life of the transaction. Consumer testing should evaluate not only what credit disclosures consumers can absorb at the initiation of a transaction, but also what disclosures they can find and understand at a later point.

The Acting Comptroller argues against a knee-jerk response of piling on additional disclosure requirements as a way of solving consumer problems. We agree that disclosures alone are insufficient. Substantive regulation - prohibition of unfair, abusive credit terms - is necessary. To return to the nutrition labeling analogy, for food we do not rely on disclosure; we also affirmatively forbid poisonous substances in foods. We would never contend that it was acceptable to allow cyanide in foods as long as the label disclosed it. By the same token, disclosure alone is not sufficient to protect consumers from toxic credit terms. Yet, because of federal preemption of state credit laws, disclosures are currently the primary consumer protection for many types of transactions. Congress - and the regulatory agencies - should affirmatively forbid unfair and abusive credit terms.

2. The right of rescission should not be watered down. The right to rescind a consumer credit transaction that places the family home at risk is one of the most important protections of the Truth in Lending Act. The right of rescission means that the family has three days *after* signing to review the transaction and back out of the loan if it is abusive or different than the lender promised - or if, upon reflection, it is simply an unwise step for the family to take. If the lender misrepresented the terms of the loan in the Truth in Lending disclosure statement, the right to rescind can extend for up to three years.

The right of rescission is critical to increasing and preserving homeownership. It gives families an opportunity to reflect on the wisdom of placing their home at risk. It deters bait and switch tactics, because lenders know that the consumer will have the opportunity to study the actual terms of the loan after the closing and compare them to what was promised. While the right of rescission is by no means sufficient to prevent predatory mortgage lending, it gives homeowners some protection against abusive loans.

Section 201 of H.R. 2061 would completely undermine this crucial protection for homeowners. It would create three exceptions - one for insured depository institutions, one for all refinance loans, and one for all home equity lines of credit. These changes would undermine homeownership and give a green light to predatory lenders.

Congress should not assume that insured depository institutions are above predatory lending. Many of the most egregious predatory lending cases have involved just such institutions. For example, many banks have rented their charters out to payday lenders who are making abusive loans at triple-digit interest rates to vulnerable borrowers. Even for insured depository institutions that have resisted abusive loans and bait and switch tactics, there is no reason to remove the deterrent that the right to rescind provides.

As to refinance loans, these have been perhaps the most prevalent form of predatory mortgage lending. Unscrupulous lenders and mortgage brokers target homeowners who want to borrow a small amount of money, and sign them up for loans refinancing their existing home mortgages. Often the lender will make a high-cost loan that refinances a subsidized mortgage, a Habitat for Humanity mortgage, or a low-cost prime mortgage. Eliminating the right to rescind refinance loans would be the worst step Congress could take.

Finally, as to home equity lines of credit, the right to rescind is particularly important because of the limited information the consumer gets at closing. With a closed-end mortgage, the consumer is told the total finance charge, the payment amount, and the number of payments. For a home equity line of credit, the consumer gets none of these disclosures. In fact, some sellers finance consumers' purchases with an open-end line of credit for this very reason - because they need not tell the consumer these important terms. To eliminate rescission for home equity lines of credit would only create greater incentives for sellers to set up spurious open-end credit as a means of financing purchases.

The industry has argued that few consumers exercise the right to rescind within the three-day period after closing. The right to rescind has a deterrent effect on bait and switch tactics, and creates incentives for lenders to make sure their borrowers understand the terms of the loan and that the loan is appropriate for them. Thus, the very existence of the right to rescind should reduce the number of borrowers who want to rescind. Also, the number of rescissions may be reduced because, when a borrower does consider rescinding, the lenders may resolve the problem by explaining or deleting the term the consumer did not expect. If the number of loans that are rescinded is low, it means that the right to rescind is working.

The right to rescind is important even for a good loan, because it gives the family a chance to review whether to put their home on the line. But it is far more important for bad loans. As long as there are a significant number of bad loans, Congress should not undermine the right to rescind.

C. Reducing the number of financial institutions required to provide HMDA disclosures would be a serious mistake at this critical juncture.

The Home Mortgage Disclosure Act (HMDA) is one of a class of laws enacted by Congress to ensure that depository and non-depository mortgage lending institutions serve their communities by providing credit in a fair and non-discriminatory manner. Some in the banking industry have advocated using regulatory relief legislation as a vehicle for amending HMDA to reduce the number of banking institutions that presently report under this law. We believe that reductions in HMDA reporting would undermine the utility and effectiveness of this vital information source and therefore, strongly oppose such changes to the HMDA statute.

Congress enacted HMDA in 1975 to make mortgage markets work more efficiently. The data source serves a number of important public purposes. First, HMDA provides the public and banking regulators with data that help to show whether lenders are serving the housing needs of the neighborhoods and communities in which they are located. Second, HMDA also helps public officials to target public investment to promote private investment where it is needed. Third, HMDA provides loan level data that assist in identifying possible discriminatory lending patterns and to assist with the enforcement of anti-discrimination, community reinvestment, and consumer protection statutes. HMDA is also relied upon for a number of other regulatory and public policy research purposes, which include serving as the core database for the establishment of the annual affordable housing goals for Fannie Mae and Freddie Mac.

To accomplish these purposes, a comprehensive database is required. By design, HMDA now covers more than 80 percent of all home lending. Federal Reserve Board Governor Susan Schmidt Bies recently noted that "Congress believed those objectives would be served by requiring depository institutions to disclose mortgage loan information publicly, not just on an aggregate basis, but institution by institution and application by application."[10]

Accordingly, HMDA requires certain mortgage lenders with offices in metropolitan areas to collect, report, and disclose annual data about applications, originations, home purchases, and refinancing of home purchase and home improvement loans. At the same time, HMDA exempts the smallest depository institutions from these reporting requirements (those with assets under $34 million). This threshold is indexed annually.

Industry representatives have suggested that the HMDA reporting threshold be raised to $250 million. While such an adjustment may seem relatively minor, it is worth noting that about 60 percent of the nation's depository institutions have assets between $34 million and $250 million (5,348 of 8,861 banks and thrifts). Of this number, we estimate that approximately 2,300 of these currently report under HMDA. In 2004, nearly 9,000 lenders (including non-depository mortgage

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[10] Remarks by Governor Susan Schmidt Bies at the Financial Services Roundtable Annual Meeting, March 31, 2005.

companies) reported 37 million HMDA loan applications, up from 8,100 lenders in 2003.[11] Thus raising the threshold to the $250 million mark would newly exempt about 25 percent of depository institutions and 25 percent of current HMDA filers from submitting HMDA reports.[12]

The elimination of loan level HMDA reporting for 2,300 lenders would hamper enforcement of the laws, such as the Equal Credit Opportunity Act, the Fair Housing Act, and the Community Reinvestment Act (CRA). Consider that since 1990 over 1,200 institutions with between $34 million and $250 million in assets received below satisfactory CRA ratings.[13] Instead these institutions received the two lowest ratings of "Needs to Improve" or "Substantial Non-Compliance" that require depository institutions to redress their poor performance of meeting the credit needs of the communities where they take deposits. The lack of HMDA reporting for many of these institutions significantly complicates ongoing regulatory oversight to ensure that lending occurs in a fair and non-discriminatory manner. For example, small bank CRA exam procedures require the regulators to assess anomalies in the spread of loans found in the HMDA data between different geographic areas. It notes that "If available, review HMDA data" (first in a list of possible data sources) to assess the lending patterns inside and outside the bank's assessment area.[14] However, if an institution is not required to report HMDA data, the institution is not required to collect mortgage data for the regulators during their CRA evaluation and instead the regulators sample the institution's lending pattern.[15] By eliminating the HMDA requirement for 2,200 lenders, the entire spread of home mortgage activity would essentially be eliminated from CRA consideration.

Two arguments are often offered to support additional exemptions to HMDA. In the first, advocates of weaker reporting requirements contend that while the number of lenders to be exempted is great, they represent a relatively small share of the collective assets in the banking system. Such reasoning ignores the plain reality that in many states lenders in this size category represent the vast majority of all banking institutions. For example, depository institutions with assets between $34 million and $250 million represent over 70 percent of all banks and thrifts chartered in Alabama, Iowa, Kentucky, Louisiana, and West Virginia, and over 60 percent of the assets in some 20 additional states. Further, within particular local markets these lenders could very well account for significant shares of the mortgage market. The best way to ensure that these lenders are lending fairly to all is for them to report under HMDA.

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[11] Remarks by Governor Edward M. Gramlich to the National Association of Real Estate Editors, Washington, D.C., June 3, 2005.

[12] CFA analysis of Federal Deposit Insurance Corporation (FDIC), Statistics of Depository Institution database, downloaded June 16, 2005, data as of March 31, 2005.

[13] CFA analysis of Federal Financial Institutions Examination Council (FFIEC) CRA Rating database, downloaded June 16, 2005, data as of April 1, 2005.

[14] See, Federal Financial Institutions Examination Council, "Small Institution CRA Examination Procedures, November 13, 1995.

[15] FFIEC, "Community Reinvestment Act; Interagency Questions and Answers Regarding Commuity Reinvestments; Notice," Fed. Reg. 66 No. 134, July 12, 2001 at 36645.

The second argument advanced by proponents of less reporting is that HMDA poses an unfair regulatory burden on smaller depository institutions. As mentioned previously, HMDA already exempts the smallest lenders and non-metropolitan based lenders. For the others, this argument seems to be a carryover from the days when HMDA was reported manually. Today, software for HMDA reporting is readily available and relatively inexpensive. The Federal Financial Institutions Examination Council offers free HMDA software on its website for any institution that wants to use it.[16] It has been our experience that lenders in all size categories routinely submit their HMDA reports to the regulators in electronic form, making the literal paperwork burden for HMDA compliance limited.

For these reasons, we urge the Committee not to make changes to HMDA reporting thresholds.

D. Preemption of the voter mandated Constitutional interest rate ceilings in the state of Arkansas is bad policy and unfair to Arkansas voters.

In the last Congress, S. 904 was proposed to 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.[17] Unlike most states,

[16] See http://www.ffiec.gov/crahmdacf/default2.cfm.

[17] 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.

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.[18] The courts of the state of Arkansas have upheld both the constitutionality and the enforcement of this provision repeatedly since its enactment.[19]

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.[20] 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.[21]

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.[22] 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.[23]

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.**[24]

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[18] Const. Art. 19, § 13(a).

[19] *See, e.g., Luebbers v. Money Store, Inc.* 344 Ark. 232, 40 S.W. 3d 745 (2001).

[20] Pub. L. No. 106-102 (199), Section 731, *amending* 12 U.S.C. § 1831u(f).

[21] *Evans v. Harry Robinson Pontiac-Buick, Inc.* 336 Ark. 155, 983 S.W.2d 946 (1999).

[22] *See* Letter to Senators Shelby and Sarbanes from Senator Blanche Lincoln, September 16, 2003.

[23] *See* Letter to Senators Lincoln and Pryor from Jeb Joyce, representing the Arkansas Fair Credit Coalition, October 20, 2003.

[24] Conversation with Susan Purtle, consumer attorney with Legal Aid of Arkansas, October 21, 2003;

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?

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.[25] 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 rate 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.[26] 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.

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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.

[25] *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.

E. The proposed mortgage servicers' exemption from a requirement in the Fair Debt Collection Practices Act is bad public policy and will undermine efforts to rein in foreclosure inducing practices of some mortgage servicers.

The House has passed H.R. 1025, which would allow "covered mortgage servicers" to avoid providing a notice to consumers currently required by the Fair Debt Collection Practices Act ("FDCPA"). We believe this is a bad provision which will be harmful to consumers.

Currently the FDCPA covers all mortgage servicers *except those* who collect on mortgage loans which were "not in default at the time . . . obtained."[27] This coverage is especially important in recent years when allegations of abusive collection practices have been prevalent in the mortgage servicing industry.[28] The FDCPA requires debt collectors to notify consumers in the initial written communication to them that "the debt collector is attempting to collect a debt and that any information obtained will be used for that purpose."[29]

The notice to consumers required in the initial communication from mortgage servicers who are collecting delinquent debts is important to consumers. This notice informs them that they are protected in their dealings with the mortgage servicer by the application of a federal law – the Fair Debt Collection Practices Act.

1. The exemption for some mortgage servicers would apply to *all* mortgage servicers. Although the exemption in H.R. 1025 for mortgage servicers is framed as a narrow exception to be applicable only to those mortgage servicers "for whom the collection of delinquent debts is incidental to the servicer's primary function of servicing current federally related mortgage loans," it would actually apply to all mortgage servicers. This is so because no consumer would have any reasonable way of knowing the servicer's "primary function." How is a servicer's primary function determined? By the mortgage servicer? Where is the information publicly available? At what point in time does the test apply -- when the loan was transferred for servicing, at the beginning of that calendar year, or at some other point in time?

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[27] 15 U.S.C. § 1692a(6)(F)(iii). The Senate report emphasized the application of this section to "mortgage service companies and others who service outstanding debts for others, so long as the debts were not in default when taken for servicing. . . ." S. Rep. No. 382 , 95th Cong., 1st Sess. 3, *reprinted in* 1977 U.S.C.C.A.N. 1695 at 3.

[28] See, e.g. Settlement between Fairbanks Capital and FTC and HUD: "Fairbanks Capital Settles FTC and HUD Charges: *Agencies Allege Fairbanks Engaged in Illegal Practices in Servicing Subprime Loans; Defendants Will Pay Over $40 Million for Consumer Refunds.*" November 12, 2003; http://www.ftc.gov/opa/2003/11/fairbanks.htm.

[29] 15 U.S.C. § 1692e(11).

Because qualification for the exemption would be impossible to determine, the effect would be to exempt all mortgage servicers from the requirement for the 807(11) notice. This is neither the stated intent of the bill, nor of the Congressional sponsor.

2. The FDCPA notice which would no longer be required of mortgage servicers is helpful to consumers and should not be eliminated. Homeowners are experiencing increasing problems with their mortgage servicers. The consumer protections that apply to servicers are few (some state laws, and those under RESPA), and generally completely unknown to consumers. However, once the consumer receives the 807(11) notice from a mortgage servicer, the consumer is alerted that another consumer protection law is applicable to the dealings with the servicer – the FDCPA. This information is valuable to a consumer who has an ongoing dispute with a servicer, especially where there is some question about the application of payments, and/or the degree of delinquency. As consumers benefit from this notice, it should not be eliminated for all mortgage servicers.

3. Consumers need *more* protections in dealings with mortgage servicers, not fewer. Although some may view the notice required by 807(11) as relatively insignificant, it nevertheless has been held to trigger important consumer protections under the FDCPA for bad acting mortgage servicers.[30] In a case in the 7th Circuit Court of Appeals, the court, obviously appalled by the bad faith acts of the servicer, held that the FDCPA applied to the servicers because it had sent the 807(11). Clearly frustrated with the lack of available remedies against a servicer who so completely mistreated consumers, the court used one of the few remedies available. There are too few laws limiting the damage that mortgage servicers can do to homeowners. Full application of the FDCPA should not be restricted in this current legal environment.

4. If servicers have difficulty complying with the FDCPA, a much narrower amendment can be drawn. One stated rationale for this amendment is that servicers are purchasing mortgage loans in such large quantities that they often cannot determine between the time of purchase and the time the first notice is sent out, whether the loan is delinquent such that the FDCPA applies and the 807(11) must be included in the first communication. However, if the issue is really timing, then a narrower amendment would be to allow some period of time after the purchase of the loan by the servicer to pass before this notice is required. This would be far preferable to eliminating the requirement altogether.

5. Existing protections should only be exchanged for new protections. Consumers have experienced increasing problems with mortgage servicers in the past decade -- both those who are collecting delinquent mortgage accounts, and others. Given the current legal regime, if some consumer protections applicable to the relationship with servicers were to be eliminated, they should be replaced with other protections. Despite the extensive documentation of serious problems with mortgage servicers, there have been no updates to the FDCPA or RESPA in favor of consumers in two decades.

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[30] See Schlosser v. Fairbanks Capital Corp., 323 F.3d 534 (C.A.7,2003).

F. Allowing virtually unlimited diversity jurisdiction in federal courts for national banks and federal thrifts is a bad idea.

Both the Office of the Comptroller of the Currency and Office of Thrift Supervision have proposed provisions which would establish that for diversity purposes in federal court, both federally chartered savings banks and national banks would be considered citizens only in the states in which they have their main office. These 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. Because of a split in the circuits on this issue, the case is now pending before the U.S. Supreme Court.[31]

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 a consumer try to stop a foreclosure if every case involving a national bank would always be removed to federal court? 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 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.[32]

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, the proposal to establish by rule that federally chartered national banks and thrifts are only considered residents of the state in which they have "declared" their main office to be, threatens to make a mockery of this basic idea. In all the states in which the institution has branches, it 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. In its ruling against the bank on this issue recently, the Fourth Circuit Court of Appeals also recognized the

[31] Wachovia Bank, Nat. Assn. v. Schmidt, 388 F.3d 414, (4th Cir. 2004), No. 04-1186.

[32] It may be possible for a federal court to enjoin *the parties* from proceeding with a foreclosure; however, a federal court cannot enjoin a state court's proceedings. Do these federal agencies anticipate that the federal courts will adjudicate foreclosure disputes as well as all other actions involving federally chartered financial institutions?

legal absurdity of the bank's argument on the *need* for diversity jurisdiction.[33] The bank with branches in a state has just as much of a tie to that state, and perhaps more, than it does to the state in which it has declared it "main office" to be.

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.

G. S. 603, entitled, "the Consumer Rental-Purchase Agreement Act of 2005' is *not* a consumer protection bill -- it is solely designed to protect the rent to own industry from having to provide meaningful consumer protections.

Despite its name **The Consumer Rental-Purchase Agreement Act of 2005, S.603** is not what it purports to be; it is *not* a consumer protection bill. This bill only provides protections for industry, not for consumers.[34] Although the bill pretends to advance consumer protections in 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

[33] As the court said:

[T]he "rationale underlying the concept of diversity jurisdiction" would still provide no warrant to adopt the dissent's position. The notion that Congress believed that national banks that actively conduct business in a state cannot get a fair adjudication of state-law claims in that state's courts is rank speculation, as even the dissent would have to acknowledge. In fact, if one were to engage in surmise, it would be just as defensible to conclude that Congress believed it entirely reasonable in such circumstances to deny national banking associations resort to the federal courts, over the courts of the states in which the banks have chosen to locate branch offices; for it might have appeared unseemly to permit the national banks to seek and receive the trust and business of a state's citizens, but at the same time to permit them to refuse, out of distrust of those citizen-customers, to subject themselves to the courts created by those citizens to protect their rights against those who seek, receive, and reach their trust reposed. Wachovia Bank v. Schmidt, 388 F.3d 414, (4th Cir. 2004) at 424, 425.

[34] When S.603 was introduced in the Senate in the last Congress, as S. 884, 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; 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).

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 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. 603: 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. 603.

The RTO customer base, almost exclusively low-income, could certainly benefit from 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.603. 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, 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. 603 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. 603, 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. The maximum penalty to be assessed against a dealer who violates the minimal *disclosure* requirements of S. 603 is effectively only 25% of one month's rental payment. A single term's rental payment is generally less than $100, leaving the maximum amount of damages due for a violation of this Act, only $100 – hardly a sufficient incentive to ensure compliance with the law.[35]

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. 603 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.

II. 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.

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[35] S. 603 establishes a penalty for violations of the Consumer Leasing Act in 15 U.S.C. § 1640. *See* Sec. 1012(a). The statutory penalty for violating the Consumer Leasing Act is 25% of the *total* of the payments required under the lease, with a minimum of $100 and a maximum of $1,000. However, leases under the Consumer Leasing Act are always *at least* four months long (this is required to be covered by the Consumer Leasing Act, (15 U.S.C. § 1667(1)), and thus 25% of the total amount might amount to some real dollars. By contrast, leases governed by S. 603 are by definition only one term – one week or one month – automatically renewable in each of the following terms by the making of the payment. As a result, the penalties for violating S. 603's provision will almost never be more than the statutory minimum of $100.

The 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 than 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 guilty by the courts in, 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, but 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 include 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.

I. Congressional oversight is critical to ensure that CRA regulations are not weakened.

The Community Reinvestment Act (CRA) is an extremely vital tool for stimulating bank lending and improving access to banking services for the nation's underserved urban and rural communities. While we applaud the banking regulatory agencies for improving upon the proposed changes originally issued this past fall, we still remain concerned that, if adopted, the new rules could permit banks under the $1 billion asset threshold level to reduce their levels of branches, availability of low-cost banking accounts and international remittance services, and community development loans and investments to low- and moderate-income communities. We urge the Committee to exercise the necessary level of oversight to ensure that cutbacks in these vital activities do not occur.

II. Important Proposals to Update Federal Laws to Protect Consumers Include:

J. The application of the Truth in Lending Act to overdraft "bounce" loans should be clarified

The Federal Reserve Board recently issued final 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 overdraft "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 overdraft "bounce" loans *inform* consumers about the true costs of this credit.

Bounce "protection"[36] is a new form of overdraft protection that over ninety percent of banks are using to boost their non-interest revenue.[37] A recent study by the Center for Responsible Lending estimates that consumers paid over $10 billion for overdraft loans.[38] As we recently wrote to this committee, banks that use "courtesy overdraft" programs charge steep fees, take payment in full directly out of consumers' next bank deposit, and encourage consumers to overdraw their accounts, unlike traditional overdraft protection that consumers apply for and that guarantees coverage of overdrafts with reasonable fees and affordable repayment terms.

Bank overdraft "bounce protection" 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.[39] 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.

Banks covering overdrafts do not ask for consumers' affirmative consent to borrow from the bank, do not guarantee to pay overdrafts, and do not disclose the loan's interest rate. Banks that advance cash at the ATM or point of sale when consumers overdraw bank accounts turn consumers' debit cards into credit cards without the benefit of credit card protections. The Office of Comptroller of Currency has recognized that bounce loans are credit as defined by TILA.[40] Some state regulators have reached the same conclusion.[41] All federal bank regulators,

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[36]Bounce "protection" is a euphemism used by banks to describe this high-cost credit product.

[37]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.

[38] Center for Responsible Lending, "Underregulated & Overpriced: The $10 Billion Overdraft Loan Market," May 26, 2005.

[39]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.

[40]Daniel P. Stipano, Deputy Chief Counsel, Office of Comptroller of Currency, Interpretive Letter #914, September 2001.

[41]Indiana Department of Financial Institutions, Newsletter--Winter 2002 Edition (Nov. 2002), at 2; Letter from Assistant Attorney General Paul Chessin, Colorado Department of Law, Consumer Credit Unit, Mar. 21, 2001

except the Office of Thrift Supervision, acknowledge that overdrafts are credit. The Joint Guidance on Overdraft Protection Programs, issued by most federal bank regulatory agencies early this year, acknowledges that "When overdrafts are paid, credit is extended."[42]

Overdraft loan 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.

A recent study by the Consumer Federation of America found that over eighty percent of the largest banks, controlling over half the deposit dollars in the United States, include fine print in account agreements that permit those banks to make overdraft loans through automated teller machines and at the point of sale.[43] These overdraft loans go beyond covering paper checks that would otherwise be returned unpaid and permit consumers to borrow the bank's money without notice, consent, or comparable cost disclosures. While it violates federal law for banks to repay cash advances on credit cards by withdrawing funds from consumers' checking accounts at the same bank, banks routinely repay their extensions of credit and fees on overdraft loans by exercising their right of setoff.

Congress must clarify that overdraft "bounce" loans are covered by the basic consumer protections found in the Truth in Lending Act. Federally insured depository institutions should be required to warn consumers when ATM and debit card transactions will overdraw an account and trigger a fee. They should also be required to provide affordable repayment terms when making these loans.

K. Prohibit all banks, including state chartered banks, from providing exorbitantly priced payday loans in violation of state laws.

The Federal Deposit Insurance Corporation, the only bank regulatory agency to permit its banks to partner with payday lenders, has failed to protect consumers and is instead threatening

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(in response to referral from the Administrator for the Colorado Uniform Consumer Credit Code).

[42] Department of the Treasury, Joint Guidance on Overdraft Protection, Federal Reserve System Docket No. OP-1198, 70 Fed. Reg. 9,127 (February 24, 2005) p. 7.

[43] Consumer Federation of America, "Overdrawn: Consumer Face Hidden Overdraft Charges From Nation's Largest Banks, June 9, 2005.

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.[44] Recently the FDIC announced revisions to its guidelines, directing banks to halt payday lending once consumers have been in debt three out of the prior twelve months. While this announcement may discourage some banks from continuing to partner with storefront lenders, we urge you to clarify that bank charters are not for rent. The 11th Circuit decision in *BankWest v. Baker*[45] found that the Federal Deposit Insurance Act does not preempt state laws that attempt to regulate banks' payday loan partners.

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.

Payday lenders face growing resistance from state legislatures, especially in states where these loans are not legal. In 2005, the Texas legislature killed an industry safe harbor bill and last year Georgia legislators passed a tough anti-payday loan enforcement bill, recently upheld by the 11th Circuit in an appeal brought by the FDIC banks and their payday loan partners.

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.

<u>L. The jurisdiction limits and statutory penalties of the Truth in Lending Act and the Consumer Leasing Act need to be brought up to 21st Century standards</u>

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.[46] 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.

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[44] 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.

[45] 2005 WL 1367795 (11th Cir. June 10, 2005).

[46] See Consumer Price Index, Inflation Calculator, U.S. Department of Labor, Bureau of Labor Statistics, http://www.bls.gov/bls/inflation.htm.

M. 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.[47]

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,[48] refund anticipation loan purveyors,[49] payday loan companies, and wire transfer or remittance operators. Some products from banks, such as over-priced, deceptively marketed "bounce protection," also look more and more like fringe banking products.[50]

We support the proposal to 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."[51]

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[47] *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/

[48] For an archive of materials on rent to own stores *see* http://www.pirg.org/consumer/#rent

[49] *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

[50] *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/.

[51] "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

According to a recent Pew Hispanic Center report, "Billions In Motion,"[52] 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.

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[53] 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—

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[52] *See* "Billions In Motion: Latino Immigrants, Remittances and Banking," the Pew Hispanic Center and the Multilateral Investment Fund, November 2002.

[53] 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

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.

N. Expand the Electronic Fund Transfer Act to apply to all forms of electronically processed payments.

Payment 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 its proposed 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 step 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.

PREPARED STATEMENT OF ARTHUR R. CONNELLY *

CHAIRMAN & CEO, SOUTH SHORE SAVINGS BANK
SOUTH WEYMOUTH, MASSACHUSETTS AND
MEMBER, EXECUTIVE COMMITTEE OF THE BOARD OF DIRECTORS
AMERICA'S COMMUNITY BANKERS, WASHINGTON, DC

JUNE 21, 2005

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am Arthur Connelly, President and CEO of South Shore Savings Bank, South Weymouth, Massachusetts. South Shore Savings Bank is a $900 million State-chartered savings bank owned by South Shore Bancorp, a mutual holding company.

I am here this morning representing America's Community Bankers. I am a member of the Executive Committee of ACB's Board of Directors and Chairman of ACB's Government Affairs Steering Committee. I want to thank Chairman Shelby for calling this hearing and thank him and Senator Crapo for their leadership in crafting legislation to address the impact of outdated and unnecessary regulations on community banks and the communities they serve.

ACB is pleased to have this opportunity to discuss recommendations to reduce the regulatory burden placed on community banks. When unnecessary and costly regulations are eliminated or simplified, 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 meaningful reduction of regulatory burden.

This hearing and this topic are important and timely. Community banks operate under a regulatory scheme that becomes more and more burdensome every year. Ten years ago, there were 12,000 banks in the United States. Today, there are only 9,000 left. ACB is concerned that community banks are becoming less and less able to compete with financial services conglomerates and unregulated companies that offer similar products and services without the same degree of regulation and oversight. Community banks also bear a greater relative burden of regulatory costs compare to large banks. Community banks stand at the heart of cities and towns everywhere, and to lose that segment of the industry because of over regulation would be debilitating to those communities.

Community banks today are subject to a host of laws, some over a half-century old that originally were 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. Further, every new law that impacts community banks brings with it additional requirements and burdens. This results in layer upon layer of regulation promulgated by the agencies frequently without regard to the requirements already in existence.

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.

Community banks must also comply with an array of consumer compliance regulations. As a community banker, I understand the importance of reasonable consumer protection regulations. As a community banker, I also see how much it costs, both financially and in numbers of staff hours for my small mutual community bank to comply with the often-unreasonable application of these laws. As a community banker, I see projects that will not be 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 hundreds of times larger must comply.

Bankers are not the only ones concerned about the impact of the increasing layers of regulation on community banks. According to FDIC Vice Chairman John Reich, the bank and savings association regulatory agencies have promulgated over 800 regulations since 1989. In the opinion of the Vice Chairman, although most of the rule changes were put in place for good, sound reasons, over 800 changes in 15 years are a lot for banks to digest, particularly smaller community banks with limited staff. Vice Chairman Reich believes that regulatory burden will play an increasingly significant role in the viability of community banks in the future. I agree.

The most egregious form of regulatory burden results from arbitrary actions by government agencies. ACB wants to alert the Committee to recent arbitrary actions by the National Credit Union Administration that appear to us to be a textbook case

* Appendix held in Committee files.

of agency overreaching. Although Congress has clearly granted credit unions the freedom to choose the form of organization that best meets their strategic and market objectives, the NCUA seems incapable of applying an evenhanded approach to conversion matters. The agency recently invalidated the conversion attempts of Community Credit Union and Omni American Credit Union in Texas before the member votes were even tabulated. The NCUA said that the credit unions violated the agency's conversion regulations because required disclosure documents that were mailed to all credit union members was not properly folded. Both the Texas Credit Union Commissioner and the Director of the OTS have determined that the way the notice was folded is not reason to start the 90-day conversion voting process over. The NCUA's actions could prevent these credit unions from exercising their right to determine their institutions' charter or cost the two credit unions hundreds of thousand of dollars to begin the process over again.

Before turning to specific recommendations for legislative changes, I would like to discuss two areas where the implementation of laws by the regulators has been carried out in a fashion that creates unnecessary uncertainty and burden on community banks, namely, anti-money laundering, and corporate governance.

Community bankers fully support the goals of the anti-money laundering laws, and we are prepared to do our part in the fight against crime and terrorism. As laudable as these goals are, there currently exists an atmosphere of uncertainly and confusion about what is required of banks. This results from inconsistent messages being given by regulatory staff in the field, the region, and Washington. For example, Washington officials repeatedly assure the banking industry that the banking agencies do not have a "zero-tolerance" policy, where every minor discrepancy is treated as a significant failure to comply with the law. Nevertheless, regional offices and individual examiners continue to articulate a "zero-tolerance policy" when conducting BSA examinations and when making presentations during industry conferences. In another example of inconsistent policy, FinCEN has admonished banks not to file "defensive suspicious activity reports," but as recent enforcement actions taken by the banking agencies and prosecutions by the Department of Justice demonstrate, it is safer for banks to file SAR's, when in doubt.

The opportunity costs of BSA compliance go beyond hampering an institution's ability to expand and hire new employees. In some cases, fear of regulatory criticism has led some institutions to sever ties with existing banking customers or forego the opportunity to develop banking relationships with new customers.

ACB and other industry representatives have been working with FinCEN and the banking regulators to improve the regulation of our anti-money laundering efforts. Among the many reform proposals suggested by ACB, we have proposed modernizing the cash transaction reporting regulations. FinCEN and law enforcement report that the Cash Transaction Report (CTR) database is littered with unhelpful CTR's. We believe that this attributable to the $10,000 threshold set in 1970 and a well-intentioned, but unhelpful exemption system that many community banks find to be more burdensome than simply filing a CTR. Adjusted for inflation since 1970, the threshold would be $48,000. ACB has suggested that the $10,000 threshold be increased for business customers as many businesses of all sizes routinely conduct transactions over $10,000. The 30-year old regulations need to be updated to reflect today's economic reality. We believe that updating the threshold for business customers would help, not hinder law enforcement. An increase in the threshold would help meet a 1994 Congressional mandate to reduce CTR filings by 30 percent and provide law enforcement a cleaner, more efficient CTR database. We have also suggested that banks be allowed more flexibility in exempting business customers from CTR requirements by modifying or eliminating the current 12-month waiting period for new customer exemptions.

We have made some progress in clarifying bank responsibilities under other anti-money laundering and terrorist financing regulations. As a result of a dialogue among industry, FinCEN and the banking agencies, FinCEN and the agencies recently issued joint guidance to banks on what level of scrutiny they should use with respect to the accounts of money service businesses. ACB commends the agencies for providing this needed clarification of bank responsibilities. ACB will continue to work with government agencies to provide further clarification of the responsibilities of banks under the Nation's anti-money laundering laws. We look forward to the release of additional guidance in this area and are pleased that the agencies have planned training sessions for examiners and bankers so that a consistent message can be given to everyone at the same time.

The Sarbanes-Oxley Act contained much needed reforms, restoring investor confidence in the financial markets that were in turmoil as a result of the major corporate scandals at the beginning of this decade. Community bankers support that Act and other laws, like the Federal Deposit Insurance Corporation Improvement

Act, that improve corporate governance, enhance investor protection, and promote the safety and soundness of the banking system. However, the implementation of the Sarbanes-Oxley Act by the Securities and Exchange Commission and the Public Company Accounting Oversight Board and the interpretation of those regulatory requirements by accounting firms have resulted in costly and burdensome unintended consequences for community banks, including, even, privately held stock institutions and mutual institutions.

For example, the PCAOB requires the external auditor to audit the internal controls of a company, rather than audit the CEO's attestation with respect to the internal controls—which was the practice generally permitted by the banking agencies for compliance with FDICIA's internal control requirements. ACB believes that this change in practice is a significant cause of a dramatic increase in bank audit fees. Many publicly traded banks are reporting an increase in audit fees of 75 percent over the prior year. Some banks are reporting audit fees equal to 20 percent of net income. Privately held and mutual banks also are experiencing significant increases in auditing fees because the external auditors are applying the same PCAOB standards to these nonpublic banks.

ACB has provided concrete suggestions to the banking regulators, the SEC, and the PCAOB on ways to reduce the cost of compliance with internal controls and other requirements, while still achieving the important goal of improved corporate governance and transparency. We appreciate the separate guidance on internal control reporting and attestation requirements issued concurrently by the SEC and the PCAOB, and are hopeful that it might provide some relief to the escalating audit fees.

ACB appreciates the willingness of the staffs of Chairman Shelby, Senator Sarbanes, and other Senators to discuss the views and experiences of community banks in relation to the implementation of Section 404, and want to thank Senator Sarbanes for his assistance in securing the participation of one of our members in the SEC Roundtable on the Implementation of Sarbanes-Oxley Internal Control Provisions.

(We have attached a letter, which ACB recently submitted to the banking regulators, detailing these suggestions and also suggestions for improving antimoney laundering regulation.)

While ACB is not currently recommending statutory changes to anti-money laundering and corporate governance laws, we believe that Congress has an important oversight role to play to ensure that meaningful regulatory efforts to reduce burden continue, and to step in and change laws, when that becomes necessary.

Legislative Recommendations

ACB has a number of recommendations to reduce regulations applicable to 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.

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.

Unnecessary and Redundant Privacy Notices

ACB strongly urges the elimination of required annual privacy notices for banks that do not share information with nonaffiliated third parties. Banks with limited information sharing practices should be allowed to provide customers with an initial notice, and provide subsequent notices only when terms are modified. I am sure you are all inundated by privacy statements each fall. I am equally confident that most or all of them remain unread. At my bank we send out thousands of such notices each year at significant cost, in both dollars and staff time, even though our policies and procedures have remained consistent over many years. Redundancy in this case does not enhance consumer protection; rather it serves to numb our customers with volume.

Others share information only under very controlled circumstances when certain operational functions are outsourced to a vendor. The requirement to send notices should be amended when circumstances have not changed or when we are only reiterating that no customer information is ever shared. We do agree a notice should be sent, but it becomes an expensive burden to send it multiple times when once will more than suffice.

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.

In proposed regulations, the SEC has offered to remove some aspects of the disparity in treatment for broker-dealer registration and the IAA, but still has not offered full parity. Dual regulation by the OTS and the SEC makes savings associations subject to significant additional cost and regulatory burden. Eliminating this regulatory burden could free up tremendous resources for local communities. 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 might 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 5 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 nonfinancial activities).

Other Important Issues

Interest on Business Checking

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 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.

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 nonresidential 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 nonresidential 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. 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.

A recent court decision has cast doubt on national banks' ability to access the Federal courts on the basis of diversity jurisdiction. Regulatory relief legislation should also clarify that national banks are citizens of their home States for diversity jurisdiction purposes.

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 multiagency 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 (that the debt collector is attempting to collect a debt and any information obtained will be used for that purpose) when the debt collector 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 insured depository institutions 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, that is, those other than housing, education, and certain secured loans. This would conform the law to the current requirement for all other officers, that is, 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 savings association's service corporation from investing in the savings association service corporation.

ACB proposes legislation that would provide parallel investment ability for banks and savings associations to participate in both BSC's 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 CDC's. 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 prenotify 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 nonconforming activities, rather than the current 2-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 firesale 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.

Streamlined CRA Examinations

ACB strongly supports amending the Community Reinvestment Act to define banks with less than $1 billion dollars in assets as small banks and therefore permit them to be examined with the streamlined small institution examination. 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.

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.

PREPARED STATEMENT OF DAVID HAYES

PRESIDENT AND CEO, SECURITY BANK DYERSBURG, TN AND

CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA, WASHINGTON, DC

JUNE 21, 2005

Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, my name is David Hayes, Chairman of the Independent Community Bankers of America (ICBA)[1] and President and CEO of Security Bank; a 135 million community bank in Dyersburg, Tennessee. I am pleased to appear today on behalf of ICBA and its nearly 5,000 members to testify on proposals to reduce the regulatory burden on banks, thrifts, and credit unions.

We are especially pleased by the leadership of Senator Crapo, who is drafting legislation for the Committee. Senator Crapo has taken a comprehensive look at all of the regulatory relief ideas that were recommended to this Committee last year. The matrix that Senator Crapo developed after that hearing is a useful compendium of these ideas. This broad approach is essential because other efforts, such as the bill the House passed last year (H.R. 1375) included little true relief for community banks.

[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the Nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its 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. For more information, visit ICBA's website at *www.icba.org.*

To add impetus to the effort to broaden the scope of regulatory relief, ICBA worked closely with Representative Jim Ryun on his Community Banks Serving Their Communities First Act. The Communities First Act (H.R. 2061) includes regulatory and tax relief that is critical to community banks and their customers. It includes additional provisions that apply to all banks and bank customers. Virtually all of the regulatory provisions in the bill are included in Senator Crapo's matrix. All but one are items that the other financial groups have agreed to include on a list of 78 consensus items agreed to as part of the regulatory burden reduction project being led by FDIC Vice Chairman John Reich. ICBA hopes that Senator Crapo will include many items from H.R. 2061 in the bill he is developing for this Committee.[2]

Our testimony will focus on the specific proposals in the Communities First Act and explain why they should be included in this Committee's new regulatory relief bill. Before that, I will briefly explain why regulatory relief is so important to community banks, their customers, and the communities they serve.

Community Banks Need Regulatory Relief

Since 1992, 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 market 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. Obviously part of the reason is due to economies of scale that community banks have always accepted as a fact of life. However, in recent years, the disproportionate impact of the ever-mounting regulatory burden is significantly impacting community bank profitability. I agree with Vice Chairman Reich that it is a leading cause of consolidation in our industry.

At the same time credit unions, with their unfair tax-exempt advantages 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 total small bank assets (less than $1 billion) have decreased.

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.[3] The authors suggest that the regulatory environment has evolved to the point of placing small banks at an artificial disadvantage to the detriment of their primary customers—small business, consumers, and the agricultural community.

While larger banks have hundreds or thousands of employees to throw into the regulatory breach, a community bank with $100 million in assets typically has just 30 full time employees, a $200 million bank about 60 employees. If my bank is faced with a new regulation, we must train one or more of our current employees to comply, and complying with the new regulation will take time away from customer service. Unlike larger institutions, we cannot just add a new person and pass the costs on to our customers.

It's not just smaller community banks that are feeling the pain. Larger community banks as well are drowning in paperwork and regulatory burden. They are hiring 2 or 3 full-time employees to do *nothing* but Bank Secrecy Act compliance. They have had to expend hundreds of thousands of dollars for Sarbanes-Oxley Act compliance.

This is not just about numbers and costs. I assure you we are not crying "wolf." If we do not get meaningful relief *soon,* more and more community banks will throw up their hands, and give up their independence.

Why should policymakers care about community banks? First, community banks play a strong role in consumer financing and an especially vital role in small business lending. Commercial banks are the leading suppliers of credit to small business, and community banks account for a disproportionate share of total 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, nearly three times their share (13 percent) of bank industry assets. And they account for 64 percent of total bank lending to farms.

Second, community banks that fund local businesses are particularly attuned to the needs of their communities and are uniquely equipped to facilitate the local economic development process, which can be time-consuming and resource intensive.

[2] In a similar vein, ICBA plans to work with the Senate Finance and House Ways and Means Committees on the tax relief components of H.R. 2061.

[3] Gunther and Moore, "Small Banks' Competitors Loom Large," Southwest Economy, Federal Reserve Bank of Dallas, Jan./Feb. 2004.

Community bankers provide tremendous leadership in their communities, which is critical to economic development and community revitalization.

Community bankers serve on hospital boards, attend economic development corporation meetings, and engage in similar activities. You could argue that this is not an efficient and cost-effective way to spend our time, but for most community banks, our survival depends on the economic vitality of our communities. Branches of large megabanks do *not* provide this same commitment to the community.

Bank Secrecy Act Compliance

While our testimony today does not include legislative recommendations for changes in the Bank Secrecy Act, this certainly does not mean that community bankers do not have serious concerns about how the Act is being enforced. In fact, it is topic 1A when bankers discuss the regulatory burden. However, we believe the agencies have authority to address most of the problems. These center around whether or not there is a "zero tolerance" examination climate, as well as uncertainty about what the agencies expect from banks.

ICBA recently filed a comment letter with the banking agencies under the EGRPRA process with a number of recommendations regarding BSA compliance, including:

- *Bank Secrecy Act Administration.* Issue additional guidelines and provide reference tools for compliance so that bankers *and* examiners know what is expected. (The anticipated June 30, 2005 revised examination procedures and outreach programs for bankers *and* examiners should help, but balance is clearly needed.)
- *BSA Currency Transaction Reporting.* Increase the filing threshold from $10,000 to $30,000 to eliminate unnecessary filing. Improve the CTR exemption process so banks use it.
- *Suspicious Activity Reporting.* Simplify the filing process and issue easily accessible guidance on when banks should report.

At this point, ICBA strongly urges this Committee to engage in thorough oversight to ensure that BSA compliance does not impose an unreasonable and unproductive burden on the economy and truly achieves its important goals.

The Credit Union Bill is Not Like the Communities First Act

Several weeks ago the credit union industry had introduced what it is calling a regulatory relief bill. Some representatives of that industry compared their bill (H.R. 2317) with the Communities First Act. The bills are not at all comparable. The credit union bill is a powers enhancement proposal, while the Communities First Act includes no new powers for anyone. CFA is strictly designed to lift the regulatory and tax burden for community banks and help level the playing field. In contrast, the credit union bill would, among other things substantially increase the ability of credit unions to make loans to businesses. Therefore, ICBA is unalterably opposed to H.R. 2317. Congress should eliminate the credit unions' unfair tax and regulatory advantages over community banks, not give them even more new powers.

There is one area that we believe credit unions very much need regulatory burden relief. Their regulator, the National Credit Union Administration, is undermining credit unions' ability to choose to convert to a mutual thrift charter. Recently, NCUA invalidated a vote by a Texas credit union's members to convert solely because of the way the required disclosure was folded. This is just the latest example of NCUA's efforts to unreasonably block credit union conversions. We urge Congress to exercise its oversight role and, if necessary, act to require the NCUA to adhere to the statutory requirement to allow credit unions to convert their charters.

Industrial Loan Companies

Industrial loan companies (ILC's) are hybrid financial charters that are exempt from the Bank Holding Company Act (BHCA). This exemption gives ILC's certain preferential authorities over other financial charters, including the authority to be owned by commercial firms. This violates the long-standing principle of maintaining the separation of banking and commerce, most recently reaffirmed by the Gramm-Leach-Bliley Act. ICBA believes that the best way to deal with and eliminate the mixing of banking and commerce made possible by the ILC loophole is to close it by bringing ILC's under the BHCA.

Given that ILC's already enjoy extraordinary authorities due to their BHCA exemption, we do not believe these authorities should be expanded. In recent testimony before the House Financial Services Committee, Federal Reserve Board Governor Donald Kohn reiterated the Fed's long-standing support for this position. "Stated simply, if ILC's want to benefit from expanded powers and become functionally indistinguishable from other insured banks, then they and their corporate parents should be subject to the same rules that apply to the owners of other full-service banks."[4] We strongly support this position.

Specific Legislative Recommendations

ICBA strongly supports the bank regulatory reduction project mandated by the Economic Growth and Paperwork Reduction Act of 1996 (EGRPRA) and commends the EGRPRA task force, led by FDIC Vice Chairman Reich, for the excellent job it has done to identify those banking regulations that are outdated, unnecessary, or unduly burdensome. Through the public comment process, banker outreach meetings, and the EGRPRA website, the project has generated a large number of recommendations for reducing the regulatory burden on banks. While the bank regulators have been working hard to identify burdens they can reduce on their own, they report to us that there are severe limits on what they can do without help from Congress. Many burdensome and outdated regulatory requirements are hard-wired into Federal statute.

The Communities First Act includes a variety of legislative proposals to reduce the burden of regulation on community banks. Many of the following legislative changes from H.R. 2061 build on the concept of a tiered regulatory and supervision system recommended by Vice Chairman Reich by targeting relief to institutions based on their size. Others are of special concern to community banks, but would apply to all banks, regardless of size. All would go a long way toward improving community banks' ability to compete and serve local communities.

Home Mortgage Disclosure Act

The Communities First Act would make several changes to the Home Mortgage Disclosure Act. Section 101 would increase two reporting exemption levels from $30 million and $34 million[5] in assets to $250 million. While this may appear to be a substantial increase, the vast majority of industry assets would remain covered. In fact, the FDIC reports that as of March 31, 2004, banks and thrifts with $250 million or less in assets held only 6.7 percent of industry assets. The amendment would index the $250 million level using the existing procedure in HMDA.

Title II of H.R. 2061 makes several additional changes in HMDA that could apply to a bank of any size, depending on its activity or location. Section 202 would exempt banks with fewer than 100 reportable loan applications per year per category. This would lift the burden from banks for which mortgage lending is not a major business line.

Banks that operate outside Metropolitan Statistical Areas are exempt from HMDA. Section 202 would also allow the Federal Reserve to develop a definition of Metropolitan Statistical Area for HMDA purposes, instead of using Census Bureau definition created for entirely different reasons. Current law requires the use of the Census Bureau definition, so certain areas that are truly rural are included in metropolitan statistical areas. This may serve the purposes of the Census Bureau, but the Federal Reserve should have the flexibility to modify these definitions when determining which areas must be covered by HMDA. This would avoid unnecessarily covering certain rural banks that are relatively close to metropolitan areas.

Finally, Section 202 would benefit all banks that must continue to report HMDA data by requiring the Federal Reserve to review and streamline the data collection and reporting requirements every 5 years.

It is important to note that the banking industry has included each of these HMDA provisions on its list of consensus items for inclusion in a regulatory relief bill in its response to Senator Crapo.

Reports of Condition (Call Reports) & BHC Policy Statement

Section 102 of the Communities First Act would permit highly rated, well-capitalized banks with assets of $1 billion or less to file a short call report form in two quarters of each year. This would reduce the reporting burden for these banks, while still providing the banking agencies with the data they need.

Section 204 would benefit all banks by directing the agencies to reduce or eliminate filings that are not outweighed by the benefits to safety and soundness or the ability of the FDIC and other regulators to accurately determine the financial condition and operations of the reporting institutions. ICBA believes that this Congressional directive would reverse the repeated increases in the reporting burden imposed when agency economists and financial analysts seek to add "just one more" item to the call reports. While many of these items provide interesting information,

[4] Statement of Donald L. Kohn, Member, Board of Governors of the Federal Reserve System, June 9, 2005.

[5] The $34 million began as a $10 million exemption, but has been increased by statute and by the Federal Reserve using an inflation-based index.

we question whether private companies—banks—should have to provide non-essential information under threat of government sanction.

The current call report instructions and schedules consist of 458 pages. While extensive and time consuming to produce, these quarterly filings by community banks are not essential to the agencies. The fact is that in most community banks, the world just does not change that dramatically between March 31 and June 30 of each year. The FDIC will not lose track of us if every other quarter we file a short form instead of the extensive report and Chairman Greenspan will still be able to conduct monetary policy without our real time data. On the other hand, this would significantly reduce the reporting burden for banks like mine, while still providing the banking agencies with the data they need.

Section 104 of the Communities First Act would direct the Federal Reserve to make bank holding companies with assets up to $1 billion eligible for the Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors. To qualify, the holding company must also (1) not be engaged in any nonbanking activities involving significant leverage, and (2) not have a significant amount of outstanding debt that is held by the general public. This change would reduce the paperwork burden on these small, noncomplex, holding companies, while maintaining the Federal Reserve's ability to obtain holding company information for larger institutions.

Again, the banking industry has included each of these recommendations as consensus items on the list for Senator Crapo.

Sarbanes-Oxley Act, Section 404

Section 404 of Sarbanes-Oxley imposes tremendous unexpected costs on virtually all companies. A recent ICBA survey showed that—including outside audit fees, consulting fees, software costs, and vendor costs—the average community bank will spend more than $200,000 and devote over 2,000 internal staff hours to comply with the internal control attestation requirements of Section 404. Section103 of the Communities First Act recognizes that these added costs are unnecessary for community banks. First, unlike other companies, banks have been under similar requirements for years, though with an exemption for banks under $500 million in assets. Congress imposed these requirements on banks after the crises of the 1980's. So, Section 404 is redundant when imposed on the banking sector. Second, unlike other companies, banks are closely supervised and examined by Federal officials on a regular basis and the adequacy of their internal controls is assessed by bank examiners. Companies like Enron and WorldCom were not regulated the same way. Not only is this burden redundant and unnecessary for community banks, it is a key factor in undermining their ability to remain independent.

The banking industry has also agreed that this proposal is a consensus item on the list for Senator Crapo.

Director Interlocks and Loans to Officers

Section 105 of the Communities First Act increases the size of bank eligible for an exemption from interlocking director prohibitions from $20 million to $500 million. It has always been a challenge for the smallest institutions to find qualified directors. Now that directors' responsibilities have increased under the Sarbanes-Oxley Act and other requirements, this has become a challenge even for larger community banks.

Section 108 of the Communities First Act allows banks with less than $1 billion in total assets to make loans to executive officers, in the aggregate, up to two times capital. The current asset size limit is $100 million in deposits. This is not a tenfold increase, because a bank with $1 billion in assets could have considerably less than that in deposit liabilities.

Section 205 would help all banks by increasing the special regulatory lending limit on loans to executive officers for loans other than those for housing, education, and certain secured loans to $250,000.[6] This limit has not been adjusted for over 10 years, so this amendment simply makes an appropriate adjustment for inflation.

These adjustments are all included in the banking industry's consensus recommendations to Senator Crapo.

Protection for Community Banks Under SIPC

The Securities Investor Protection Act does not provide immediate protection to community banks that suffer losses when a securities firm fails. Current law ex-

[6] Executive officers would remain subject to the same limit on directors and principal shareholders, the loans-to-one-borrower limit, and to the requirement that loans to insiders not be on preferential terms.

empts commercial banks from SIPC coverage and assumes that all commercial banks are in a position to fend for themselves in such cases. This may be true for large commercial banks, but it is less so for community banks.

Section 106 of the Communities First Act would provide banks with assets up to $5 billion the same protection afforded other investors and other depository institutions for their brokerage account assets under the SIPA.

This is included in the banking industry's consensus recommendations to Senator Crapo.

Examination Schedules

Section 107 of the Communities First Act would give Federal regulators flexibility to determine the examination interval for well-rated, well-capitalized banks with up to $1 billion in assets. This would replace the current 18-month exam schedule for banks with less than $250 million in assets. The banking industry supported this as a consensus recommendation.

Section 110 would increase CRA examination intervals for banks up to $1 billion.[7]

Both of these changes would help strong, well-run community banks focus on service to their communities rather than responding to unnecessarily frequent examinations.

Truth in Lending Right of Rescission

Section 201 of the Communities First Act calls for several changes that would expedite consumers' access to their funds without undermining the protection that the 3-day right of rescission provides. They would apply without regard to the size of the institution involved.

Subsection (a) directs the Federal Reserve to provide exemptions when the lender is a federally insured depository institution. The right of rescission was imposed to protect consumers against high-pressure loan sellers often connected with illicit home improvement operations or similar schemes. The loan programs of federally insured institutions are, obviously, run on a far different basis and are subject to regular scrutiny by banking regulators. Our customers know exactly what they have applied for and are receiving. They are frequently annoyed when they hear they have to wait an additional 3 days for their funds.

Subsection (b) addresses another source of annoyance for consumers, the fact that borrowers have to wait 3 days to get the benefit of a refinancing transaction even if they are not taking any cash out of the deal. It makes no sense to insist that a consumer wait to begin taking advantage of a lower interest rate or different term, which are the typical purposes of these kinds of transactions.

Finally, Subsection (c) eliminates the right of rescission when a borrower is opening up an open-ended line of credit. The very design of the product grants consumers a perpetual right of rescission if that is what they want. The consumer can simply refrain from drawing on the account for 3 days or longer. On the other hand, consumers who need immediate access to their line of credit should have it.

The banking industry has included the provisions of Section 201 in its consensus recommendations.

Privacy Notices

One of the most wasteful provisions of the Gramm-Leach-Bliley Act has been the requirement that financial institutions send annual privacy notices to their customers. The law requires them to be written in impossible-to-understand legalese. The industry and agencies have been working on ways to simplify this language, but the task is daunting. However, Section 203 of the Communities First Act offers a measure that would greatly reduce the number of these notices that must be mailed. It simply says that if an institution does not share information (except for narrow purposes, such as providing information to an outside data processing firm) and has not changed its policies, it need not send out the annual notices. While any size institution could take advantage of this provision, community bankers are especially interested in having this option. I can tell you that my customers and their trash collectors would also be grateful.

Like virtually all of the regulatory provisions of the Communities First Act, this section is a banking industry consensus item.

Impact of New Regulations on Community Banks

Neither we—nor you—can anticipate all of the potential new burdens that future laws and regulations may impose on community banks. Therefore, Section 109 of

[7] It is important to note that this examination interval is a separate issue from the question of examination procedures for banks under $1 billion in assets. The regulatory agencies have already adopted, or have proposed adopting those streamlined procedures.

the Communities First Act directs the banking agencies to take into account the effect any new regulation, requirement, or guideline would have on community banks. This sends a clear message from Congress to the agencies that the public policy of the United States is firmly committed to maintaining a strong, vibrant, community bank sector for our economy.

Conclusion

ICBA greatly appreciates this opportunity to testify on this important issue. In a major way, the future of community banking depends on what you do. The banking industry is united on the need for regulatory burden relief. Indeed, virtually all the proposals in Representative Ryun's Communities First Act are included in the industry's recommendations to Senator Crapo. The bill simply highlights those provisions that are important to community banks. We strongly urge Senator Crapo to include them in his regulatory relief bill. That would provide real benefits to community banks and the communities and customers that they serve.

PREPARED STATEMENT OF CHRISTOPHER A. KORST

SENIOR VICE PRESIDENT, RENT-A-CENTER, INC.

JUNE 21, 2005

The following written statement is submitted in support of S. 603, the Consumer Rental-Purchase Agreement Act, on behalf of the Coalition for Fair Rental Regulation.

S. 603 has been introduced once again in this Congress by Senator Mary Landrieu, and cosponsored by a number of other Senators, Republican and Democrat alike, including Senators Shelby and Johnson of this Committee. That legislation, standing alone or as part of an overall 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, Senator Landrieu and her colleagues have successfully struck a balance between the interests of the consumers on the one hand and the rental merchants on the other.

For the record, it should be noted that this Committee first passed rental-purchase legislation in 1984. That bill, sponsored by Senators Hawkins and Gorton, would have required just a few disclosures in rental-purchase contracts, and would have provided only a minimum of other consumer protections. By way of contrast, S. 603 would mandate 10 contract disclosures, would require the disclosure of key financial and other information in advertisements and on price tags in store locations, in addition to the many substantive consumer protections the bill would establish. In this regard, it is fair to say that if enacted, this legislation would represent one of the most comprehensive, substantive Federal consumer protection laws ever enacted.

Introduction to the RTO Industry and S. 603

The rent-to-own, or rental-purchase industry, offers household durable goods—appliances, furniture, electronics, computers, and musical or band instruments are our 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.

Our companies offering household durables typically provide delivery and set up of the merchandise, as well as service and replacement products, throughout the rental period. We do not check the credit of our customers, and do not require down payments or security deposits. 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 nice things 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 of, 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.

Rent-to-own industry statistics indicate 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 approximately 8,000 rent-to-own furniture, appliance, and electronic stores throughout the country, and in Puerto Rico. Additionally, there are 5,000 or so 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, although slightly less than one-half of all stores are 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 in a number of significant 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 critical distinction—under traditional credit transactions, the consumer must make all of the payments 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.

Forty-seven State legislatures have enacted rent-to-own specific legislation, beginning with Michigan in 1984. All of these legislative bodies concluded that this unique transaction is not a form of consumer credit, but instead is something very different. S. 603 is consistent with the approach taken by these various State laws. However, 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. Finally, if enacted, this legislation 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.

Summary of Bill Contents

This bill strikes a balance between the needs of consumers for protection from overreaching and unscrupulous merchants, and the need to establish and maintain a fair and balanced competitive marketplace in which honest businessmen and—women can survive and thrive.

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 significantly exceed the disclosure mandates under Truth-in-Lending as well as the Federal Consumer Lease 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 the Truth-in-Lending Act (TILA) nor the Consumer Lease Act (CLA) 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.

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.

Preemption

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. In this respect, it must be clear that this bill does not preempt State law. However, it should also be recognized and understood that this bill 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.

The Argument Against APR Disclosures

Some groups have called for any Federal rental-purchase legislation to include the disclosure of some "imputed annual percentage rate" in these agreements. The industry believes that this view is misguided, for several reasons. First, in order for a transaction of any kind to include an interest component, there must be debt—that is, the consumer must owe a sum certain, and must be unconditionally obligated to repay that sum. That is simply not the case under the typical rent-to-own transaction. Second, the notion of "imputed interest" misleads as to the true economics of the RTO transaction, which has many benefits, services, and options that traditional credit transactions just do not offer. For example, in addition to the immediate use of the rented merchandise, delivery and set up are included in the price, as is maintenance on the merchandise throughout the rental. If the item cannot be repaired at the customers' homes, then replacement products are delivered for use while the original rental item is being repaired. Additionally, as noted several times, rental customers always enjoy the unfettered right to terminate the transaction and return the products without penalty, as well as the right to reinstate such terminated agreements.

All of these additional benefits, services and options have value to the consumer. As the Federal Trade Commission noted in its seminal report on the rent-to-own industry in 2000:

> *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.
>
> There are . . . some practical considerations that suggest that *an APR disclosure requirement for rent-to-own transactions may be difficult to implement, and could result in inaccurate disclosures that mislead consumers.*
>
> In addition to the cash price of the merchandise itself, *the calculation of the APR also would have to take into account the additional consumer services and options bundled with the merchandise.* Rent-to-own dealers typically include delivery, pickup, repair, loaner, and other services in the basic rent-to-own rental

> rate. Many traditional retailers charge extra fees for these services, reflecting the value to the consumer and the cost to the seller. The return option provided with rent-to-own transactions also provides value to consumers and imposes costs on dealers, including the cost of retrieving, refurbishing, restocking, and rerenting the returned merchandise. *In a traditional retail credit sale, additional fees for these services and options, over and above the cash price of the merchandise itself, would be considered part of the amount financed, not part of the service charge.* Similarly, additional fees for these services and options should be considered part of the amount financed for rent-to-own transactions."

Two things are clear from the FTC Report. One, an imputed APR is an inappropriate and misleading disclosure in rental-purchase transactions because there is simply no debt involved in this transaction. Two, studies by the National Consumer Law Center and the U.S. Public Interest Research Group, purporting to show "interest rates" in rent-to-own transactions, fail to take into account the totality of the transaction and its benefits and services, and consequently must be considered misleading at best.

In conclusion, S. 603 is strongly supported by the rental-purchase merchants throughout the country because it represents fair and balanced regulation of the rent-to-own transaction at the Federal level. This legislation is necessary so that a uniform public and economic policy is established where these transactions are concerned. States should and would have the ability to enact more stringent regulation of the transaction in response to local concerns and conditions if the need arises. However, by defining this transaction under Federal consumer protection law, this Congress extends its traditional role in consumer regulation, as first established with the passage of the Truth-in-Lending Act nearly 40 years ago.

PREPARED STATEMENT OF CHRIS LOSETH *

PRESIDENT & CEO, POTLATCH NO.1 FEDERAL CREDIT UNION AND CHAIRMAN, IDAHO CREDIT UNION LEAGUE GOVERNMENT AFFAIRS COMMITTEE ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

JUNE 21, 2005

Chairman Shelby, Ranking Member Sarbanes, Senator Crapo, 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 percent of our Nation's approximately 9,000 State and Federal credit unions and their 86 million members.

I am Chris Loseth, President & CEO of Potlatch No.1 Federal Credit Union and Chairman of the Idaho Credit Union League's Government Affairs Committee. Potlatch No.1 Federal Credit Union is a low-income community chartered credit union, serving a total of thirteen counties—eleven in Idaho and two in Washington. Five of these counties are included in our low-income community charter, while the other eight counties were added through the Underserved Community designation.

The average unemployment rate in the counties we serve (through March 2005) is 8.1 percent (with the high being 14.6 percent). We are very aware of these circumstances and offer several programs to assist our members when they need us most. For example, we offer checking accounts that have no minimum balance requirement, no monthly fees or transactional fees. We also offer debit cards with no monthly fees or transactional fees. Our ATM's charge no fees to our members. According to Callahan and Associates, a national rating service, we rank in the 93rd percentile for checking account penetration, and in the 92nd percentile for checking accounts outstanding among credit unions in the United States for March 2005.

Our lending services also have no loan set up fees, no application fees, no annual fees, and are priced competitively in the marketplace for the benefit of our members. We rank in the 94th percentile for loans outstanding and in the 90th percentile for our loan to share ratio among credit unions in the United States (Callahan and Associates, March 2005).

Potlatch No.1 Federal Credit Union offers members free financial counseling through our trained staff, financial literacy classes on a range of topics for our mem-

* Appendix held in Committee files.

bers, and provides volunteers to teach in the local elementary, junior and senior high schools and local colleges to help further financial literacy education. We offer free AD&D insurance to our members, free life savings insurance, free notary services, and low balance certificates of deposit. We also do not have fees for low balance savings accounts, check cashing, and a many other common nuisance fees that many financial institutions charge.

Our credit union's ability to continue serving the financial needs of our current members and our potential members who need access to our services in Northern Idaho and Eastern Washington will be significantly reduced *without* the regulatory relief this Committee is addressing.

CUNA is pleased that the Committee is moving forward with its efforts to provide regulatory relief of unneeded and costly burdens. Some might suggest that the Credit Union Membership Access of 1998 [1] (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 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, (for example, the intermediation 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 Federal Credit Union 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:

- 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."

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 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 CUMAA 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, de-

[1] Pub. L. No. 105–219 Sec. 401; 112 Stat. 913 (1998); 12 U.S.C. 1752a note and 1757a note.
[2] P. L. 105–219, Sec. 2, 112 Stat. 913.
[3] U.S. Dept. of the Treasury, Comparing Credit Unions with Other Depository Institutions, (Wash. DC: 2001).

spite repeated attempts, legal challenges brought by banking groups against the National Credit Union Administration's (NCUA) field of membership policies under CUMAA have not proved fruitful.

As unique institutions, credit unions today stand distinctly in need of regulatory relief.

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 year, 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 (PCA) 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.

In addition:

(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 charges 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 PCA 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 percent 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 percent net worth ratio. "(T)his exceeds the 4 percent 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 percent on any loan, and the term of many types of loans may not extend beyond 12 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, multigroup 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 loan (MBL) 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 percent 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 MBL's must generally meet 12-year maturity limits and can only be made to members. Credit union MBL's 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 PCA have been imposed on credit unions for the last several years.

An important study regarding the regulation of credit unions was published in 2003 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 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.

[4] Jackson, III, William E., University of North Carolina-Chapel Hill. The Future of Credit Unions: Public Policy Issues, 2003.

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 Improvements Legislation That CUNA Supports

CUNA strongly supports H.R. 2317, the Credit Union Regulatory Improvements Act (CURIA), which was recently introduced by Representatives Royce and Kanjorski in the House of Representatives. In the 108th Congress, CUNA had also endorsed 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, Housing, and Urban Affairs 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—all of which CUNA has endorsed—that are contained in the newly introduced H.R. 2317.

H.R. 2317—The Credit Union Regulatory Improvements Act

Although this legislation goes beyond what was included in the Regulatory Relief measure that passed the House last year, 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. This portion of my testimony will describe the different sections of CURIA, followed by an explanation of why CUNA strongly supports the proposed and necessary changes.

H.R. 2317, The Credit Union Regulatory Improvements Act of 2005—Section-by-Section Description

Title I: Capital Reform

CUNA strongly supports this title, which reforms the system of PCA for credit unions by establishing a dual ratio requirement: A pure leverage ratio and a net worth to risk-asset ratio. The resulting system would be comparable to the system of PCA in effect for FDIC insured institutions while taking into account the unique operating characteristics of cooperative credit unions.

Section 101. Amendments to Net Worth Categories

The Federal Credit Union Act specifies net worth ratios that, along with a risk-based net worth requirement, determine a credit union's net worth category. This section would continue to specify net worth requirements, but at levels more appropriate for credit unions and comparable to those currently in effect for banking institutions.

Section 102. Amendments Relating to Risk-Based Net Worth Categories

Currently, federally insured credit unions that are considered "complex" must meet a risk-based net worth requirement. This section would require all credit unions to meet a risk-based net worth requirement, and directs the NCUA Board to design the risk-based requirement appropriate to credit unions in a manner more comparable to risk standards for FDIC-insured institutions.

Section 103. Treatment Based on Other Criteria

Current risk-based net worth requirements for credit unions incorporate measures of interest-rate risk as well as credit risk. The comparable standards for risk-based capital requirements for FDIC insured institutions of Section 102 deal only with credit risk. This section would permit delegation to NCUA's regional directors the authority to lower by one level a credit union's net worth category for reasons of interest rate risk only that is not captured in the risk-based ratios.

Section 104. Definitions Relating to Net Worth

Net worth, for purposes of PCA, is currently defined as a credit union's retained earnings balance under generally accepted accounting principles. The Financial Accounting Standards Board (FASB) is finalizing guidance on the accounting treatment of mergers of cooperatives that would create a new component of net worth, in addition to retained earnings, after a credit union merger. The unintended effect of the FASB rule will be to no longer permit a continuing credit union to include the merging credit union's net worth in its PCA calculations. This section addresses that anomaly and defines net worth for purposes of PCA to include the new component for post-merger credit unions.

It was our understanding that FASB intended to apply the standard to credit unions beginning in early 2006, following a comment period, but now may be putting application of the standard off until the beginning of 2007. 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 its proposal 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 NCUA and others, supports a technical correction that would amend the Federal Credit Union Act to make it clear that net worth equity, including acquired earnings of a merged credit union as determined under GAAP, and as authorized by the NCUA Board, would be acceptable. Senior legal staff at FASB have indicated support for a legislative approach, and we urge the Committee to likewise support such an effort, well in advance of the effective date so credit unions will have certainty regarding the accounting treatment of mergers.

Legislation was introduced by Representative Bachus to address this issue in H.R. 1042, the "Net Worth Amendment of Credit Unions Act," which passed the House of Representatives on June 13, 2005 by voice vote. The language to correct this issue is identical in H.R. 1042 and H.R. 2317.

Also in this section, the definition of secondary capital for low-income credit unions is expanded to include certain limitations on its use by those credit unions. The definition of the net worth ratio is modified to exclude a credit union's share insurance fund deposit from the numerator and denominator of the ratio, and the ratio of net worth to risk-assets is defined, also to exclude a credit union's share insurance fund deposit from the numerator.

Section 105. Amendments Relating to Net Worth Restoration Plans

Section 105 would provide the NCUA Board with the authority to permit a marginally undercapitalized credit union to operate without a net-worth restoration plan if the Board determines that the situation is growth-related and likely to be short term.

This section would also modify the required actions of the Board in the case of critically undercapitalized credit unions in several ways. First, it would authorize the Board to issue an order to a critically undercapitalized credit union. Second, the timing of the period before appointment of a liquidating agent could be shortened. Third, the section would clarify the coordination requirement with State officials in the case of State-chartered credit unions.

The following is a detailed discussion of the need for and logic of PCA reform.

History of Credit Union PCA

The PCA section of CUMAA established for the first time "capital" or "net worth" requirements for credit unions. Prior to that time, credit unions were subject to a requirement to add to their regular reserves, depending on the ratio of those reserves to "risk-assets" (then defined as loans and long-term investments). The purpose of Section 1790d (PCA) 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 NCUA to implement regulations that establish a system of PCA 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.

There are, however, a number of ways that credit union PCA under CUMAA differs from PCA as it applies to banks and thrifts under FDICIA. Chief among these is that the net worth levels that determine a credit union's net worth classification are specified in the Act rather than being established by regulation as is the case for banks and thrifts. Further, the levels of the net worth ratio for a credit union to be classified "well" or "adequately" capitalized are 2 percentage points (200 basis points) above those currently in place for banks and thrifts, even though credit unions' activities are far more circumscribed that those of banks. In addition, the system of risk-based net worth requirements for credit unions is structured very differently from the Basel-based system in place for banks and thrifts. For example, the Basel system is credit-risk based while credit union risk-based net worth requirements explicitly account for the difficult-to-quantify interest rate risk. In PCA as implemented under FDICIA, interest rate risk is instead dealt with through examination and supervision.

Need for Reform of Credit Union PCA

Net worth 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 NCUA from approving credit union fields of membership comprising more than one group. Since its adoption 7 years ago, NCUA and credit unions have had sufficient time to experience PCA requirements. 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 been operating under PCA for several years.

There are two basic problems with the current PCA system.

- *High Basic Credit Union Capital Requirements.* Credit unions have significantly higher capital requirements than do banks, even though the credit union National Credit Union Share Insurance Fund (NCUSIF) 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 do other depository institutions.
- *Risk Based System is Imprecise.* The current system of risk-based net worth requirements for credit unions provides an imprecise treatment of risk. It is only when a portfolio reaches a relatively high concentration of assets that it signals greater risk and the need for additional net worth. This unartful system weakens the measurement of the NCUSIF's exposure to risk, and provides blurred incentives to credit unions on how to arrange their balance sheets so as to minimize risk. A Basel-type method of applying different weights to asset types based on the asset's risk profile would permit a more precise accounting for risk than does the current credit union system, thus improving the flow of actionable information regarding net worth adequacy to both regulators and credit unions.

Taken together, these problems have created an unnecessary constraint on healthy, well-managed credit unions. Credit unions agree that any credit union 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. Because credit unions themselves fund the NCUSIF, they are keenly aware that they are the ones that pay when a credit union fails. Therefore, *CUNA strongly supports a rigorous safety and soundness regulatory regime for credit unions that is anchored by meaningful and appropriate net worth requirements that drive the credit union system's PCA requirements.*

Under the current system of PCA, there are many credit unions that have more than enough capital to operate in a safe and sound manner, but that feel constrained in serving their members because potential reductions in their net worth category can result from growth in member deposits, even when uninduced by the credit union. The current law stipulates that a credit union with a 6 percent net worth ratio is "adequately" capitalized. Considering the risk exposure of the vast majority of credit unions and the history of their Federal share insurance fund, 6 percent is more than adequate net worth. However, as a result of the effect of potential growth on a credit union's net worth ratio under the present system of PCA, a very well run, very healthy, very safe and sound credit union feels regulatory constraints operating with a 6 percent net worth ratio. Without access to external capital markets, credit unions may only rely on retained earnings to build net worth. Thus, 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.

We are not here describing credit unions that aggressively and imprudently go after growth, just for growth's sake. Rather, any credit union can be hit with sharp and unexpected increases in member deposits, which are the primary source of asset growth for credit unions. This can happen whenever credit union members face rising concerns either about their own economic or employment outlook (as in a recession) or about the safety of other financial investments they may hold (as when the stock market falls). The resulting cautionary deposit building or flight to safely translates into large swings in deposit inflows without any additional effort by the credit union to attract deposits. As an example, total credit union savings growth rose from 6 percent in 2000 to over 15 percent in 2001 despite the fact that credit unions lowered deposit interest rates sharply throughout the year. The year 2001 produced both a recession and falling stock market, and was topped off with the consumer confidence weakening effects of September 11.

Credit union concern about the impact of uninduced growth on net worth ratios goes far beyond those credit unions that are close to the 6 percent 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 always to be classified as "well" rather than "adequately" capitalized. In order to do that, they must maintain a significant cushion above the 7 percent level required to be "well" capitalized so as not to fall below 7 percent after a period of rapid growth. A typical target is to have a 200 basis point cushion above the 7 percent standard. Thus, in effect, the PCA regulation, which was intended to ensure that credit unions maintain a 6 percent adequately capitalized ratio, has created powerful incentives to induce credit unions to hold net worth ratios roughly 50 percent higher than that level, far in excess of the risk in their portfolios. The PCA regulation in its present form thus drives credit unions to operate at "overcapitalized" levels, reducing their ability to provide benefits to their members, and forcing them instead to earn unnecessarily high levels of net income to build and maintain net worth.

There are two ways to resolve these problems with the current system of PCA. One would be to permit credit unions to issue some form of secondary capital in a way that both provides additional protection to the NCUSIF and does not upset the unique cooperative ownership structure of credit unions. CUNA believes that credit unions should have greater access to such secondary capital. However, this bill does not provide access to secondary capital.

The other solution is reform of PCA requirements themselves. Reform of PCA should have two primary goals. First, CUNA believes any reform should preserve the requirement that regulators must take prompt and forceful supervisory actions against credit unions that become seriously undercapitalized, maintaining the very strong incentives for credit unions to avoid becoming undercapitalized. This is essential to achieving the purpose of minimizing losses to the NCUSIF. Second, a reformed PCA should not force well-capitalized credit unions to feel the need to establish a large buffer over minimum net worth requirements so that they become overcapitalized.

H.R. 2317 would reform PCA in a manner consistent with these two requirements by transforming the system into one with net worth requirements comparable to those in effect for FDIC insured institutions, and that is much more explicitly based on risk measurement by incorporating a Basel-type risk structure.

Under H.R. 2317, a credit union's PCA capitalization classification would be determined on the basis of two ratios: The net worth ratio and the ratio of net worth to risk assets. The net worth ratio would be defined as net worth less the credit union's deposit in the NCUSIF, divided by total assets less the NCUSIF deposit. The ratio of net worth to risk assets would be defined as net worth minus the NCUSIF deposit divided by risk assets, where risk assets would be designed in a manner comparable to the Basel system in effect for banks of similar size to credit unions. The tables below show the ratio cutoff points for the various net worth classifications. A credit union would have to meet both ratio classifications, and if different, the lower of the two classifications would apply. For example, a credit union classified as "well capitalized" by its net worth ratio, but "undercapitalized" by its ratio of net worth to risk assets would be considered undercapitalized.

Net Worth Categories	Net Worth Ratio	Ratio of Net Worth to Risk Assets
Well Capitalized	5% or greater	8% or greater
Adequately Capitalized	4% to < 5%	8% or greater
Undercapitalized	3% to < 4%	6% to 8%
Signif. Undercapitalized	2% to < 3%	< 6%
Critically Undercapitalized	<2%	NA

The net worth cutoff points specified in H.R. 2317 are substantially similar to those currently in effect for FDIC insured institutions, yet, the ratios would have the effect of being more stringent on credit unions for two reasons. First, not all of an individual credit union's net worth is included in the numerator of the ratio; the NCUSIF deposit is first subtracted. Second, a portion of banks' net worth can be met by secondary or Tier II capital. All but low-income credit unions have no access to secondary capital, so all credit union net worth is equivalent to banks' Tier I capital, which has more characteristics of pure capital than does Tier II.

H.R. 2317 would require NCUA to design a risk-based net worth requirement based on comparable standards applied to FDIC insured institutions. The outlook for those standards as they will apply to banks is currently under review by the Federal banking regulators. Federal banking regulators have indicated that when Basel II takes affect for the very largest U.S. banks (approximately 25 banks and thrifts), some modifications to Basel I for all other U.S. banks will be implemented.

The exact nature of the changes to Basel I for the vast bulk of U.S. banks and thrifts is as yet unclear, although U.S. banking regulators have stated they do not intend to permit smaller U.S. banks to be disadvantaged compared to the largest banks when Basel II lowers net worth requirements for the very large institutions. Thus, it will be the modified version of Basel I in place for smaller banks that will be the standard under which NCUA will construct a risk weighting system for credit unions. Since it will be Basel based, it will focus on credit risk, leaving the treatment of interest rate risk to the supervisory process. The new credit union risk-based system will provide a much more precise measure of balance sheet risk than the current risk-based net worth requirement.

H.R. 2317 will improve the risk-based components of PCA and place greater emphasis on the risk-based measures, while lowering to the same level in effect for banks, the pure net worth ratio requirements for a credit union to be classified as adequately capitalized. CUNA believes that in addition to relying on improved risk measurements, a reduction of the pure net worth levels to be classified as well- or adequately capitalized is justified for the following reasons:

- One of the original justifications for higher credit union PCA net worth requirements (higher than for banks) was the 1 percent NCUSIF deposit. While FASB and NCUA have both affirmed that the 1 percent NCUSIF deposit is an asset and thus part of net worth, as a result of the unique funding mechanism of the NCUSIF (it has been funded solely by credit unions), the 1 percent deposit appears on the books of both the NCUSIF and insured credit unions. H.R. 2317 has addressed this issue by defining the net worth ratio as net worth less the 1 percent NCUSIF deposit divided by assets less the 1 percent deposit. *Thus, to be adequately capitalized, a credit union must hold net worth equal to about 5.7 percent (on average) of its assets to meet the 5 percent net worth requirement. This means that the discretionary and mandatory supervisory actions of PCA will be applied at higher levels of individual credit union capitalization than for similarly situated banks and thrifts.*
- 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 was 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 bank can easily access the capital markets. However, if a bank's capital ratio falls substantially due to losses, investors are likely to be wary of providing additional capital to it. Other institutions similarly have limited access to capital markets when they have experienced substantial losses. Thus, the lack of effective access to outside capital in times of financial stress might not really distinguish credit unions from banks or other depository institutions as much as it might appear.

- The other reason that a credit union's net worth ratio might fall—rapid asset growth—does not require higher net worth requirements for credit unions either. Asset growth (which comes from savings deposits) can be substantially influenced by a credit union's dividend policies. Under the current PCA system, lowering dividend rates creates the dual effects of retarding growth and boosting net income, both of which raise net worth ratios which would not occur had dividend rates been lowered. H.R. 2317 would permit a credit union to protect a reasonable net worth ratio with appropriate dividend rate cutting rather than being required to hold additional net worth.

There is substantial evidence that credit unions actually require *less* net worth than do for-profit financial institutions in order to provide protection to the deposit insurance system.[5] 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 enticed to act 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 percent and 1.3 percent, of insured shares 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 as provided in H.R. 2317 would preserve and strengthen the essential share-insurance fund protection of PCA and would more closely tie a credit union's net worth requirements to its 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 the unnecessary accumulation of net worth.

Title II: Economic Growth

Section 201. Limits on Member Business Loans

This section eliminates the current asset limit on MBL's at a credit union from the lesser of 1.75 times actual net worth or 1.75 percent 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 MBL 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 MBL's if its net worth falls

[5] See "The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers," Edward J. Kane and Robert Hendershott, *Journal of Banking and Finance,* Volume 20, September 1996, pp.1305–1327. Kane and Hendershott summarize their paper as "the paper analyzes how differences in incentive structure constrain the attractiveness of interest-rate speculation and other risk-taking opportunities to managers and regulators of credit unions." See also Differences in Bank and Credit Union Capital Needs, David M. Smith and Stephen A. Woodbury (Filene Research Institute, Madison, WI. 2001) Smith and Woodbury find that credit unions have lower loan delinquencies and net-charge off rates than do banks, and that charge-offs at credit unions are only two-thirds as sensitive to macroeconomic shocks as they are at banks. They also explain that because of the governance structure in credit unions "economic theory predicts that credit unions would take less risk than banks." (p. 5).

below 6 percent. This change will permit the NCUA to determine if such a policy is appropriate and to oversee all MBL's granted by an undercapitalized institution.

Section 204. Member Business Loan Exclusion for Loans to Nonprofit Religious Organizations

This section excludes loans or loan participations by Federal credit unions to nonprofit religious organizations from the MBL limit contained in the Federal Credit Union Act, which is 12.25 percent of the credit union's total assets. This amendment would offer some relief in this area by allowing Federal credit unions to make MBL's 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 CUMAA. The law currently provides exceptions to the MBL 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 205. Credit Unions Authorized to Lease 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.

Having described briefly how CURIA would address credit union member business lending concerns, I would like to provide the Subcommittee with a detailed rationale for these needed changes.

Helping Small Business

Title II, Section 203 of CUMAA established limits on credit union MBL activity. There were no statutory limits on credit union member business lending prior to 1998. 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 (that is, 7 percent) can be counted. Hence the limit is (1.75 x .07) or 12.25 percent 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 nonfarm economic activity in the United States 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 MBL's. 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. FDIC 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 percent 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 Percent Limit Discourages Entry into the MBL Business.* Even though very few credit unions are approaching the 12.25 percent 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 percent of assets. For example, in today's market, a typical experienced mid-level commercial loan officer would receive total compensa-

tion of approximately $100,000. The substantial costs associated with hiring an experienced lender, combined with funding costs and overhead and startup costs (for example, 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 percent limitation. In fact, assuming credit unions could carry salary expense of 2 percent of portfolio, 76 percent of CU's couldn't afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25 percent of asset maximum. Alternatively, assuming credit unions could carry salary expense of 4 percent of portfolio, 63 percent of CU's could not afford to be active member business lenders even if they had portfolios that were equal in size to the current 12.25 percent 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 percent cannot also support business lending. If all net worth could be counted, the actual limit would average between 18 percent and 19 percent of total assets rather than 12.25 percent 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 has not been adjusted since that time, would result in an approximate 33 percent 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 member business lending "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 MBL's reported in the Treasury study has continued in recent years. Credit union MBL net chargeoffs have averaged just 0.08 percent over the 4-year period since the Treasury study, while the comparable average net chargeoff rate at commercial banks was 1.28 percent and at savings institutions it was 1.11 percent. *MBL's 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 mid-year 2004, the dollar amount of MBL's was less than one-half of 1 percent of the total commercial loans held by U.S. depositories.* Credit union MBL's represent just 3.1 percent of the total of credit union loans outstanding and only 17.9 percent of U.S. credit unions offer MBL's. According to credit union call report data collected by the NCUA, the median size of credit union MBL's granted in the first 6 months of 2004 was $140,641.

Currently, only 11 credit unions in Idaho, out of a total of 68 (only 16 percent), offer MBL's to their members. The average size MBL is $91,653. The total amount of business lending by credit unions in Idaho is *$17.3 million,* while banking institutions in Idaho make *$4.3 billion* in business loans. In Idaho, credit unions represent 0.4 percent of the market share for business lending, while banking institutions represent 99.6 percent; and, while credit union business loans represent only 0.66 percent of credit union assets, banking institutions' business loans represent 78.98 percent of bank assets.

Adjusting credit union MBL limits from 12.25 percent to 20 percent of assets, which is the equivalent to the business lending limit for savings institutions, would not cause these numbers to change dramatically.

This adjustment would help small business. As noted earlier, small businesses are the backbone of the U.S. 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 United States 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 percent of banking industry assets in 1992. By year-end 2003, the largest 100 banking institutions accounted for 65 percent of banking industry assets—a 23-percentage point increase in market share in just 11 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: Regulatory Modernization

Section 301. 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 302. 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 303. 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 NCUA Board.

All Federal credit unions must comply with this limitation. We are very concerned that credit union 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 304. Increase in 1 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 percent of its shares and undivided earnings in these organizations, commonly known as credit union service organizations or CUSO's. The amendment raises the limit to 3 percent .

CUSO's 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 CUSO's 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 percent limit should be eliminated or set by NCUA through the regulatory process, we appreciate that the increase to 3 percent will provide credit unions more options to investment in CUSO's to enhance their ability to serve their members.

CUNA also would support raising the borrowing limitation that currently restricts loans from credit unions to CUSO's 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 305. 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 paycheck to paycheck 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 know of members who 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. Take the example of one of our credit unions in Pueblo, which attracts migrant workers who live in that area for several months each year, many who return year after year. It is well-known that this particular group is taken advantage of because of the language barrier. The Pueblo credit union has developed a group of bilingual 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 both the House and Senate on this issue: The International Consumer Protection Act, introduced in the House (H.R. 928) by Representative Gutierrez and in the Senate (S. 31) by Senator Sarbanes. Additionally, the Expanded Access to Financial Services Act (H.R. 749), introduced by Representatives Gerlach and Sherman, contains identical language to this provision, and passed the House of Representatives on April 26, 2005, by voice vote. CUNA strongly supports all legislative efforts to pursue this provision and is grateful to Ranking Member Sarbanes for the introduction of his bill.

Section 306. 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 307. 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 308. 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 some credit unions 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 credit unions to use such a provision. However, the safety of credit union personnel may be at stake. One instance I know of involved a credit union member who seemed to have a fixation on an employee and had made inappropriate comments. Another involved an older member who refused to take no for an answer from a young teller whom he persistently asked to date. We have heard of 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 other reports from credit unions 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.

Section 309. 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 310. Credit Union Conversion Voting Requirements

This section would change the Federal Credit Union Act from permitting conversions after only 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.

Last year, the NCUA adopted new regulatory provisions to require credit unions seeking to change their ownership structure to provide additional disclosures to their members to ensure 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 would 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 CUMAA 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 percent 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.

Recently, CUNA's Board adopted a set of principles related to credit union conversions, and we want to share its provisions with the Committee.

Principles Regarding Credit Union Conversions

- We support the right of member/owners to exercise their democratic control of their credit unions.
- The credit union charter currently provides the best vehicle for serving the financial needs of consumers.
- CUNA encourages credit unions that are considering conversions to make their decisions based solely on the best interests of their members.
- Full, plain language, disclosures are essential to furthering the democratic process.
- Credit union directors and managers have a fiduciary responsibility to present objective and honest information as well as reasonable business alternatives (for example mergers, liquidations.)
- We believe that the net worth of the credit union belongs to the members and should remain with them. There should be no unjust enrichment to Directors and senior management upon later conversion to a bank.
- CUNA supports NCUA and State regulators in the full use of their current authority to ensure members understand the conversion process and that fiduciary duties of credit union boards are fully enforced.

Section 311. Exemption from Premerger 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 premerger notification requirements and fees of the Federal Trade Commission.

Section 312. 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.

108th Congress: H.R. 1375—Financial Services Regulatory Relief Act (Credit Union Provisions)

Most of the provisions of H.R. 2317, as outlined above, were also included in last Congress's 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

CUNA supports this section which 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

None of the following provisions have been included in CURIA, nor past versions of regulatory relief legislation, yet represent legitimate burdens faced by credit unions that are deserving of relief. We encourage the Committee to consider including them in any future legislation.

- 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 CUMAA 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.

- Accounting Treatment of Loan Participations as Sales.

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, it is our understanding that 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), if the transaction did not meet "True-Sale-At-Law" test. 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.

Conclusion

In summary, Mr. Chairman, we are grateful to the Committee for holding this important hearing. The Potlatch No.1 Federal Credit Union's ability to continue serving the financial needs of our current members and our potential members who need access to our services in Northern Idaho and Eastern Washington will be significantly reduced without the regulatory relief this Committee is addressing. We strongly urge the Committee to act on this very important issue this year. And, we strongly urge the Committee to make sure that the provisions in CURIA are a part of any Congressional action to provide financial institutions regulatory relief. We strongly believe that our future will be determined by our ability to provide relief in these important areas. Without this relief, many credit unions will be unable to respond to the financial needs of millions of Americans.

PREPARED STATEMENT OF EDWARD PINTO

PRESIDENT, COURTESY SETTLEMENT SERVICES, LLC
ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

JUNE 21, 2005

Good Morning. I am Ed Pinto, President of Courtesy Settlement Services LLC in Sarasota, FL. Thank you, Chairman Shelby and Ranking Member Sarbanes, for giving me the opportunity to testify on behalf of the National Federation of Independent Business (NFIB) regarding interest bearing checking accounts for small businesses. Eighty-six percent of NFIB members support allowing business owners to earn interest on their business checking account balances.

I commend the Committee for conducting this hearing on Regulatory Relief. I am also pleased that the House has overwhelmingly voted in favor of H.R. 1224 by a vote of 424–1, to overturn this archaic law that prohibits interest on business checking accounts.

The big banks have consistently opposed repealing the ban on interest checking, and have proposed compromise legislation, a compromise that would delay the implementation of the repeal by 3 or more years. Their efforts to insulate themselves from free-market competition have hurt small businesses, the acknowledged job creation engines of this country. This bill is necessary consumer protection legislation, and every day it is delayed is an injustice to the more than 25 million taxpayers filing business income tax returns with the IRS!

Let me repeat that number—there are over 25 million business income taxpayers! [1] This issue may seem like small potatoes—perhaps only an average of $100 or $200 per year per small business—but multiply it by 25 million and consider the job creation power of our Nation's small businesses, and the impact will be large. The House-passed bill, as currently written with a 2-year delay, is already a compromise, and NFIB strongly urges the Committee to resist efforts to further lengthen the phase-in period. I urge you not to deny this much needed legislation to these millions of taxpayers.

While it has been 16 years since I started my first business, I can still vividly 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 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 growing 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 she 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. Boy, was it complicated. First, we analyzed my account history to determine how much to keep in my regular account so as to "earn" enough to avoid incurring fees on my regular checking account, my second encounter with compensating balances. 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

[1] "The Small Business Economy-A Report to the President," U.S. Small Business Administration, Office of Advocacy, (2004).

the transfer or I could set a floor amount and automatically sweep all funds in excess of that amount. Not being a glutton 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 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 did not know was that a sweep account is really designed for a larger company, one 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 noninterest bearing account issue, resulted in a flood of paper from the bank. Each day we would receive a reconciliation statement to let us know how the money had been shifted around in the past 24 hours. And because this is done via the mail, there was always a 2-to-3 day delay in the information flow so we never had 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, my sweep account fees were paying for all of this paperwork.

Don't get me wrong. I am not arguing against sweep accounts. But they are a bookkeeping hassle for a small business. Wouldn't these misguided resources be better spent on tasks that help grow the business, rather than keeping up with a flood of paperwork?

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 all too many small-business owners do—a fact that restricts much-needed job creation capital from those who need it most.

I know that there are many simpler nonbank alternatives to this crazy system, but is that Congress' intent? And so, while I have continued to work with a traditional banking institution (without a sweep account I might add), it makes even less sense today why this prohibition is continued. I don't even believe that it makes sense for banks. Creating by legal fiat a restriction that can be sidestepped with sweep accounts (even if in an inefficient manner) or does not apply to competitors of banks, in the long-run will only hurt the banks themselves. I challenge anyone to present a justification for a result that can only be cited as a textbook example of the law of unintended consequences run amok.

The Senate has an opportunity to eliminate an archaic law that has run headlong into the creativity of the free-market. The current law saddles America's small businesses with an inefficient alternative that costs small businesses billions in annual revenue that could be used to grow these businesses and the jobs that go along with them.

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.

PREPARED STATEMENT OF EUGENE F. MALONEY *

EXECUTIVE VICE PRESIDENT, FEDERATED INVESTORS, INC.

JUNE 21, 2005

My name is Eugene F. Maloney. I am Executive Vice President, Corporate Counsel and a member of the Executive Committee of 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 20 years, I have been a member of the faculty of Boston University School of Law where I teach a course entitled Securities Activities of Banks. Our mutual funds are used by over 1,000 community banks ei-

* Appendix held in Committee files.

ther 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 that 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, if not evaluated in an historical context, 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, and 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 that 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 banks' costs when paying interest on business checking accounts or the resulting impact on banks' earnings. The record does not include the type of detailed analysis that 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.

When this matter was before Congress last year, the House Committee report included 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 the earnings or assets of banks.

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]

In anticipation of my appearance before the committee today, we commissioned a study by Treasury Strategies of Chicago to provide us with their views on the impact of the repeal of Regulation Q (see Exhibit B).

Some of the key findings that we offer for your consideration are as follows:

- Companies now maintain liquid assets of approximately $5 trillion.
- Fifty-seven percent (57 percent) of corporate liquidity is now in deposits or investments that mature in 30 days or less.
- As we speak, banks are adjusting their balance sheets to mitigate interest rate risk to maintain their spread revenues.

This is a volatile mix. It becomes obvious that if higher-than-market interest rates are offered by banks to corporate customers, we risk a repeat of the 1980's debacle of massive movement of money to institutions that are ill-equipped to rationally deploy it.

Treasury Strategies (see Exhibit B) has suggested the following options to prevent this from occurring:

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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).

[3] Id. at 24.

Do not Increase from 6 to 24 the Number of Permissible Transfers per Month into MMDA Accounts

The House version calls for this increase. However, since MMDA accounts currently enjoy lower reserve requirements and are not limited in the rates they may pay, this would become the surviving vehicle. In effect, this would be tantamount to full repeal on day one without any phase-in period or risk management safeguards.

Cap the Interest Rates Payable on these Deregulated Accounts during the Phase-In Period

Our elasticity studies show that medium-sized and small business begin to adjust their deposit/investment behavior when rate offerings reach 40 percent of the 90-day Treasury bill rate and complete their adjustments when rates reach 80 percent. By contrast, larger companies begin their adjustment process at the 80 percent point and will move virtually all of their short-term investments if rate offerings reach 110 percent of the Treasury bill rate.

Therefore, an approach to an orderly transition would be to initially allow payment of interest at up to 40 percent of the 90-day Treasury bill rate. Then, this could rise 10 percent every 6 months and be phased out after 3 years.

Limit the Amount of Interest-Bearing Business Demand Deposits a Bank can Hold as a Percentage of its Capital

Bank capital is an excellent protection against risk. As corporate cash moves from other investments and into banks, banks will have to deploy that cash in the form of more loans and investments. This could lead to excesses or dislocations if unchecked. Limits on the amount of deregulated deposits that a bank can initially take in to a specific percentage of its capital would provide an appropriate safeguard.

One approach in this regard might be to limit deposits in this deregulated account initially to an aggregate of XX percent of a bank's total capital. This limit could be raised by YY percent every 6 months and eliminated altogether after 3 years.

Limit Interest Payments to Just Uninsured Deposits

Bank depositors enjoy the benefit of insurance on the first $100,000 of their deposit. Investors in mutual funds or direct money market instruments do not have the same protections. If the market for "business cash" is deregulated, the playing field for this cash should be leveled. This would not only allow for effective and transparent rate competition, but also induce banks to insure that they pursue safe and sound policies.

There are two possible approaches to implementing this safeguard. One is to allow for payment of interest on only the uninsured portion of a company's deposit. The other is to establish a distinct, uninsured account type that could pay interest on the entire deposit. A phase-in period for the latter option is appropriate.

Collateralize the Deregulated Deposits

Banks are currently required to post collateral to safeguard public sector deposits. In many cases, banks must set aside U.S. Government securities equal to 100 percent or more of each deposit.

Requiring banks to collateralize these deregulated deposits would ensure their safe deployment. At the same time, banks could still earn a spread on the rates paid versus their earnings on the collateral itself.

Money market mutual funds are in fact backed by a specific portfolio of marketable securities. Collateralization of interest-bearing demand deposits is analogous.

An approach to implementing this could be to begin with the requirement that each bank back these deposits, in the aggregate, 100 percent with U.S. Government and agency obligations. This figure could be reduced by 10 percent every 6 months and phased out after 3 years.

Implement a Phased Approach

Record levels of short-term liquidity relative to bank deposits, the volatility of the flow of funds among investment instruments, and the balance sheet readjustment that banks are navigating due to the rising rate environment combine to make this a less than ideal time to repeal Regulation Q. We would recommend deferring implementation to a more stable environment, perhaps 6 to 12 months following enactment.

Once implemented, some combination of the buffers cited above should be put into place and phased out over an additional 3-year period. This would allow for a smooth transition and avert serious market dislocations.

Other anticipated fallout we expect to occur should the repeal go forward are:

1. Increased credit risk that will raise the banks' rate of loan charge offs; and

2. Pressure on banks' profitability and subsequent increases in charges for discrete services. Some statistics on this point are: (a) profit risk of $4 billion; (b) increased interest expense of $6 to $7.5 billion per year; and (c) for the banks studied by Treasury Strategies, it has been determined that in order to break even on their business customer base, banks will need to grow deposits or raise service charges by the following:

With Respect to Small Business:

- grow deposits by 80 percent; or
- raise service charges by 34 percent.

With Respect to Mid-size Companies:

- grow deposits by 35 percent; or
- raise service charges by 16 percent.

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.

PREPARED STATEMENT OF BRADLEY E. ROCK *

President and Chief Executive Officer,
Bank of Smithtown, and Chairman, Government Relations Council,
American Bankers Association

June 21, 2005

Mr. Chairman and Members of the Committee, my name is Bradley Rock. I am Chairman, President and CEO of Bank of Smithtown, a $750 million community bank located in Smithtown, New York founded in 1910. I am also Chairman of the Government Relations Council of the American Bankers Association (ABA). ABA, on behalf of the more than two million men and women who work in the Nation's banks, 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 or eliminate unnecessary, redundant, or inefficient regulatory burdens that increase costs not only for banks, but also for the customers and businesses that use banks—and that is nearly everyone.

In my testimony, I would like to make three key points:

- Excessive regulatory burden is not just a problem 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 ongoing 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 without congressional action.

The Federal banking agencies, which are now in the fourth phase of the 10-year regulatory review required by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), are evaluating ways to reduce unduly burdensome regulations. EGRPRA, which became law in 1996, is the last comprehensive regulatory relief bill enacted by Congress. In the decade following EGRPRA's enactment, banks have struggled to shoulder the effects of some of the most imposing legislation of the past 100 years. Much of it was prompted by renewed focus on accounting practices and heightened security in the aftermath of September 11. While the impetus behind the compliance obligations imposed by the USA PATRIOT Act, the Sarbanes-Oxley Act, and the privacy provisions of the Gramm-Leach-Bliley Act (GLBA) are reasonable, too often their enforcement and practical effects are not.

When 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 (PCAOB), and the American Institute of Certified Public Accountants (AICPA) are also taken into account, it is abundantly clear that bank resources are being stretched too thin. Obviously, this is not in the interest of banks, but it also means that banks have fewer resources available to meet the stated policy goals of lawmakers and regulators.

We have submitted comments to regulators recommending changes that involve the Bank Secrecy Act (BSA), including discontinuing currency transaction reports (CTR's) for seasoned customers, eliminating the verification requirement for customers purchasing monetary instruments, and establishing a standard for suspending repetitive SAR filings on continuing activities in which law enforcement has no interest. Other suggested changes involve such issues as appraisal standards, real estate lending standards, and annual audit and reporting requirements.

We have long since reached a point where only the active involvement of Congress can result in a comprehensive reduction of outdated, inefficient, and costly regulatory burdens. A more detailed explanation of some of the areas in which ABA is seeking reform is found at the end of this testimony in the appendix.

Regulatory Burden Has an 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 boxing outside of one's weight class. Even the best moves will not, in the end, overcome the disadvantages of being dwarfed by the size of your challenger. New laws add heft to the regulatory burden. Banks are against the ropes.

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.

During 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] indicates that the total cost of compliance *today* for banks would range from $34 billion to $42 billion per year and this does not include compliance costs due to legislation enacted in the last 5 years, such as the USA PATRIOT Act and Sarbanes-Oxley. Compliance costs are expected to grow at an even faster pace in the coming years.

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 $69 billion to $84 billion. This would clearly have a big impact on our economies. In fact, it represents nearly 10 percent of all consumer loans or 11 percent of all small business loans.

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. 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 or consolidate with larger banks. Our members routinely mention regulatory burden as the first or second critical factor threatening the viability of his or her community bank. 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.

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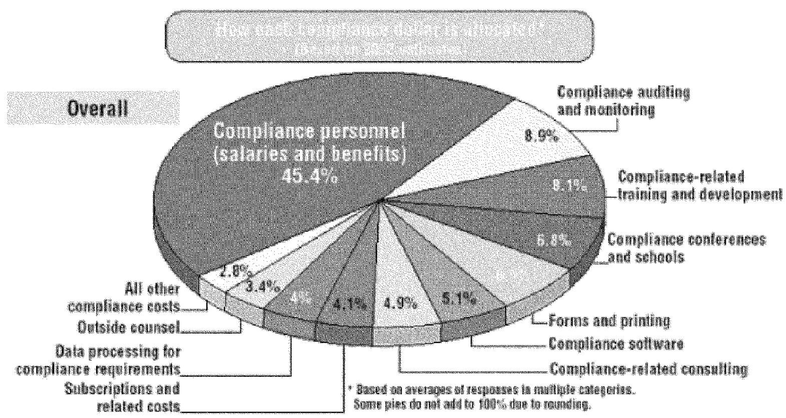
[1] "Survey of Regulatory Burden," American Bankers Association, June 1992; Elliehausen, "The Cost of Banking Regulation: A Review of the Evidence," Staff Study, Board of Governors of the Federal Reserve System, April 1998.

Bankers at all levels, from bank directors and CEO's to compliance managers and tellers, spend endless hours on compliance paperwork. Much of this work falls heavily on tellers. For example, they fill out the more than 13 million CTR's filed annually. Yet the 35-year-old rules related to CTR's have become redundant and lost their usefulness due to several developments, including formalized customer identification programs; more robust suspicious activity reporting; and, government use of inquiry and response processes.

At Bank of Smithtown, every person in every department has major compliance responsibilities. Because of the complexities involved, my bank pays more than $100,000 each year to outside firms 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.

I personally spend about one-and-a-half days per week just on compliance issues. Some CEO's tell me that they are now spending nearly half of their time on regulatory issues. This means that for banking alone, CEO's 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.

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.



Source: *Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey.* ABA Banking Journal, June 2003.

Banks that can least afford increasing compliance costs are hit the hardest. Consider a small bank, which can have as few as 20 employees or less. In order to fulfill their compliance obligations, banks of this size often are forced to hire an additional full-time employee just to complete reports related to BSA. Not only is this a huge expenditure of time and money, but bankers wonder if these reports are even being read. The cost versus benefit analysis fails to make the case for many of the rules and regulations banks must follow, and the reports that we generate.

In fact, there are more than *3,200 banks and thrifts with fewer than 25 employees; nearly 1,000 banks and thrifts have fewer than 10 employees.* These banks, which serve primarily small communities in nonurban areas, 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. 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.[2]

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

[2] Crain and Hopkins, "Impact of Regulatory Costs for Small Firms," Small Business Administration, Office of Advocacy, 2001.

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 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 there have been positive benefits of the Sarbanes-Oxley Act, banks have experienced inordinately large increases in annual auditing fees as a result of it and new rules developed by the PCAOB. Even nonpublicly traded banks have been impacted. Many community banks' accounting fees have more than doubled. *One community bank in New York saw its accounting fees jump from $193,000 in 2003 to more than $600,000 in 2004.*

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 urge that the Committee look at the costs versus benefits in the application of some of the Act's provisions to community banks. We have also asked the SEC to increase the 500 shareholder registration threshold.

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.

Congressional Support for Burden Reduction is Critical

The agencies have made considerable progress in the last several 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 EGRPRA, will provide meaningful relief. We applaud the openness of the banking regulators to the concerns of the industry as they conduct this review. Doubt exists as to whether this effort will be—or even can be—successful in achieving a meaningful reduction in the burden unless Congress becomes an active partner. Most bankers have seen previous regulatory relief efforts 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.

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. ABA pointed this out to Congress years ago and HUD has still not implemented this 1996 statutory change.

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, nonbank competitors, including money market funds and mutual funds, are selling savings and investment products to bank customers. The same is true of credit unions 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, nonbank 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 2 years. They also know that nonbank lenders will not have their loans examined, probably ever, because the Federal Trade Commission (FTC) 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.

PREPARED STATEMENT OF MIKE VADALA

PRESIDENT AND CEO, THE SUMMIT FEDERAL CREDIT UNION

ON BEHALF OF

THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

JUNE 21, 2005

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 almost 800 Federal credit unions—member owned financial institutions across the Nation—representing nearly 26 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.

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 86 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 U.S.C. 1752(1)). While over 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 8,945 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. In the 7 years since Congress passed the Credit Union Membership Access Act (CUMAA—P.L. 105–219) Federal credit unions have added almost 1,000 underserved areas resulting in low cost financial services being made available to over 87 million people. 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. Unlike banks and thrifts, credit unions have never cost the American taxpayer a single dime. While the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loans Insurance Corporation (FSLIC) were both started with seed money from the U.S. Treasury, every dollar that has ever gone into the National Credit Union Share Insurance Fund (NCUSIF) has come from the credit unions it insures. Furthermore, unlike the thrift insurance fund that unfortunately cost hundreds of billions of dollars, credit unions have never needed a Federal bailout.

I currently serve as the President and CEO of The Summit Federal Credit Union headquartered in Rochester, New York, a position I have held for 10 years. Established in 1941, The Summit FCU is a multi-SEG credit union with over 600 groups, approximately 47,000 members and more than $340 million in assets. I have been involved in the credit union movement for more than 25 years, the last 21 of which have been at The Summit FCU.

I also presently serve as the Vice-Chair of the National Association of Federal Credit Unions' Board of Directors, and will become the Board Chair in July of this year. I am also a former Chair of the Association's Legislative and Political Action Committees. I am a past President of the New York State Telephone Credit Union Association and still serve on that Board. I am active with Syracuse University as a member of the School of Management Advisory Council, Alumni Board and Athletic Policy Board. I serve on the local United Way Executive Committee, and am a former Chairperson of the March of Dimes Walk America.

Looking Beyond CUMAA

Credit unions have been the target of criticism by some in the banking industry for more than two decades. Over the past few years, the banker attacks have only 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 the forefront. CUMMA overturned in 8 short months a decision that had encompassed 8 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 added in haste and not widely supported by the credit union community. These include:

- arbitrary limitations on member business loans;
- imposition of a bank-like Prompt Corrective Action (PCA) requirement that, given the structure of credit unions, serves in many respects as an overly restrictive constraint on growth; and
- various other 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 either converted to a State chartered credit union or mutual savings bank) to begin work on developing well-reasoned proposals to enhance the Federal credit union charter and 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 the session and in subsequent meetings:

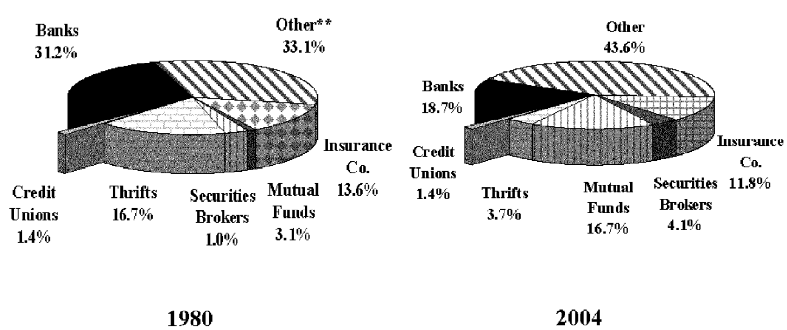
- NCUA should work to eliminate unnecessary regulations and work with Congress to repeal laws which are only serving to drive small financial institutions out of business.
- Mergers seem to be a practical and necessary way of creating financially viable credit unions that can survive in today's financial services marketplace.
- It is important that the regulatory environment 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 86 million Americans—more than at any time in history. At the same time, it is important to note that over the past 24 years, the credit union market share, as a percentage of financial assets, has not changed and, as a consequence, credit unions provide little competitive threat to other financial institutions. According to data obtained from the Federal Reserve Board, during the 24-year period from 1980 to 2004 the percentage of total financial assets held by credit unions remained constant at only 1.4 percent.

FINANCIAL ASSETS

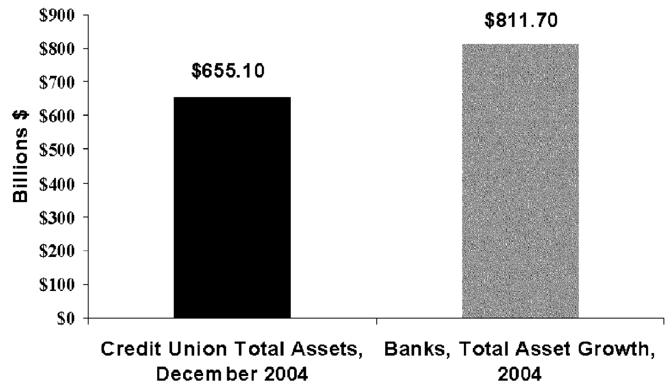


**Other includes items such as private pension funds, mortgages, asset-backed securities, finance companies, and investments in bank personal trusts.

Source: Flow of Funds Accounts of the United States, FRB

The above chart only tells part of the story. Credit unions remain small financial institutions. Today, the average credit union has $71 million in assets, while the "average" bank and thrift has over $1 billion in assets.

BANKS' ONE YEAR ASSET GROWTH = 124% OF TOTAL CU ASSETS



Source: NCUA; FDIC

Furthermore, a number of individual banks have total assets greater than the entire credit union community combined. As shown in the chart above, the annual asset growth of the commercial bank sector last year exceeded the size of the entire credit union community, that is total assets—with banks growing in just 1 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 61 percent over the course of the past 30 years, from an all-time high of 23,866 in 1969 to 8,945 this past March. 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 5,534 today.

NAFCU Meets with Policymakers to Enhance the Federal Charter

Over the past 4 years, NAFCU has been working with former NCUA Board Chairman Dennis Dollar, current NCUA Board Chairman JoAnn Johnson, Board Member Deborah Matz and their respective staffs in an effort to improve the regulatory environment for Federal credit unions. We are pleased to see that these efforts have been productive 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 were contained either in whole or in part in previous regulatory relief measures passed by the House. Credit unions exist in a very dynamic environment where the laws and regulations dealing with credit union issues are currently in need of review and refinement in order to ensure credit unions can continue to respond to changing market conditions.

Regulatory Relief Provisions

NAFCU supports the following twelve provisions, all of which were included in Title III of the Financial Services Regulatory Relief Act of 2004—which passed the House last year—and are included in the Credit Union Regulatory Improvements Act of 2005 (CURIA), H.R. 2317, introduced in the House during 109th Congress. (We would note that H.R. 2317 includes minor technical changes to the language and urge that the updated language from H.R. 2317 be used in any Senate regulatory relief measure.) NAFCU urges that the following provisions be included in any regulatory relief bill that the Committee considers:

Leases of Land on Federal Facilities for Credit Unions

NAFCU supports the effort to give credit unions the opportunity to negotiate land leases on Federal property under the same terms and conditions as credit unions now able to lease space in Federal buildings under the Federal Credit Union Act (FCUA). The credit unions that will be impacted by this change are predominantly 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 (for example $1.00 a year) to a "fair market value" rate of over $2,000 a month. For nonprofit 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. 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 1 Percent Investment Limit in Credit Union Service Organizations

NAFCU supports this provision to increase the 1 percent investment limit in credit union service organizations (CUSO's). However, in lieu of just raising the limit to 3 percent, as found in the last version of regulatory relief passed by the House, NAFCU recommends that Congress give the NCUA Board authority to establish an appropriate investment limit recognizing that as time goes on, that limit may warrant further adjustment.

Member Business Loan Exclusion for Loans to Nonprofit Religious Organizations

NAFCU supports this effort to exclude loans or loan participations by federally insured credit unions to nonprofit 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 nontraditional financial institutions that prey on our Nation's immigrants and others who live and work in underserved communities. The House passed stand-alone legislation to this effect (H.R. 749) on April 26, 2005.

Voluntary Mergers Involving Certain 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, 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.

Conversion of Certain Credit Unions to Community Charter

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. 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.

Credit Union Governance

The Federal Credit Union Act 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 21st century Federal credit union. We support changes that would remove many of these provisions from the Federal Credit Union Act and instead allow the NCUA its regulatory authority to keep these governance issues current. For example, one antiquated provision prohibits credit unions from expelling disruptive or threatening members without a two-thirds vote of the membership; we believe the regulator and the credit union board should have some discretion in such cases. Additionally, NAFCU supports the following credit union governance proposals 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.

Provide NCUA with Greater Flexibility in Responding to Market Conditions

NAFCU supports the proposal to give 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. This provision would still keep that limit, but give NCUA greater flexibility to make adjustments based on market conditions.

Exemption from Premerger 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 premerger 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. NAFCU supports providing credit unions regulatory relief along those same lines, eliminating the requirement that credit unions register with the Securities and Exchange Commission (SEC) as broker/dealers when engaging in certain activities.

Additionally, NAFCU supports including the language from The Business Checking Freedom Act of 2005, H.R. 1224, which was passed by the House on May 24, 2005 by a vote of 424–1. Similar language was also included in H.R. 1375 last year and would allow the Federal Reserve to pay interest on balances held by depository institutions, including credit unions, at a Federal Reserve Bank.

There are additional provisions in CURIA which were not incorporated in the Financial Services Regulatory Relief Act of 2004 as it passed the House. NAFCU encourages the Committee to review CURIA which includes updated legislative language. Most notably, Title I of CURIA contains a provision that would alter net worth requirements for PCA purposes; language which was also introduced as a stand-alone bill in the House known as the Net Worth Amendment for Credit Unions Act, H.R. 1042. The House passed H.R. 1042 on June 13, 2005.

Modify the Statutory Definition of "Net Worth" to Include the Retained Earnings from Other Institutions that have Merged with the Surviving Credit Union

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: $2M (net worth of credit union A) + $2M (net worth of credit union B) = $4M (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 $2M ($2M (net worth of credit union A) + $2M (net worth of credit union B) = $2M (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. Consequently, the surviving credit union may have trouble meeting PCA requirements, unless credit union net worth is redefined. We support including the language from H.R. 1042, the Net Worth Amendment for Credit Unions Act in any regulatory relief package. It is important to note that this amendment does not legislate accounting practices; credit unions will be required to use the "purchase method" of accounting for mergers in order to receive a clean audit. This amendment does not grant credit unions that currently lack the authority to offer alternative capital accounts the authority to do so, nor does it confer upon NCUA the regulatory authority or discretion to authorize such accounts now or in the future. This amendment is intended to address a narrow and technical accounting issue and in the process simply maintain the status quo so that, in the case of merging credit unions, 2 + 2 can continue to equal 4.

At a House Subcommittee on Financial Institutions and Consumer Credit hearing on H.R. 1042 this past April, the Subcommittee heard support for the legislation from NCUA and the National Association of State Credit Union Supervisors (NASCUS). Additionally, Mr. Robert Herz, the Chairman of FASB, testified at the hearing that the legislation does not pose an issue to FASB's standard setting activities. The House passed H.R. 1042 under suspension of the rules on June 13, 2005.

Risk-Based Capital/PCA Reform

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 NCUSIF. We urge inclusion of the proposal put forth by the NCUA and included as Title I of the CURIA bill in any regulatory relief legislation.

The American Bankers Association (ABA) expressed three concerns regarding risk-based capital in a letter to NCUA dated November 18, 2004. We believe that these concerns have been addressed in the actual proposal transmitted to Capitol Hill and incorporated into Title I of CURIA. Specifically, the ABA said that:

(1) CU's need a meaningful leverage ratio;
(2) There should be no substantive difference between bank and CU leverage ratio standards; and,
(3) Secondary capital would undermine the unique character of credit unions.

Neither the NCUA proposal nor Title I of CURIA would expand the authority for NCUA to authorize secondary capital accounts. As far as leverage ratios are concerned, NCUA's proposal:

- Advocates a system involving complementary leverage and risk-based standards working in tandem;
- For the leverage requirement, NCUA advocates a reduction in the standard net worth (that is, leverage) ratio requirements for credit unions *to a level comparable to what is required of FDIC insured institutions.* In order to achieve comparability between the Federal insurance funds, it is necessary to factor in the NCUSIF's deposit-based funding mechanism; and
- The risk-based proposal tailors the risk-asset categories and weights of BASEL II, as well as related aspects of the FDIC's PCA system, to the operation of credit unions. This approach is consistent with BASEL II and the FDIC's PCA system, addressing credit and operational risks under the risk-based requirement and acknowledging other forms of risk, such as interest rate risk.

The ABA's letter of November 18, 2004, also reiterates the recommendation contained in their April 18, 2000 comment letter to NCUA that said:

> NCUA should adopt a more bank-like risk-weighted capital system and then work with the banking agencies within the umbrella of the Federal Financial Institutions Examination Council to improve the current risk-based capital adequacy standard to better recognize credit quality and the use of internal risk models to manage financial institution risk.

What NCUA has transmitted to policymakers on Capitol Hill (which is included in CURIA), in fact, closely resembles the bank-like risk-weighted capital system and was developed with ample input from the Treasury Department. One difference, however, is that NCUA's proposal does not consider any credit union "internal risk models." While NCUA may in the future make that part of the risk mitigation credit, we have no assurance that this will be the case, so one could objectively conclude that the proposed risk-base capital system for credit unions is, in fact, more stringent than that currently applicable to banks and thrifts.

As you may recall, during last year's (June 22, 2004) Senate Banking Committee hearing on Regulatory Relief, the panel of industry witnesses discussed the issue of risk-based capital for credit unions and at the conclusion of that discussion a bank witness noted his understanding that the credit union industry "would like to see the leverage ratio eliminated and have only risk-based capital . . . . [while banks] have several capital ratios that we have to comply with, three to be certain, and that includes a leverage ratio. So if they [credit unions] 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." To which NAFCU witness Bill Cheney responded: ". . . we are not asking to eliminate it." (Transcript at page 151).

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, as proposed in Title II of the House CURIA bill. 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 CUMAA in 1998, the law 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.

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. Providing credit unions some relief from the regulatory burdens that they face will allow credit unions to better serve their members and meet their needs in a dynamic marketplace. We urge the Committee to consider the important provisions we 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.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN M. REICH

Q.1. Do you support passing a regulatory relief bill, especially one that would help small banks, this year?

A.1. Yes, I believe the time to take action to address the accumulated regulations that face the banking industry is now. 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. I hope Congress will accept the recommendations that have come from the EGRPRA process and incorporate them into a regulatory relief bill that will provide real relief for the industry, including community banks.

Q.2. Are you worried about the decline of small banks in this country?

A.2. I have expressed on many occasions my concern that if we do not provide relief from regulatory burden, a vital part of the banking system, namely America's community banks, may be in jeopardy. Some community bankers have sold their institutions and there are an increasing number of community bankers who are seriously considering selling their institutions because of the impact that increasing compliance costs are having on their institutions' profitability. The community banking sector has traditionally been a vibrant part of this country, providing leadership and financial support to communities and countless individuals, families, small businesses, and municipalities. Yet this sector is not necessarily a permanent part of our financial landscape. The impact of regulatory burden on these institutions should not be underestimated, and it is one of the most compelling reasons why this interagency effort needs to be successful. I firmly believe that without a change in the approach by policymakers to small bank supervision, the community bank may be an endangered species in our society.

Q.3. Are you concerned about the cost of regulatory compliance that small banks are faced with?

A.3. I am concerned that as community banks bear a disproportionate impact of regulatory burden they will become less and less viable as regulations accumulate. A 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 arena and stimulate consolidation of the industry into fewer, larger banks."

Q.4. Can any of your suggestions be implemented without legislation?

A.4. My written statement outlines several initiatives the FDIC has undertaken alone or on an interagency basis that did not require legislation. We continually strive to improve the way we conduct our affairs and always look for more efficient and effective ways to meet our responsibilities. However, the regulatory/banking industry consensus recommendations to relieve burden that are outlined in my June 21, 2005 testimony will require legislative changes.

Q.5. Many of the small banks in my State are concerned with compliance with the Bank Secrecy Act. Can changes be made to make the BSA work better, either administratively or legislatively without jeopardizing the War on Terror or any law enforcement initiatives?

A.5. The FDIC is mindful that small banks may perceive the requirements of the Bank Secrecy Act and the implementing Treasury regulations as onerous. The FDIC is actively involved in ongoing efforts to review the Bank Secrecy Act requirements. The objective of these efforts is to lessen burdens where practicable, while enhancing the value of the reports and records generated by financial institutions. Small banks could potentially benefit by some of the measures under consideration, such as raising the monetary threshold for the filing of Currency Transaction Reports. While the FDIC cannot unilaterally make such regulatory changes, the FDIC bears in mind the interests of smaller banks, many of which it supervises, while it participates in these discussions with other Federal entities and with industry.

We ultimately defer to the judgment of the Department of the Treasury and its Financial Crimes Enforcement Network (FinCEN) and to that of law enforcement with respect to any changes to the Bank Secrecy Act to improve its effectiveness. However, we offer comments below with respect to our efforts to address these issues, including working in various committees and subcommittees formed, in part, for those very purposes.

For our part, the FDIC will continue to support proposals and initiatives that streamline the reporting processes created by the Bank Secrecy Act, to the extent that those recommendations do not diminish the strength or effectiveness of the Bank Secrecy Act. Interagency working groups have been instrumental in developing and refining effective rules and regulations and for coordinating consistent regulatory programs among the various Federal banking agencies. The agencies actively participate in foreign and domestic initiatives aimed at strengthening anti-money laundering controls and procedures. A number of interagency working groups have been formed for task-specific purposes, including drafting risk-based revisions to the Bank Secrecy Act, issuing interpretive guidance for the financial services community, and developing examination procedures and training.

The Bank Secrecy Act Advisory Group (BSAAG),[1] in particular, is a public-private partnership devoted to the discussion of money laundering schemes, enforcement of anti-money laundering laws, and remedies for making all reporting processes more efficient. The BSAAG, established by Congress in 1994, serves as a forum for focusing discussion of anti-money laundering efforts for both the private and public sectors. The BSAAG serves to advise the Treasury Department on policy issues related to recordkeeping requirements

[1] The Bank Secrecy Act Advisory Group is made up of over 40 officials from all Federal banking agencies, law enforcement, the banking industry; and the securities, insurance, and gaming industries. The chairman of this working group also is the Chairman of FinCEN, the agency that administers the BSA.

of the BSA, including procedures for filing Currency Transaction Reports (CTR) and Suspicious Activity Reports (SAR), exempting retail and other accounts, and enhancing examination procedures.

The BSAAG established numerous subcommittees, each tasked with exploring more effective processes to reduce the burdens imposed by the current processes and enhance the information that financial institutions provide to law enforcement. As members of the BSAAG, the Federal banking agencies actively participate in the discussions of the full working group, as well as the various subcommittees.

Q.6. Would you support eliminating the restriction on the number of transactions from Money Market Demand Accounts?

A.6. Under Regulation D, depository institutions must limit savings account and money market deposit account (MMDA) activity to no more than six withdrawals and transfers per month from a savings account or MMDA if the transactions are overdraft protection transfers, automatic bill payments, wire transfers, telephone transfers, and personal computer banking transfers. Generally, the FDIC supports changing the restriction on the number of transactions per account by raising the allowable number of transfers for savings accounts and MMDA's.

Q.7. What do you think of the Securities and Exchange Commission's (SEC) Regulation B proposal for the Gramm-Leach-Bliley Act?

A.7. Under Title II of the Gramm-Leach-Bliley Act (GLBA), Congress intended that banks continue to provide certain traditional banking services that were covered under the bank broker-dealer exceptions in GLBA. As issued in June 2004, the SEC's Regulation B Proposal would restrict or prohibit various traditional bank securities activities that the FDIC believes are protected by GLBA. Regulation B would impose a new, SEC-created set of complex requirements and restrictions on such traditional bank services as trust, securities custody and safekeeping activities, and networking arrangements with securities brokers. In particular, the following provisions present significant compliance burdens that may prevent banks from continuing to provide trust, fiduciary, and custody services to the public.

- "Chiefly compensated" requirement—The "chiefly compensated" test should be measured on a broadly defined line-of-business or department-wide basis rather than on an account-by-account basis, as generally required by the SEC. An account-by-account test would force banks to build expensive new reporting systems. Although the SEC proposed an alternate line-of-business approach to determining compliance with the "chiefly compensated" requirement, the 11 percent ceiling on "sales" compensation limits the number of banks that can use this approach, especially if 12b–1 fees are classified as "sales" compensation. The FDIC believes that the ratio of total "sales" compensation to total trust or fiduciary compensation, determined on a bank-wide or line-of-business basis, should be used to determine compliance with the "chiefly compensated" requirement. The FDIC believes that the ceiling on the amount of "sales" compensation should be less than 50 percent, but that, in any event, the ceiling needs to be substantially higher than the 11 percent proposed by the SEC.

- Banks have for many years provided custodial and administrative services to 401(k) and related retirement and employee benefit plans, including securities order-taking for such plans. Despite Congress's protection of such traditional bank activities in GLBA, the SEC's Regulation B Proposal would restrict or prohibit such securities order-taking services for general bank customers, as well as retirement and employee benefit plans. The FDIC believes that banks must be permitted to: (1) take orders for securities transactions from all custodial customers; and (2) charge securities movement fees that do not differ based on whether the order was taken by the bank directly from the customer or from the customer's broker. The FDIC would support reasonable limits on the ability of banks to solicit custodial order-taking.
- GLBA permits banks to establish and maintain "networking" arrangements with a broker-dealer, under which bank customers may be referred to the broker-dealer for securities services. The Act also permits nonregistered bank employees to receive a nominal fee for these types of referrals. The proposed Regulation B would establish a restrictive definition of what constitutes a "nominal" cash referral fee. Also, as proposed, Regulation B seeks to regulate bank bonus plans. The FDIC believes that bank bonus plans should not be affected by a prohibition on paying referral fees to unregistered bank employees unless the bonus plan is clearly a conduit for paying impermissible referral fees. "Nominal" referral fees, which are permissible, should not be defined by reference to a fixed dollar amount or formula. The FDIC believes that the standards of reasonableness that have been used by bank examiners to determine whether a referral fee is "reasonable" should be incorporated into the regulation, since what dollar amount constitutes a "nominal" referral fee will continue to depend on various circumstances that will change over time. Banks should be allowed to pay nonnominal referral fees to unregistered bank employees for the referral of certain corporate, institutional, governmental, and not-for-profit customers.

In summary, the FDIC believes that the SEC's proposed Regulation B will present banks with significant compliance burdens that might prove to be so restrictive as to endanger the provision of the traditional banking products and services that Congress intended to protect. We believe that the staff of the SEC's Division of Market Regulation should work more closely with the Federal banking regulatory agencies in order to craft a regulation that will allow banks to continue to offer their traditional products and services, while at the same time protecting the interests of investors.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JULIE L. WILLIAMS

Q.1. Do you support passing a regulatory relief bill, especially one that would help small banks, this year?

A.1. Yes. In the written statement that I submitted to the Committee on Banking, Housing, and Urban Affairs in connection with the June 21 hearing, I recommended a number of legislative changes that would help reduce unnecessary regulatory burden on national banks.[1] Many of these would benefit community national banks. For example, the OCC supports amendments that would provide greater flexibility for national banks wishing to operate as Subchapter S corporations; modernize corporate governance by eliminating the outdated requirement in current law for mandatory cumulative voting in elections of national bank directors; and modernize the corporate structure options available to national banks. In addition, the Federal banking agencies, including the OCC, jointly have recommended that certain legislative amendments to reduce burden that have been identified as part of the regulatory review process required by Section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1986 (EGRPRA). These amendments also were included in my written statement. We urge the Committee to include these amendments in the regulatory burden relief legislation currently being prepared, and we look forward to continuing to work with the Committee and its staff as the legislative process moves forward.

Q.2. Are you worried about the decline of small banks in this country?

A.2. As described in the testimony of Vice Chairman John Reich, on behalf of the FDIC, before the Committee at the June 21 hearing, there has been a decline in the number of community banks, especially small community banks, in the United States over the past 20 years.[2] This decline reflects the fact that there has been substantial consolidation in the banking industry during that period, based principally on economic and demographic factors, particularly in smaller communities.

However, the decline in the number of community banks does not indicate that their importance is diminished. Our banking system works best with a variety of types and sizes of financial institutions available to consumers, and community banks are an integral part of this system. The OCC is fully committed to ensuring that the community banks we supervise continue to play a vital role in the financial services market. We devote a very significant proportion of our resources to the supervision of community banks and, as my answer to the following question shows, we have pursued regulatory and supervisory strategies that reduce regulatory burden on these smaller institutions, while ensuring that they remain safe and sound.

Q.3. Are you concerned about the cost of regulatory compliance that small banks are faced with?

A.3. Yes. Unnecessary regulatory burden has become an issue of competitive viability, particularly for our Nation's community banks. Our experience as community bank supervisors makes us keenly aware of the burden of regulation shouldered by community banks. The time and effort community bankers spend working to meet government compliance and paperwork requirements is time

[1] *See http://www.occ.treas.gov/ftp/release/2005–60b.pdf.*

[2] *See* Testimony of John M. Reich, Vice Chairman, FDIC, before the Senate Committee on Banking, Housing, and Urban Affairs, June 21, 2005, p. 6.

and effort unavailable for community bankers to serve their customers and communities.

The OCC has advocated a number of measures designed to make regulation more efficient, less costly, and less demanding on community banks. For example, when we heard from community bankers that higher State legal lending limits were placing them at a competitive disadvantage, we introduced a new regulatory legal lending limit program, recently expanded and extended, that raised lending limits for community banks, consistent with safety and soundness, so that they could compete more effectively in these States.[3] The amendments to the Community Reinvestment Act (CRA) regulation, recently finalized by the OCC, together with the Federal Reserve Board and the FDIC, are another example of modifications to our regulations in order to reduce burden on community banks.[4]

We also have implemented more efficient ways for national banks to file corporate applications. Our electronic filing system, called E-Corp, is available to national bankers through the OCC's website. E-Corp enables most applications to be submitted electronically and processed more expeditiously than ever before.

In addition, the OCC has advocated reform of the regime of consumer compliance disclosures in order to reduce confusion on the part of bankers and consumers alike, and to reduce compliance costs for financial institutions. An important example is the work of the OCC and the other Federal banking agencies on a project to simplify the privacy notices required by the Gramm-Leach-Bliley Act. Here, for the first time, we are using consumer testing to find out what consumers want to know and what style of disclosure is most effective in communicating that information to them. This project has the potential both to produce more effective and meaningful disclosures for consumers and to reduce burden on the banks that prepare and distribute privacy notices.

Finally, the OCC supports the community banks we supervise by working proactively to enhance their sound operation through the advice and direction provided by our experienced examiners, through a fair and balanced application of laws and regulations, and through the outreach programs that we regularly conduct. These programs are designed to bring key information and guidance to bankers on important topics of current interest. We use a variety of formats, including telephone seminars, which provide a cost-effective method of giving guidance on a wide range of supervisory issues. For example, the OCC has conducted telephone seminars on topics like Bank Secrecy Act and anti-money laundering compliance, credit risk issues, and corporate governance concerns.

Q.4. Can any of your suggestions be implemented without legislation?

A.4. All of the items submitted for the Committee's consideration at the June 21 hearing require legislative action. However, as part of the EGRPRA regulatory review process, we are working with the other Federal banking agencies to identify rules that could be

[3] *See* 12 CFR § 32.7. This is the provision of our rules that sets the standards for participation in this program.

[4] The OCC approved these amendments on July 19, 2005. The final rule is available at: *http://www.occ.treas.gov/ftp/release/2005–71a.pdf.*

modified to reduce burden. In addition, I note that as part of our general rulemaking process, the OCC has a longstanding commitment to avoid regulatory burdens that exceed what is necessary to ensure that our regulations effectively protect safety and soundness, foster the integrity of bank operations, and safeguard the interests of consumers.

Q.5. Many of the small banks in my State are concerned with compliance with the Bank Secrecy Act (BSA). Can changes be made to make the BSA work better, either administratively or legislatively without jeopardizing the War on Terror or any law enforcement initiatives?

A.5. The BSA establishes the primary mechanism for detecting and punishing money laundering and related financial crimes perpetrated against and through domestic financial institutions. Among other things, the recordkeeping and reporting requirements of the BSA provide law enforcement and other supervisory agents with information that is highly beneficial to investigations related to various financial crimes. As a supervisory agency responsible for implementing the BSA, however, the OCC must ensure that any modifications to the financial recordkeeping and reporting rules will not impede criminal investigations. The OCC, along with the other Federal banking agencies, however, recognizes that the BSA requires the banking industry to dedicate time, personnel, and equipment, at a tangible cost, to support these criminal investigations by law enforcement. These costs can weigh heavily on community banks. The OCC will continue to work closely with the other Federal banking agencies and the Financial Crimes Enforcement Network (FinCEN), the administrator of the BSA, to explore ways to streamline the reporting processes created by the BSA without diminishing the value of the information produced.

The OCC has taken a number of actions to assist national banks in complying with BSA requirements, thereby making BSA/AML compliance less burdensome and confusing for financial institutions. For example, the Federal Financial Institutions Examination Council (FFIEC) last month issued the Bank Secrecy Act/Anti-Money Laundering Examination Manual (FFIEC BSA/AML Examination Manual), which was the result of a collaborative effort of the Federal banking agencies, FinCEN, and the Office of Foreign Assets Control. The manual is a compilation of existing regulatory requirements, supervisory expectations, and sound practices in the BSA/AML area and marks an important step forward in the effort to ensure the consistent application of the BSA to all banking organizations. The guidance and procedures contained within the Manual will assist banking organizations in understanding relevant laws and regulations. The Federal banking agencies and FinCEN have planned a series of nationwide conference calls and regional outreach meetings to assist banking organizations in further understanding the Manuals.[5]

In addition, in response to concerns about unregistered and unlicensed money services businesses (MSB's), the Federal banking agencies, NCUA and FinCEN issued in April 2005 interpretive guidance to banking organizations regarding the Bank Secrecy Act

[5] The Manual can be found at *www.ffiec.gov/pdf/bsamanual.pdf.*

and MSB's.[6] That same month the Federal banking agencies, the NCUA, and the Treasury Department published updated frequently asked questions (FAQ's) regarding the application of the agencies' customer identification rules, set forth at 31 CFR § 103.121.[7]

Q.6. Would you support eliminating the restriction on the number of transactions from Money Market Demand Accounts?

A.6. The OCC has not taken a position on this issue. We note however, this issue arises in connection with the repeal of the statutory prohibition that prevents banks from paying interest on demand deposits. We support the repeal of that prohibition.[8] This prohibition was enacted approximately 70 years ago for the purpose of deterring large banks from attracting deposits away from community banks, but it is no longer effective or necessary. The development of innovations in financial products, such as sweep services, allow banks and their customers to avoid the statutory prohibition. The repeal of this prohibition would reduce burden on consumers, including small businesses, and reduce costs associated with establishing additional accounts.

Q.7. What do you think of the SEC's Regulation B proposal for the Gramm-Leach-Bliley Act (GLBA)?

A.7. The OCC believes that the SEC's proposed Regulation B reflects a fundamental misinterpretation of the language and purposes of the "broker" exceptions in GLBA. The SEC's proposed rules would require banks to make substantial changes in the way they conduct well-established and already highly regulated lines of banking business and would impose a new, SEC-created regime of extraordinarily complex requirements and restrictions on long-standing banking functions and relationships. Far from implementing the "exceptions" for banks adopted by Congress, we believe that proposed Regulation B would insert the SEC to an unprecedented and unforeseen degree in the management of banks' internal operations. Our views are more fully expressed in the comment letter to the SEC, dated October 8, 2004, that the OCC submitted jointly with the Federal Reserve Board and the FDIC. I have enclosed a copy of that letter for your information.*

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MARK OLSON

Q.1. Do you support passing a regulatory relief bill, especially one that would help small banks, this year?

A.1. The Board strongly supports the development and adoption of a regulatory relief bill that provides meaningful relief to banking organizations, including small banks, in ways that do not compromise the safety and soundness of banking organizations, consumer protections, or other important objectives that Congress has established for the financial system. To help achieve this goal, the

[6] "Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States," OCC Bulletin 20005–19 (April 26, 2005).
[7] *See* OCC Bulletin 2004–3 (April 28, 2005).
[8] This provision was included in H.R. 1224, the Business Checking Freedom Act of 2005, as recently reported by the House Financial Services Committee and as passed by the House on May 24, 2005.
* Held in Committee files.

Board has supported a number of regulatory relief proposals, including several that would provide important benefits to small banks.

For example, the Board strongly supports an amendment that would repeal the provisions in Federal law that currently prohibit depository institutions from paying interest on demand deposits. As I explained in my testimony, this amendment should assist small banks in attracting and retaining business deposits. In addition, the Board supports an amendment that would raise, from $250 million to $500 million, the statutory asset threshold below which an insured depository institution may qualify for an extended 18-month examination cycle. This amendment potentially would allow an additional 1,100 small depository institutions to benefit from an extended examination cycle while preserving the important benefits provided by the existence of mandatory exam cycles.

Q.2. Are you worried about the decline of small banks in this country?

A.2. While the number of banks in the country has been decreasing gradually in recent years, that trend does not signal a decline either in the profitability of the community banking business or in the value community banks provide to the economy and their local communities.

At the end of 2004, there were approximately 7,200 insured commercial banks with less than $1 billion in assets, representing more than 94 percent of all insured commercial banks. While the total number of banks with less than $1 billion in assets has declined by about 200 each year for the past 5 years, the net change does not tell the whole story. First, a number of institutions grow out of this category through internal growth or acquisitions. Second, despite the consolidation in the sector, entrepreneurs and investors continue to find opportunities in small banks, a point that is illustrated by the steady demand for new bank charters. Over the past 5 years, for every five banks that disappeared through consolidation, another two new charters were granted.

If you look at their balance sheets and income statements, you will see that smaller banks are thriving. Capital, earnings, and asset quality are improving for banks of all sizes, but particularly for banks with less than $1 billion in assets. In 2004, nonperforming assets, net charge-offs, and loan-loss provisions for these banks were at long-term lows. The continuing strength of the financial sector is also visible in supervisory ratings. At year-end 2004, less than 1 percent of banks in this category nationwide were rated below the threshold for problem institutions.

This country reaps substantial benefits from its tradition of small, locally oriented banks. Small banks help assure that diverse funding sources are available for small businesses and they provide retail banking customers with convenient locations and personal service. Surveys conducted by the Board indicate that the single most important factor influencing a customer's choice of banks is the location of the institution's branches. Once a household has chosen a particular depository institution as the location for its main checking account, there is a strong tendency to stick with that institution. These patterns and the data described above bode well for the future of community banking. And, judging by the fact that about 10 percent of bank holding companies with less than $1 billion in assets are also financial holding companies, it seems apparent that community banks have been active in positioning themselves to diversify their business base.

Q.3. Are you concerned about the cost of regulatory compliance that small banks are faced with?

A.3. Compliance costs, like other types of costs borne by financial institutions, can result in increased prices for consumers or reduced profitability for institutions. Compliance costs can present special challenges for small institutions, which, by definition, have fewer resources than larger competitors. For these reasons, it is very important for Congress and supervisors to carefully weigh the benefits of new laws and regulations against their potential costs to institutions, consumers, and the economy as a whole.

At the Federal Reserve, we strive to review each of our regulations at least once every 5 years to identify those provisions that are out of date or otherwise unnecessary. Furthermore, we continue to work with our regulatory colleagues in the ongoing regulatory review process being conducted by the Federal banking agencies pursuant to the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). EGRPRA requires the Federal banking agencies, at least once every 10 years, to review and seek public comment on the burden associated with the full range of the agencies' regulations that affect insured depository institutions. The agencies already have solicited comments on four broad categories of regulations including those governing applications, activities, money laundering, and consumer protection in lending transactions and have conducted outreach meetings throughout the country to encourage public participation in the EGRPRA process. In response to these efforts, the agencies have received comments from more than 1,000 entities and individuals on ways to reduce the regulatory burden on banking organizations. The Board will consider and incorporate the comments relevant to our regulations as we move forward with our own regulation review efforts.

Q.4. Can any of your suggestions be implemented without legislation?

A.4. The Board strives to review each of its regulations at least once every 5 years to identify those provisions that are out of date or otherwise unnecessary. Through this process, the Board already has taken a number of important steps to streamline its regulations and eliminate or reduce regulatory burden when such action is appropriate and within the Board's regulatory or supervisory authority.

Congress, however, also plays a critical role in the regulatory relief process. The vast majority of the regulatory relief proposals supported by the Board would require statutory changes to implement. These include the Board's proposals authorizing depository institutions to pay interest on demand deposits, providing the Federal Reserve greater flexibility in establishing reserve requirements for depository institutions, and raising the asset threshold below which an insured depository institution may qualify for an extended 18-month examination cycle.

The Board has supported an amendment that would require the banking agencies to review the agencies' call report forms at least once every 5 years to determine whether any of the form's reporting requirements could be eliminated or modified. This amendment, which is supported by the other Federal banking agencies, was developed as a result of input received from banking organizations and others through the on-going EGRPRA review process. The Board and the other banking agencies could implement this amendment without any legislative changes and, indeed, the Federal banking agencies already review periodically the call report forms to determine if these reporting forms may be streamlined. The amendment, however, would ensure that this review takes place no less frequently than once every 5 years.

Q.5. Many of the small banks in my State are concerned with compliance with the Bank Secrecy Act. Can changes be made to make the BSA work better, either administratively or legislatively without jeopardizing the War on Terror or any law enforcement initiatives?

A.5. The Federal Reserve, in coordination with the other Federal banking agencies and the Financial Crimes Enforcement Network (FinCEN) of Treasury, has taken several steps to improve and streamline the BSA compliance process. Most notably, on June 30, 2005, the Federal Reserve and the other Federal banking agencies released an interagency BSA/AML examination manual. The manual provides a single set of comprehensive BSA/AML examination procedures (replacing and updating those that each agency had released on its own over the years) and comprehensive guidance on the underlying regulatory requirements. By providing clear guidance to banking organizations and promoting consistency among the agencies in the BSA examination process, the manual should help address some of the concerns raised by banking organizations regarding the BSA.

Importantly, the examination manual emphasizes risk management and the need for banks, and their supervisors, to use a risk-based approach to implementing and monitoring BSA/ AML compliance programs. This should assist many small banks that have a low BSA/AML risk profile. These banks should expect a simpler BSA/AML examination process.

The Federal Reserve also continues to work with FinCEN, law enforcement, regulatory agencies, and industry through the Bank Secrecy Act Advisory Group and other forums to improve the BSA/ AML process. For example, the Federal Reserve supports FinCEN's efforts to streamline and improve the exemptions process for Currency Transaction Reports, and has encouraged law enforcement, which is the primary user of BSA reports, to provide the banking industry, with greater feedback on the reports' usefulness.

Q.6. Would you support eliminating the restriction on the number of transactions from Money Market Demand Accounts?

A.6. Section 19(b) of the Federal Reserve Act (12 U.S.C. § 461(b)) currently requires the Board to impose reserve requirements for monetary policy purposes on "transaction accounts," which are accounts that are used for the purposes of making payments and other transfers to third parties. The Board therefore must distinguish between transaction accounts and nontransaction accounts in implementing reserve requirements.

Under the Board's Regulation D (12 CFR Part 204), money market deposit accounts (MMDA's) are not treated as "transaction accounts" and, thus, are not subject to reserve requirements provided that (i) the depositor cannot make more than six convenient transfers per month from the account, and (ii) no more than three of those transfers may be made by check, draft, debit card, or similar order payable to third parties. Eliminating the restrictions on the number of permissible transfers from MMDA's would turn these deposits into transaction accounts. In such circumstances, it would be imperative that these accounts be subject to reserve requirements, as they would be under the current provisions of the Board's Regulation D. Allowing depository institutions to offer MMDA's that were both nonreservable and transaction accounts would essentially repeal reserve requirements and could severely undermine the Board's ability to effectively conduct monetary policy.

The Board supports an alternative approach that is more cost effective for small banks and addresses concerns about reserve requirements. Currently, Federal law prohibits depository institutions from paying interest on demand deposits, which are a type of transaction account. *See, e.g.,* 12 U.S.C. § 371a. This prohibition affects business customers most directly because business customers are not eligible to hold interest-bearing negotiable order of withdrawal (NOW) accounts, which are another form of transaction account. The Board has long supported amendments that would eliminate the provisions in Federal law that currently prohibit depository institutions from paying interest on demand deposits. Doing so would permit businesses to have interest-bearing checking accounts without confusing the distinction between MMDA's and reservable transaction accounts and without undermining the Board's ability to effectively conduct monetary policy.

Q.7. What do you think of the SEC's Regulation B proposal for the Gramm-Leach-Bliley Act?

A.7. The SEC's proposed Regulation B would implement the exceptions for banks from the definition of "broker" in the Securities Exchange Act of 1934 that were adopted by Congress in the Gramm-Leach-Bliley Act (GLB Act). The exceptions in the GLB Act were designed and intended to allow banks to continue to effect securities transactions for their customers as part of their traditional trust, fiduciary, custodial, and other bank functions.

Regulation B, if implemented, would significantly disrupt the normal functions and customer relationships of banks that the GLB Act was intended to protect and preserve. Moreover, the regulation would impose substantial and unnecessary costs on banks and their customers and limit customer choice by preventing or discouraging banks from providing certain services that customers have come to expect and demand from their banking institution. The Board believes these results would not occur if the exceptions in the GLB Act are implemented in a manner consistent with the statute's language and purpose.

In October 2004, the Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency submitted a joint comment letter to the SEC on proposed Regulation B that sets forth in detail the banking agencies' concerns with the proposed regulation. This comment letter continues to represent the Board's view on Regulation B. The joint comment letter is available on the Board's website at *http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20041008/default.htm.*

The Board continues to have discussions with the SEC on ways to address the concerns of the SEC and the banking agencies on implementation of the GLB Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM RICHARD M. RICCOBONO

Q.1. Do you support passing a regulatory relief bill, especially one that would help small banks, this year?

A.1. OTS supports passage of a regulatory relief bill this year, and we will continue to work with Congress and the other Federal banking agencies (FBA's) to enact this legislation. As part of our efforts pursuant to the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), we have identified numerous, superfluous regulatory obstacles that hinder profitability, innovation, and competition in the financial services industry. Some of these provisions also impede job creation and economic growth in the general economy. Small institutions, in particular, need relief from these unnecessary burdens in order to remain competitive and to continue effectively to service consumers and small businesses in their local communities.

Q.2. Are you worried about the decline of small banks in this country?

A.2. Yes, very much so. The number of small OTS-regulated thrifts decreased significantly during the 15-year period from March 31, 1990 through March 31, 2005. Many small thrifts merged or otherwise grew into larger thrifts during this period. Partially offsetting these structural shifts was an increase in new small thrifts chartered in recent years. Nevertheless, thrifts with assets less than $500 million fell 72 percent to 691 in the first quarter of 2005 from 2,466 15 years earlier, roughly matching the decline in the number of all thrifts, which dropped 69 percent from 2,874 to 880 during the same period. Small thrifts represented 79 percent of all thrifts as of March 2005, compared to an 86 percent ratio in March 1990.

There are many reasons for the decline in small thrifts and independent community banks; chief among these being industry consolidation based on changes in market forces. What particularly concerns us, however, are policies and practices that have produced an accumulation of regulatory burden that disadvantages smaller institutions vis-ávis their larger competitors.

There are a number of reasons why market changes have, to some extent, reduced the competitive advantages held by small, local institutions and led to the decline in small thrifts. Increased competition from insured and noninsured financial institutions, and from credit unions due to relaxed common bond requirements, have made it more difficult for small community banks and thrifts to compete profitably for loans and deposits. Advances in technology and interconnected lending markets have enabled previously distant financial institutions to expand their contact with customers in small institutions' local markets. Internet banking, branching, ATM expansion, and the increased use of loan brokers have also facilitated direct access to the local markets of small community banks and thrifts.

Technology aided advances in financial markets and tools have also reduced the advantages of local lenders. Credit scoring and data-mining tools enable nonlocal lenders quickly and efficiently to identify creditworthy borrowers without personal contact. The increased use of the secondary loan markets and loan securitizations have also increased loan liquidity and made lending expansion into different markets more feasible and profitable for nonlocal lenders.

Regulatory burden and compliance costs have also contributed to the decline in small thrifts. Small thrift managers have indicated to us in conversations that increasing compliance costs make it difficult to operate profitability as a small, local institution. While we as regulators can do little about the change in market forces impacting small thrifts, we can work to reduce needless and excessive regulatory burden. We will continue to work on identifying areas where we can ease the regulatory burden facing small thrifts and banks in order to reduce compliance and related regulatory costs.

Q.3. Are you concerned about the cost of regulatory compliance that small banks are faced with?

A.3. Yes, we are very concerned with the cost of regulatory compliance facing small banks and thrifts. In discussions with managers of small thrifts, the cost of compliance is increasingly burdensome. We are particularly concerned that increasing compliance costs may be forcing some thrift managers to consider selling to larger competitors or changing their business strategy in order to take on additional risk to improve income and offset increased costs. It is unhealthy for our banking system to have regulatory compliance costs influencing strategic and economic decisions in this manner.

Q.4. Can any of your suggestions be implemented without legislation?

A.4. The items that OTS has submitted to the Senate Banking Committee for inclusion in regulatory relief legislation, generally, require statutory changes in the law. The one exception is our top regulatory relief priority of removing the duplicative oversight burden and disparate treatment of savings associations under the Federal securities laws. In our view, savings associations should have the same exemptions as banks with respect to investment adviser and broker-dealer activities that each conducts on otherwise equal terms and under substantially similar authority. Several years of discussions with the SEC on this issue have been ineffectual, and we continue to grapple with proposed regulations that treat banks and savings associations differently with regard to investment adviser and broker-dealer activities. As a result of that experience, we believe that legislation is necessary to ensure needed reforms in this area. We will, however, continue to pursue a regulatory solution with the SEC on this issue.

Q.5. Many of the small banks in my State are concerned with compliance with the Bank Secrecy Act. Can changes be made to make the BSA work better, either administratively or legislatively without jeopardizing the War on Terror or any law enforcement initiatives?

A.5. OTS and the other FBA's are aware of the burdens imposed on small institutions by the Bank Secrecy Act (BSA). The FBA's are actively reviewing existing BSA requirements in an effort to reduce burdens where practical, while enhancing the value of BSA reports and records generated by financial institutions. Our hope is that small institutions, in particular, will benefit from various measures currently under review.

The FBA's have been exploring ways to address the growing concerns of the banking industry related to the BSA recordkeeping and reporting requirements imposed by its regulations at 31 CFR § 103. The FBA's recognize that BSA provisions require considerable effort from the financial services industry to obtain, document, and provide relevant financial information to support criminal investigations by law enforcement. We will continue to work with the other FBA's, the Treasury Department and its Financial Crimes Enforcement Network (FinCEN), which administers and oversees the provisions of the BSA, to improve BSA effectiveness.

Industry concerns regarding BSA implementation and administration underscore the need for further discussion and guidance in this area. BSA serves as the primary regulatory instrument providing transparency of financial transactions conducted through domestic financial institutions. Revisions to BSA recordkeeping and reporting rules should be pursued cautiously to ensure that modifications do not undermine the efforts of law enforcement in this area.

The FBA's and FinCEN continue to work diligently with the private and public sectors to carry out the objectives of the BSA. Interagency working groups have been instrumental in developing and refining effective rules and regulations, and for coordinating consistent regulatory programs among the FBA's. The agencies continue to participate in foreign and domestic initiatives aimed at strengthening anti-money laundering controls and procedures. A number of interagency working groups have been formed for task specific purposes, including drafting risk-based BSA revisions, issuing interpretive guidance for the financial services community, and developing examination procedures and training.

The BSA Advisory Group (BSAAG) is a public-private partnership devoted to the discussion of money laundering schemes, enforcement of anti-money laundering laws, and remedies for making all reporting processes more efficient. The BSAAG, established in 1994 pursuant to a Congressional mandate, is a forum focusing discussion of anti-money laundering efforts for both private and public sectors. Since its inception, the BSAAG has advised the Treasury Department on policy issues related to the BSA, including procedures for filing Currency Transaction Reports (CTR) and Suspicious Activity Reports (SAR), exempting retail and other accounts, and enhancing examination procedures.

The BSAAG has established numerous subcommittees, each tasked with exploring more effective processes to reduce BSA burdens and enhance the information that financial institutions provide to law enforcement. The FBA's are members and active participants' of the BSAAG, including its various subcommittees.

Q.6. Would you support eliminating the restriction on the number of transactions from Money Market Demand Accounts?

A.6. OTS supports efforts to eliminate restrictions on the number of transactions from Money Market Demand Accounts, as described in Senate Banking Committee Matrix number 113. That provision is described as expanding the number of permissible transfers from money market deposit accounts from 6 to 24 per month. Although we have not seen the legislative language for this provision, we favor increasing the number of permissible transactions. We will review this provision when it becomes available.

Q.7. What do you think of the SEC's Regulation B proposal for the Gramm-Leach-Bliley Act?

A.7. The SEC's Regulation B proposal does not extend the same treatment to savings associations accorded to banks with respect to three newly created exemptions. Under the proposal, savings associations will not receive the general custody exemption in Exchange Act Rule 760, the proposed new ERISA exemption in Exchange Act Rule 770, nor the proposed Regulation S exemption in Exchange Act Rule 771 (the three exemptions).

The basis for the disparity in the treatment of savings associations under the proposal is unclear. In our view, a final rule should treat savings associations and commercial banks the same. According to the preamble to. the Regulation B proposal, the reason that the three exemptions were not extended to savings associations is that the SEC was unable to obtain sufficient information to determine whether savings associations directly engage in the types of securities activities covered by the three exemptions. In fact, savings associations do engage in the types of activities covered by the three exemptions and have been engaged in these activities for quite some time.

Since the release of the Regulation B proposal, savings associations have provided the SEC with information about activities that would be covered under the three exemptions. OTS has also provided information to the SEC regarding savings association activities covered under the three exemptions via a September 1, 2004 comment letter, as well as in numerous subsequent e-mails.

We believe this provides a sound basis for extending the three exemptions to all savings associations without regard to whether they are currently engaged in the securities activities covered by the three exemptions. This is the same approach taken with banks. OTS strongly feels that any final rule on Regulation B should provide complete parity between savings associations and commercial banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOANN M. JOHNSON

Q.1. Would you please explain why Congress should modify the statutory definition of net worth?

A.1. NCUA is requesting two changes to the Federal Credit Union Act regarding how credit union capital is defined and measured.

Most immediately, an amendment to the Federal Credit Union Act is necessary to cure the unintended consequences of business combination accounting rules the Financial Accounting Standards Board (FASB) will apply to the combinations of mutual enterprises such as credit unions. Under the new rules, the merging credit union's capital would not flow forward as capital to the combined continuing credit union. Instead, the merging credit union's "retained equity" (capital) becomes "acquired equity" (not capital) for the continuing credit union. The resulting drop in the acquiring credit union's capital could subject it to prompt corrective action sanctions and thus create a disincentive to otherwise desirable credit union mergers. This disincentive to merge will make it more difficult for NCUA to carry out the public interest in managing and minimizing losses to the National Credit Union Share Insurance Fund 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. NCUA respectfully requests expedient action on legislation such as H.R. 1042, which was approved by the House of Representatives June 13. H.R. 1042 would redefine "net worth" to include the retained earnings balance of a credit union (as determined under generally accepted accounting principles, as under current law), together with any amounts that were previously retained earnings of any other credit union with which the credit union has combined.

NCUA is also seeking changes to the FCU Act in order to move to a system of risk-based net worth requirements for purposes of implementing prompt corrective action (PCA). The Credit Union Membership Access Act of 1998 established a statutory system of capital standards and PCA for federally insured credit unions. The guiding principle behind PCA, a principle NCUA strongly supports, is to resolve problems in federally insured credit unions at the least long-term cost to the National Credit Union Share Insurance Fund (NCUSIF). However, the current statutory net worth structure establishes a system based largely on the ratio of net worth to total assets, without rating assets by their relative risk. Also, the current leverage ratios established under the PCA are much higher for credit unions than for other types of financial institutions and these ratios should be adjusted in conjunction with establishing a risk-based system. The elements of NCUA's proposal for credit union capital reform are included in H.R. 2317.

The central focus of our proposal is to provide for a more risk-based PCA system. A well-designed risk-based system would allow NCUA to account for higher- and lower-risk activities, and eliminate the inequities that currently exist for credit unions with low-risk balance sheets. A risk-based system would also reinforce the relative risks of various activities to credit union managers, and enable them to manage their compliance by adjustments to their assets and activities. Accordingly, a risk-based system would better achieve the objectives of PCA, because it would more quickly identify credit unions with the highest-risk activities and allow NCUA to focus its supervisory efforts on ensuring such credit unions have sufficient net worth to account for these risks.

NCUA also urges a reduction in the leverage requirements, comparable to those required for FDIC-insured institutions. Presently, to be "well-capitalized," a credit union must have a 7 percent leverage ratio, compared to the threshold of 5 percent for FDIC-insured institutions. The 5 percent requirement has proven adequate to protect the banks insurance fund, and with credit unions' more limited powers and conservative nature, there is no reason to impose a higher requirement on credit unions.

It is important to note in this connection that NCUA's proposal accounts for the deposit method of capitalizing the NCUSIF, by deducting an individual credit union's NCUSIF deposit from both its capital and asset base in determining the credit union's PCA leverage ratio. The effect on the average would be a required total capital to total assets ratio in the range of 5.7 percent. This treatment addresses concerns of the Treasury Department and others about possible double consideration of the NCUSIF capitalization deposit when considering credit union system-wide capital. It would apply to the PCA leverage ratio only, and not to the GAAP capital of the credit union.

A meaningful risk-based system working in tandem with a lower leverage requirement would provide incentives for credit unions to manage the risk they take in relation to their capital levels, and allows them to do so by reflecting the composition of their balance sheets in their risk-based PCA requirements. For these reasons, NCUA urges prompt enactment of credit union capital reform.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOANN M. JOHNSON

Q.1. Do you support passing a regulatory relief bill, especially one that would help small banks, this year?

A.1. NCUA supports the principle of regulatory relief and has supported legislation, such as HR. 1375, that passed the House of Representatives last Congress and addressed reforms for all Federal financial regulatory agencies and the institutions they regulate. NCUA is prepared to support, after review, a similar bill when introduced in the Senate. NCUA supports our recommended suggestions, and does not have a safety or soundness problem with the other credit union provisions mentioned in our testimony that did not originate with NCUA. On June 30, 2005, the agency sent a letter to Senator Crapo stating no objection (with one drafting suggestion) to the new suggestions appearing in Section IV of Senator Crapo's matrix dated June 14, 2005 and we are continuing to review these from the perspective of regulating federally insured credit unions.

Of particular importance to the continued safety and soundness of the credit union system, NCUA urges passage of legislation that would establish a more risk-based capital regime for all insured credit unions. Not only would such legislation enhance overall safety and soundness, but it would also revise overly restrictive leverage capital ratio requirements for credit unions engaged in low-risk activities, as most small credit unions are. NCUA's proposals for reform of credit union capital requirements are reflected in a bill that has been introduced in the House of Representatives this term as H.R. 2317. NCUA urges consideration of similar legislation by the Senate and passage of capital reform for credit unions.

NCUA also strongly supports the other credit union regulatory relief proposals that were considered by both Houses of Congress last year and that are addressed in Senator Crapo's matrix. Provisions of special interest to small credit unions would: Increase the maximum permissible loan term; revise the definition of member business loan so that fewer loans are covered by the burdensome and limiting business loan provisions of the Federal Credit Act; allow small credit unions to join together to offer additional services to members by increasing the permissible investment in credit union service organizations; and allow credit unions to cash checks and provide money transfer services to all persons in their field of membership.

Q.2. Are you worried about the decline of small banks in this country?

A.2. NCUA is aware that some representatives of the banking industry portray credit union growth as a threat to the well-being of small banks. The data reveal, however, that credit unions are not gaining market share at the expense of banks. While the number of insured institutions is similar—8,939 federally insured credit unions versus 8,942 FDIC-insured institutions—total credit union assets are only a fraction of total assets for FDIC-insured institutions and are within historical norms. Over the past 10 years, the percent of federally insured credit union assets to the assets of FDIC-insured institutions has ranged between 5.78 percent and 6.72 percent, with the current level equaling 6.44 percent.

The large majority of credit unions are of modest asset size, especially in comparison to banks and thrifts. More than 46 percent of federally insured credit unions have less than $10 million in assets, and 87 percent of credit unions have less than $100 million in assets. Further, credit union assets are much more concentrated in small institutions than are bank assets, as credit unions with less than $1 billion in assets hold 66.2 percent of credit union assets, while FDIC-insured institutions with less than $1 billion in assets hold only 13.8 percent of industry assets.

Credit unions also face significant limitations on their powers and activities to which small banks are not subject. Some examples of these limitations, which will remain even if every credit union regulatory provision under consideration were enacted, are listed below.

- Credit unions can only serve those within their fields of membership. Thus, while a credit union member can use any bank he or she finds convenient, a bank customer cannot use any credit union.
- Federal credit unions are subject to a usury limit, currently 18 percent.
- Federal credit unions have a limit on maximum loan maturities and a total prohibition on prepayment penalties.
- Federally insured credit unions' member business loans are limited by statute.
- Federal credit unions have limited investment authority.
- Federal credit unions do not have general trust powers.

- Federal credit unions have limited borrowing authority.
- Federal credit unions can only compensate one member of the board of directors for service as a director; other directors and committee members must serve as volunteers.
- Federal credit unions by statute cannot invest in the shares of an insurance company or control another financial depository institution. Thus, they cannot be part of a financial services holding company and cannot become affiliates of other depository institutions or financial companies.

The cumulative impact of all these limitations on credit unions should reveal to all objective observers that credit unions continue to operate under much more limited authority than do commercial banks. These member-owned cooperatives pose no threat—now or in the future—to the health and stability of small banks.

Q.3. Are you concerned about the cost of regulatory compliance that small banks are faced with?

A.3. NCUA realizes that smaller credit unions may lack the staff and resources to manage compliance, and makes special efforts to assist these credit unions with compliance issues. NCUA's Office of Small Credit Union Initiatives (OSCUI) oversees a variety of programs designed to promote successful, financially healthy small credit unions and stimulate economic activity within the communities they serve. OSCUI oversees 13 economic development specialists, located in NCUA's regional offices, and 30 small credit union subject matter examiners. This team of specially designated and trained staff stands ready to provide guidance and support to small credit unions struggling with compliance issues. In addition, the small credit union experts on OSCUI's staff have worked to develop partnerships with local credit union associations and other organizations to assist small credit unions.

In 2004, NCUA's regional offices sponsored 59 workshops attended by more than 1,500 credit union officials, most of whom represented small credit unions. These workshops offered advice on regulatory compliance, as well as expanding service to underserved areas and helping members build wealth.

Q.4. Can any of your suggestions be implemented without legislation?

A.4. NCUA is continually engaged in a review of its regulations and policies in an effort to eliminate unneeded and burdensome requirements. NCUA reexamines one-third of its regulations every year, so each regulation is reviewed at least once every 3 years.

While NCUA is committed to doing everything possible to reduce the regulatory burden on credit unions where appropriate and consistent with safety and soundness, the changes that would have the biggest impact, such as revising credit union net worth requirements and implementing a risk-based prompt corrective action system, require legislation.

Q.5. Many of the small banks in my State are concerned with compliance with the Bank Secrecy Act. Can changes by made to make the BSA work better, either administratively or legislatively without jeopardizing the War on Terror or any law enforcement initiatives?

A.5. NCUA believes that consistency in enforcement, combined with clear guidance about expectations for financial institutions under the BSA, are the keys to achieving the BSA's goal of combating financial crimes, including potential terrorist financing, while imposing the fewest possible regulatory burdens. NCUA continues to work with other financial institution regulators on BSA implementation and in providing guidance to credit unions on BSA compliance. Last year, NCUA sponsored a series of workshops around the country targeted at small credit unions; BSA and Office of Foreign Assets Control (OFAC) compliance information was a key part of these workshops.

Two areas that are under review are the requirements for filing Currency Transaction Reports (CTR's) and Suspicious Activity Reports (SAR's). The $10,000 threshold for filing CTR's has been in place for many years. Also, clarifications of and additions to the types of entities that are exempt from filing CTR's may be appropriate. We are aware of concerns regarding "defensive" filing of SAR's and agree that additional guidance to financial institutions on what constitutes a suspicious activity might be useful in certain situations. We are also aware of concerns about the need for uniform enforcement of CTR and SAR filing requirements. It is our understanding that these issues could be addressed through Treasury regulations and agency guidance.

NCUA has been an active participant in discussions regarding these issues by virtue of its membership in the Bank Secrecy Act Advisory Group (BSAAG). The BSAAG includes industry representatives as well as financial institution regulators and meets twice per year to discuss concerns regarding BSA enforcement and compliance. The BSAAG also has numerous subcommittees, two of which are focused on CTR and SAR requirements, and NCUA representatives participate in both of these subcommittees.

Q.6. Would you support eliminating the restriction on the number of transactions from Money Market Demand Accounts?

A.6. NCUA takes no position on the demand accounts provisions of H.R. 1224, the "Business Checking Freedom Act of 2005." However, NCUA strongly supports provisions of H.R. 1224 that would permit the Federal Reserve to pay interest on Regulation D reserves maintained by credit unions, banks, and thrifts. Under H.R. 1224, the Federal Reserve could pay the equivalent of short-term market rates on Regulation D reserves. H.R. 1224 would also give the Federal Reserve increased flexibility to set reserve requirements and allow credit unions and other depository institutions to pay interest on demand deposits.

Q.7. What do you think of the SEC's Regulation B proposal for the Gramm-Leach-Bliley Act?

A.7. The SEC's proposed Regulation B would provide a limited exemption from the definitions of "broker" and "dealer" under the Securities and Exchange Act of 1934 for certain activities conducted by credit unions. Specifically, the proposed regulation would except credit unions from the definition of "broker" for certain networking and sweep account arrangements and "dealer" for certain investment, trustee and fiduciary transactions. The proposed regulation also grants additional exemptions from the definitions of broker and dealer to banks and thrifts.

As I indicated in my comment letter regarding the proposed regulation, NCUA appreciates the extension of these exemptions to credit unions, but requests that the Commission extend to credit unions all the exceptions from the definitions or broker and dealer that are available to banks and thrifts. In particular, we urge the SEC to extend the safekeeping and custody exemptions to credit unions. Like the other activities exempted, safekeeping and custody activities do not pose safety and soundness or investor protection concerns. The requirement to register with the SEC to conduct activities that are permissible under the Federal Credit Union Act and NCUA's Regulations places credit union at a competitive disadvantage compared to banks and thrifts.

Amending the securities statutes to grant credit unions the same exemptions now given to other types of financial institutions would be a more comprehensive approach and also would provide greater certainty to credit unions that their treatment under securities laws will not be subject to future regulatory changes by the SEC. Accordingly, NCUA's preferred solution is to incorporate changes to the Federal securities statutes, such as those included in Section 312 of H.R. 2317.

The statutory changes proposed in Section 312 of H.R. 2317 provide credit unions exemptions that are similar, but not identical to, exemptions enjoyed by banks and thrifts. Credit union powers are limited by their chartering statutes, and credit unions do not have certain powers, such as general trust powers, available to banks and thrifts. The requested amendments 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.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM ERIC MCCLURE

Q.1. Do you support passing a regulatory relief bill, especially one that would help small banks, this year?

A.1. Unequivocally yes, CSBS would support passing a regulatory relief bill this year, especially one that would help small banks. This is a crucial time for Congress to take the next step in reviewing the impact that Federal statutes have had on our Nation's community banks and the affect this has had on the economy of this great country. My colleagues and I see growing disparity in our Nation's financial services industry between large and small institutions. Congress must recognize this reality, and the impact this bifurcation has on our economy. Regulatory burden always falls hardest on smaller institutions. Our community banks do a large share of our Nation's small business lending which helps to drive our economy. Regulatory burden relief for these institutions would be a booster shot for the Nation's economic well-being.

Q.2. Does the decline of small banks in this country concern you?

A.2. Community banks represent a shrinking percentage of the assets of our country's banking system, and we cannot doubt that compliance costs are in part driving mergers. Even where laws officially exempt small, privately held banks, as in the case of Sarbanes-Oxley, the principles behind these laws hold all institutions to increasingly more expensive compliance standards. Stifling economic incentives for community banks with excessive statutory burdens slows the economic engine of small business in the United States. Driving these community banks out of business dries up the availability of capital to small businesses in these communities thereby contributing to the decline of small towns in rural America.

Q.3. Are you concerned about the cost of regulatory compliance that small banks are faced with?

A.3. Our current regulatory structure and statutory framework may recognize some differences between financial institutions, but too often mandate overarching "one size fits all" requirements for any financial institution that can be described by the word "bank." These requirements are often unduly burdensome on smaller or community-based institutions. Regulatory burden always falls hardest on smaller institutions. There can be no doubt that compliance costs are in part driving mergers which are leading to a decline in the percentage of assets in community-based institutions. As the largest banks are pushing for a purely national set of rules for their evolving multistate and increasingly retail operations, keep in mind that this regulatory scheme will also impose new requirements on many State-chartered banks operating in the majority of States that do not already have similar rules in place.

Q.4. Can any of your suggestions be implemented without legislation?

A.4. A limited liability corporation is a business entity that combines the limited liability of a corporation with the pass-through tax treatment of a partnership. The FDIC has determined that banks organized as LLC's 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 handful of states now allow banks to organize as LLC's, including Maine, Nevada, Texas, Vermont and, most recently, Utah. More States may consider this option, however, because the structure offers the same tax advantages as Subchapter S corporations but with greater flexibility. Unlike Subchapter S corporations, LLC's are not subject to limits on the number and type of shareholders. Unfortunately, an Internal Revenue Service regulation currently blocks pass-through tax treatment for State-chartered banks. The Committee should encourage the IRS to reconsider its interpretation of the tax treatment of banks structured as LLC's.

Q.5. Many of the small banks in my State are concerned with compliance with the Bank Secrecy Act. Can changes be made to make the BSA work better, administratively or legislatively, without jeopardizing the War on Terror or any law enforcement initiatives?

A.5. CSBS has worked diligently with FinCEN and the Federal banking agencies to develop clear, risk-based BSA examination procedures. We hope these procedures will alleviate some of the financial industry's concerns in this area. Federal law enforcement agencies need to work with State and Federal regulators to ensure clear guidance is provided to the industry with regard to prosecution. We also urge Congress, FinCEN, and the Federal banking regulators to simplify the BSA reporting forms and look carefully at potential changes to threshold levels. We must all work hard to make sure that our regulatory approach in this area is smart, focused, and reasonable.

Q.6. Would you support eliminating the restriction on the number of transactions from the Money Market Demand Accounts?

A.6. CSBS has no official position on this issue at this time.

Q.7. What do you think of the SEC's Regulation B proposal for the Gramm-Leach-Bliley Act?

A.7. CSBS has expressed concern over the SEC's Regulation B proposal in a detailed comment letter to the SEC (see attachment).* We are concerned over what we believe are unnecessary and challenging administrative hurdles the regulation sets up that banks must comply with in order to retain exceptions from the definition of "broker." The CSBS comment letter focuses on two exemptions in the rule to the definition of "broker" concerning networking and trust and fiduciary activities. CSBS recommends a more coordinated effort between State and Federal banking and securities regulators in the hopes of leading to a reduced need for new regulatory requirements while still addressing the concerns that the SEC may have regarding certain practices.

RESPONSE TO A WRITTEN QUESTION OF SENATOR CRAPO FROM MICHAEL VADALA

Q.1. Would you explain why you believe check cashing and money transfer services should be offered within the field of membership?

A.1. Thank you Senator Crapo for the question. 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, as proposed in the House regulatory relief bill last year—which would be discretionary and not mandatory—will allow credit unions to help combat abuses by nontraditional financial institutions that prey on our nation's immigrants and others who live and work in underserved communities. By being able to reach out to the un-banked populations in their field of membership, credit unions would have the opportunity to educate and build a relationship with these individuals, hopefully establishing a level of trust that will allow them to develop a relationship with the credit union and use other financial services that the credit union provides and enter into the financial services mainstream. In the 7 years since the passage of the *Credit Union Membership Access Act,* credit unions have added over 1,000 underserved areas to their fields of membership, and we at The Summit have added five ourselves. This provision would help credit unions continue to reach the un-banked populations in these areas that have been traditionally underserved. The House passed standalone legislation to this effect (H.R. 749) earlier this year on April 26, 2005 and we hope that a provision such as this would be included in any Senate regulatory relief package.

*Held in Committee files.