FINANCIAL SERVICES REGULATORY RELIEF: THE REGULATORS' VIEWS

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

JUNE 9, 2005

Printed for the use of the Committee on Financial Services

Serial No. 109–36

U.S. GOVERNMENT PRINTING OFFICE

24–094 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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C O N T E N T S

FINANCIAL SERVICES REGULATORY RELIEF: THE REGULATORS' VIEWS

Thursday, June 9, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Representatives Bachus, Kelly, Gillmor, Ryun, Biggert, Feeney, Hensarling, Pearce, Neugebauer, McHenry, Watt, Sherman, Carson, Green, Moore of Wisconsin, and Clay.

Chairman BACHUS. [Presiding.] Good morning. Today's hearing is a continuation of our hearings on regulatory relief. We heard last month from the financial services industry, and of course today we have a follow-up panel with regulators.

I want to thank Vice Chairman Reich for your work on the EGRPRA and all the agencies; for I think you have done a splendid job of coming to a consensus on what needs to be done.

I want to thank Chairman Oxley for his commitment to reg relief. With the Patriot Act, the Sarbanes-Oxley Bank Secrecy Act, we have not raised the threshold of SARs reports, and we continue to create new regulations on the banks. And Chairman Oxley and this committee are committed to trying to reduce the regulatory burden.

I know Vice Chairman Reich testified before our committee I think in May of 2004 when you talked about 12 to 13 percent of banks' non-interest expenses were as a result of regulation, which is $36 billion in 2003. Now, a lot of that is necessary for safety and soundness, but a lot of it is unnecessary. It duplicates regulation or regulations which are duplicative.

I also want to thank Jim Ryun, who has introduced regulations for the smaller banking institutions, and Jeb Hensarling, who has the reg relief bill, and also Mr. Kanjorski, who is not here. I think he and Mr. Royce have introduced legislation to ease the burden on our credit unions. And we are going to be considering all those pieces of legislation.

Before I introduce the members of our first panel, I would like to ask if any members of the subcommittee have opening statements.

All right. Gentlelady from New York, do you have an opening statement?

Okay.

Mr. Ryun?

Mr. RYUN. Thank you, Mr. Chairman.

I want to keep my comments brief because I am looking forward to what the panelists have to say. My position on regulatory relief is well documented, and I do look forward to hearing what the panel has to say.

I believe the efforts of the committee on regulatory relief are timely and appropriate, and I think it is especially important for us to focus on the disproportional regulatory burden the small community banks shoulder. We have seen a tragic reduction in the number of small banks serving our small communities, and I believe this trend is largely due to the inability to provide the resources necessary for compliance with all the regulatory responsibilities put upon them.

Community First Act is intended to relieve this burden in ways that are consistent with the goal of ensuring that the consumer is protected and properly served. I look forward to comments from our panelists on the specific areas of CFA that they believe will be worthwhile as well as any concerns they might have on language inside the bill.

I look forward to taking the information shared today and working with my colleagues, Mr. Hensarling and Mr. Moore, to craft a bill to provide regulatory relief to financial institutions and ultimately serve the consumers of financial services throughout this country.

I want to thank you again, Mr. Chairman, and I yield back the balance of my time.

Chairman BACHUS. Thank you.

Are there other members—Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman. I want to thank you again for your leadership and holding this important hearing, and helping to do what we can to reduce the regulatory burden on our nation's financial institutions.

I also want to specifically thank and recognize Chairman Powell and Vice Chairman Reich of the FDIC for their work in this area. I have reviewed much of it and found it to be very thorough, very thoughtful and very helpful.

As we learned last month in our hearing, our financial institutions are in desperate need of regulatory relief and without it many Americans may be kept from purchasing their first home, buying an automobile for work, funding a child's education or starting a new business that creates new jobs.

I think many of us have concluded that with meaningful regulatory relief we can free up more capital for these valuable purposes without undermining safety and soundness.

Along with my colleague, Mr. Ryun and many of us on this panel, I am especially concerned at the disproportionate impact that the regulatory burden has on our smaller financial institutions, particularly our community banks and our small credit unions, and I hope each of our panelists will address that in specific.

There are so many areas that we could get in to, but we need to recognize that corporately bank regulators, our financial institutional regulators, have now promulgated over 800 regulations in the last 15 years. I do not know how we can expect our small community-based financial institutions to adapt and comply with this regulatory change or to keep up with this pace.

And, again, there are many examples that I know we can address. Just a couple of examples come to mind. I hope that some on the panel will address, for example, the annual privacy notices of Gramm-Leach-Bliley and particularly with respect to financial institutions that do not share information.

Is there really a pressing need if a bank does not share information, if they do not change their policies to send out these documents each and every year to their customers? Last month we heard where some community banks hire two to three employees to do nothing, nothing but Bank Secrecy Act compliance. Now, is anyone actually reading all of these SARs and CTRs, and is it a meaningful tool for our law enforcement officials? I think that is something that we need to examine.

Anyway, Mr. Chairman, I am anxious to hear the testimony and I look forward to working with you, my colleague, Mr. Moore, and all my other colleagues to see what we can do to get more resources into the front lines of community lending and help more families.

And I yield back.

Chairman BACHUS. Thank you.

If there are no other opening statements, I would like to introduce the first panel.

I would like to also comment that we did pass H.R. 1375 last year by an overwhelming margin, and that bill actually had 8 of the 10 recommendations that you all have reached consensus on. So we continue to look for other areas of regulatory relief.

I know Mr. Hensarling and I have discussed some of the proposals on the SARs, on the filings of the SARs, either eliminate some of your filings by seasons to customers or things of that nature. But we probably will not take testimony on that this morning unless you all want to comment on how we might could reduce the number of those filings, particularly when there has been widespread publicity that our Government agencies are not reviewing those.

Our panel consists of Mr. John Reich, vice chairman of the Federal Deposit Insurance Corporation—and we have already acknowledged your fine work on this interdisciplinary commission study; Mr. Don Kohn, governor, Board of Governors in the Federal Reserve System—welcome you back; Ms. Julie Williams, acting comptroller, Office of the Comptroller of the Currency—always good to have you, Ms. Williams; Mr. Riccobono, acting director, Office of Thrift Supervision.

This is a group of really veteran witnesses today.

The Honorable Joann Johnson, chairman of the National Credit Union Administration—welcome you, Chairman Johnson; and Mr. Randall James, commissioner of the Texas Department of Banking—and you are testifying on behalf of the Conference of State Banking Supervisors; and Mr. George Latham, deputy commissioner, Bureau of Financial Institutions from the State of Virginia and testifying on behalf of the National Association of State Credit Union Supervisors.

We welcome each of you.

And we will start, Vice Chairman Reich, with your testimony.

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

Mr. REICH. Thank you, Mr. Chairman. I want to thank you as well as Ranking Member Sanders, Congressman Hensarling, Congressman Moore and other distinguished members of this subcommittee for your continuing commitment to pursuing regulatory relief.

I appreciate this opportunity to testify and update you on our efforts to reduce the regulatory burden on our nation's banks.

I am here today as the interagency leader of the regulatory review process mandated by the Economic Growth and Regulatory Paperwork Reduction Act, EGRPRA.

In a former life, I was a 23-year community banker in Sarasota, Florida, the last 10 years of which were as CEO of a community bank.

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 to you that over the last 2 years the agencies have worked well together, and I think we are making progress, but there is still much left to be done.

There are three points that I want to make in my testimony this morning. My first point is that the banking industry has been on the receiving end of a substantially increased Federal regulation in recent years and is suffocating under the weight of an emulated regulatory burden which threatens, in my view, the future viability of community banking in particular. We need to act now to rebalance the scales, so to speak, provide regulatory relief to offset some of the regulatory load the industry is carrying.

I think it is important for me to review with you the changing demographics that are taking place in the industry, which I think will provide some added context to the discussion of regulatory burden.

Most people recognize that there has been considerable consolidation in the banking industry over the past 20 years, but not everyone fully appreciates the extent to which community banks have been disappearing from the scene.

As chart one indicates that is before you now, with the red line, at the end of 1984, 20 years ago, there were 17,139 banks with less than a billion dollars in assets. By the end of last year, that number had dwindled to 8,378, a decline of 8,700 institutions or a 51 percent decline over a 20-year period.

Equally dramatically, look at institutions under $100 million in assets. There were 11,700 banks and thrifts at the end of 1984 and only 4,094 at the end of last year—a 65 percent decline in community banks, small community banks over the past 20 years.

Let me turn to market share trends for the same-sized institutions on our second chart. Perhaps more dramatic than the decline in numbers of institutions has been the decline in market share. This chart shows that the total market share of institutions with less than a billion dollars in assets was 33 percent 20 years ago at the end of 1984, and the fair market share has rather steadily declined to 14 percent at the end of last year.

For the smallest community banks, those with less than $100 million in assets, the market share has declined from 9 percent to 2 percent over the past 20 years. All of these numbers have been adjusted for inflation.

I want to address the matter of industry profitability, because it is widely reported but little understood, and I would like to provide some context.

By the end of 2004, there were 8,975 banks in the country, banks and thrifts, and for the fourth consecutive year there were record earnings in the industry. Those earnings totaled $122.9 billion. One point three percent of the total number of institutions in the country accounted for 73 percent of industry earnings. Those 1.3 percent were those institutions, 117 institutions, with over $10 billion in assets. So 1.3 percent of the institutions accounted for 73 percent of the earnings in the industry.

Six-point-seven percent of the total number of institutions earned $107 billion of the $112.9 billion—87 percent of industry earnings. Those are all institutions over a billion dollars in assets. There were 597 of those. Those include those that are over $10 billion. Those 597 institutions accounted for 87 percent of industry earnings.

In sharp contrast, 93.3 percent of banks and thrifts, 8,378 of the 8,975 that are under a billion dollars in assets, earned $14 billion, or 12.7 percent of industry earnings. And the 20-year trend of industry earnings for institutions under a billion has reflected on chart 3 with the red line.

To break it down one more step, the 4,093 community institutions have under $100 million in assets, they represent 46 percent of our total banking industry in terms of number of banks in the country. They accounted for $2.1 billion of the $122.9 billion in industry earnings. One point seven percent of industry earnings, reflected by the blue line here, were represented by the 4,093 institutions, constituting 46 percent of our total number of institutions.

Chart 4 is an update of the chart you saw last year. It speaks for itself. It is a listing of 851 final rules which have been enacted and imposed on the industry since FIRREA was enacted in 1989, an average of 50 a year over the past 16 years.

And a point that I would like to make to you as you look at this chart is to please realize that whether it is the Community National Bank of Brattleboro or JPMorgan Chase, every institution in the country must be on top of each of these rules and regulations to determine, one, does it apply to them and, two, if it does, what do we need to do?

Let me add, Mr. Chairman, that although regulatory burden has a disproportionate impact on community banks, we are committed to addressing the problem for every financial institution. Banks, large and small, labor under the cumulative impact of regulations that diverts resources and capital away from economic development, extension of credit and job creation.

So allow me to repeat my first point, which was and is the banking industry has been on the receiving end of substantially increased Federal regulation in recent years, is suffocating under the weight of that regulation, and it threatens the future viability of community banks in particular. We need to act now to rebalance the scales.

My second point is that the industry and the regulators have reached consensus agreement on 12 recommendations to Congress for legislative relief. They are outlined in my written statement. I think they are included in most of our written statements today. We are providing also today a separate package which contains the actual legislative language.

My third and final point is to make you aware that the people at this table are working together very well, I believe. We have a longer list of items that we are working on. We have reached consensus with the trade associations. There are upwards of 60 additional items in addition to the 12 that are being presented to you today and that I hope that as our conversations continue with each other here at this table over the next few weeks that we will be back with you soon with an additional list of recommendations.

So in closing, Mr. Chairman, I would say that the degree of cooperation of the federal banking agencies and the extent of consensus that exists among the trade associations provides me with optimism that we are on the threshold of a significant opportunity this year to reduce regulatory burden.

I look forward to working with you, Mr. Chairman, Congressman Hensarling and others who have a sincere interest in reducing regulatory burden on our banking industry.

Thank you very much. I would be happy to take questions.

[The prepared statement of John M. Reich can be found on page 121 in the appendix.]

Chairman BACHUS. Thank you. And I do appreciate you mentioning Congressman Moore, who was cosponsoring the bill with Congressman Hensarling. In my opening statement, I augmented referring to Dennis and Congressman Moore's done yeoman work in this regard.

Governor Kohn?

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

Mr. KOHN. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, thank you for the opportunity to testify on issues related to regulatory relief.

The board strongly supports Congress's efforts to review the federal banking laws to determine whether they can be streamlined without compromising other public policy objectives. The board strives to review its own regulations at least once every 5 years, and we have been an active participant in the ongoing interagency regulatory review process being conducted under EGRPRA.

But some types of regulatory relief will require your action and the appendix to my testimony describes the numerous legislative relief proposals the board supports.

I am pleased to note that three of the board's most important regulatory relief suggestions recently were passed by the committee and the full House as part of H.R. 1224, Business Checking Freedom Act of 2005.

These amendments would authorize the Federal Reserve to pay interest on balances held at reserve banks, provide the board greater flexibility in setting reserve requirements and allow repository institutions to pay interest-on-demand deposits.

These amendments would improve efficiency in the financial sector, assist small banks and small businesses and enhance the Federal Reserve's toolkit for efficiently conducting monetary policy.

In addition, among the other amendments the board supports are ones that would remove outdated barriers to interstate branching by banks, raise the asset threshold below which an insured institution may qualify for an extended examination cycle, allow the board in appropriate circumstances to waive a special shareholding attribution rule in the Bank Holding Company Act and equalize and liberalize the cross-marketing restrictions that apply to certain investments made by financial holding companies.

While the board strongly supports allowing depository institutions to pay interest-on-demand deposits and branch de novo across state lines, the board opposes amendments that would grant these powers to industrial loan companies that operate outside the regulatory framework established for other types of insured banks.

Granting these expanded powers to exempt ILCs would permit them to become the functional equivalent of full service insured banks. However, these institutions operate under a special exemption in current law that allows their parent companies to avoid supervision and regulation under the Bank Holding Company Act.

As a result, these proposals would create an unlevel competitive playing field; allow firms to own and control the functional equivalent of a full service bank without being subject to consolidated supervision at the holding company level; and may undermine the framework that Congress has established and reaffirmed as recently as 1999 to maintain the separation of banking and commerce.

H.R. 1224 would allow exempt ILCs to offer business NOW accounts without adequately addressing these concerns. For example, the bill would allow those commercial and retail firms that acquired an ILC before October 1, 2003 to transform the institution into the functional equivalent of a full service bank. ILCs acquired after that date could also offer business NOW accounts if their parents are predominantly financial. Importantly, however, the bill gives the ILC's state supervisor the authority to make this determination rather than relying on the process established in the GLB Act.

In addition, the bill fails to address the supervisory issues related to the potential lack of consolidated supervision of an ILCs holding company. Consolidated supervision provides an important protection to the insured banks that are part of a larger organization because financial trouble in one part of an organization can spread rapidly to other parts. For this reason, Congress has established consolidated supervision as a fundamental component of bank supervision in the United States.

Let me be clear: The board does not oppose granting ILCs the ability to offer business NOW accounts or open de novo branches if the corporate owners of these institutions are covered by the same supervisory and regulatory framework that applies to the owners of other full service, insured banks.

Mr. Chairman, I appreciate the opportunity to discuss the board's legislative priorities concerning regulatory relief. The board would be pleased to work with the subcommittee, the full committee and their staffs as well as our regulatory compatriots as you move forward in developing regulatory relief legislation.

Thank you.

[The prepared statement of Donald L. Kohn can be found on page 89 in the appendix.]

Chairman BACHUS. Thank you.

Comptroller Williams?

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

Ms. WILLIAMS. Chairman Bachus, members of the subcommittee, I appreciate the opportunity to appear before you today to discuss the challenge of reducing unnecessary regulatory burdens on our nation's banking institutions. The Office of the Comptroller of the Currency does welcome your continued efforts to advance regulatory burden relief legislation. And I also want to express particular appreciation to Congressman Hensarling and Congressman Moore for their commitment 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 would like to touch on just a few key points from that testimony. And I also want to lay out two broader themes that I hope will guide our mutual efforts to reduce unnecessary regulatory burden.

My testimony emphasizes that the regulatory burdens on our financial institutions arise from several sources. First, we as federal banking 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 and applaud the EGRPRA regulatory burden reduction initiative that is being led so ably by 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 that has been gathered during the public comment and outreach process, the banking agencies are now developing additional specific recommendations for regulatory as well as legislative changes.

Second, we also must realize that not all the regulatory burdens imposed on banks today come from regulations promulgated by bank regulators. Thus, we welcome the interest of the subcommittee in issues such as the implementations of Bank Secrecy Act and anti-money laundering standards and reporting requirements.

And I would also like to thank you, Mr. Chairman, for your continuing involvement in an oversight of proposals by the Securities and Exchange Commission to implement the so-called push-out provision of the Gramm-Leach-Bliley Act. This attention has been invaluable in encouraging the development of rules that we hope that will be faithful to Gramm-Leach-Bliley's intent and also not so burdensome as to drive traditional banking functions out of banks.

A third key source of regulatory burden is federal legislation. Relief from some manifestations of unnecessary regulatory burden requires action by Congress. My written testimony contains a number of recommendations for legislative changes designed to modify or eliminate unnecessary requirements, provide additional flexibility and make the overall effect of particular laws less burdensome.

The list includes consensus recommendations developed and agreed to in our discussions with the other banking agencies and with the industry.

Before closing, I would just like to briefly highlight two broader themes that I hope will guide us in our efforts to tackle unnecessary regulatory burden.

The first involves consumer protection disclosure requirements and here is an area where we have an opportunity to reduce regulatory burden and improve the effectiveness of our regulations. Today, our system imposes massive disclosure requirements and massive cost on financial institutions but does not generally produce information that consumers find easy to understand, and it often lacks the information that consumers most want to know.

The success of the Food and Drug Administration's nutrition facts label proves that it is possible to deliver the information that consumers want and need in a concise and streamlined form.

Key to this kind of result is using consumer testing. The Federal banking agencies have broken new ground recently by employing consumer testing as an essential part of the interagency project to simplify the Gramm-Leach-Bliley Act privacy notices, a project that has the potential to produce more effective and meaningful disclosures for consumers and reduce burdens on institutions that generate and have to distribute privacy notices. We need to do more of this.

My second point goes back to the basics. Why do we care about regulatory burden? Isn't more regulation always better? I think not. 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 without impacting the quality and delivery of their services. We need to recognize that the risks presented by certain activities conducted by a community bank are simply not commensurate with the risks of that activity conducted on a much larger scale.

One size fits all may not be a risk-based or sensible approach to regulation in many areas, and I hope we can do more to identify those areas where some types of distinction 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 these hearings. The OCC strongly supports initiatives that will reduce unnecessary regulatory burden on the banking 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.

Thank you.

[The prepared statement of Julie L. Williams can be found on page 176 in the appendix.]

Chairman BACHUS. We thank you for that thoughtful testimony.

Dr. Riccobono?

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

Mr. RICCOBONO. Good morning, Chairman Bachus, members of the subcommittee. Thank you for the opportunity to testify on regulatory burden relief on behalf of the OTS.

I want to thank you, Mr. Chairman, for your leadership and focus in this area, and I would also like to recognize the efforts of FDIC Vice Chairman Reich on the interagency EGRPRA project.

And, Mr. Chairman, I would have said those nice things about Vice Chairman Reich even if he was not going to be my boss.

We look forward to working with the subcommittee on legislation to address the issues we discuss today. While it is always important to remove unnecessary regulatory obstacles in our financial services industry that hinder profitability and competition and, in turn, hinder job creation and economic growth, this is a particularly 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 well intended, no longer serve a useful purpose.

Before addressing these issues, it is important to note that there are two areas that I will not be discussing today: Bank Secrecy Act requirements and the rules under Sarbanes-Oxley. Virtually all institutions raise these two issues as regulatory relief priorities. While we recognize the need for relief in these areas, we are not at a point to be able to make sound recommendations on where to make reforms without compromising the underlying purpose of the laws, but we are working on it.

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

Four items that we believe provide the most significant relief for savings associations are elimination of the duplicative regulation of savings associations under the federal securities laws, eliminating the existing arbitrary limits on savings associations and consumer lending laws, updating commercial and consumer business lending limits for savings associations and establishing statutory 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 advisor 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 benefits.

While the bank and thrift charters are tailored to provide powers focused on different business strategies, in areas where powers are similar, the rules should be similar. No legitimate public policy rationale is served by imposing additional and unwarranted administrative costs on a savings association to register as an investment advisor or as a broker dealer under the federal securities laws.

OTS strongly supports legislation such as that in section 201 of H.R. 1375 to exempt savings associations from these duplicative investment advisor and broker dealer registration requirements.

Another important proposal for OTS is eliminating a statutory anomaly that subjects the consumer lending authority of a federal savings association to a 35 percent of assets limit, 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 statutory 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 association lending for commercial purposes is capped at 20 percent of assets, and commercial loans in excess of 10 percent of assets must be in small business loans.

Legislation removing the current limit on small business loans 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 operations safely and soundly.

A final but important issue, is 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 to 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 or acting 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 ability to do so consistent with safety and soundness and consumer protection.

We look forward to working with you, Mr. Chairman, and the subcommittee to address these and other regulatory burden reduction items discussed in my written statement. I will be happy to any answer questions that you may have.

Thank you.

[The prepared statement of Richard M. Riccobono can be found on page 154 in the appendix.]

Chairman BACHUS. Thank you. We appreciate your testimony.

Chairman Johnson, we welcome you, look forward to your testimony.

And all the witnesses, your entire written testimony will be submitted in the record, without objection.

STATEMENT OF JOANN JOHNSON, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Good morning, Chairman Bachus and members of the subcommittee. On behalf of the National Credit Union Administration, I am pleased to be here today to present our agency's views on regulatory efficiency and reform initiatives being considered by Congress.

Enacting this legislation 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.

The Subcommittee on Financial Institutions and Consumer Credit has been taking the lead over the last several years in many areas of interest to consumers and financial institutions such as credit unions. Legislation of the type being considered today epitomizes the real connection between and the benefits of effective financial institutions efficiently delivering consumer credit to the public.

It is my strong belief that effective regulation rather than excessive regulation should be the underlying principle supporting NCUA's critical mission of ensuring the safety and soundness of federally insured credit unions.

While we scrutinize one-third of our existing regulations annually to find ways to simplify or improve any rule that is outdated or in need of revision, these legislative proposals, if enacted, will allow credit unions to better serve their members and improve access to affordable financial services.

Last year, I testified in favor of the credit union provisions in the Financial Institutions Regulatory Relief Act of 2004. Approved by the House Financial Services Committee and passed by the House of Representatives by a vote of 392 to 25, that legislation was a significant bipartisan achievement that NCUA greatly appreciated and enthusiastically supported. Those provisions merited your support in the past and NCUA supports inclusion of those credit union provisions in any new legislation that is introduced this year.

The recent introduction of the Credit Union Regulatory Improvement Act of 2005, CURIA, also includes many of the same credit union provisions approved in last year's reg relief bill and addresses some of the most compelling statutory and consequently regulatory reform issues being discussed within the credit union industry today.

CURIA of 2003 suggested that NCUA should be authorized to design and implement a risk-based prompt corrective action system for federally insured credit unions. In order for policy makers and credit unions to make an accurate assessment of the proposal, NCUA has worked to demonstrate how such a system could be implemented. I have provided the complete plan as an attachment to this testimony and would like to discuss it briefly here.

The guiding principle behind PCA, or prompt corrective action, is to resolve problems in federally insured credit unions at the least long-term cost to the Share Insurance Fund. 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 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.

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 evidenced by our low loss history. This is largely due both to the greater restrictions on the powers of credit unions relative to other financial institutions and also credit unions' conservative nature given their member-owned structure.

In addition, the current 7 percent leverage requirement is excessive for low-risk institutions. A meaningful risk-based system working in tandem with a lower leverage requirement provides incentives for financial institutions to manage the risks they take in relation to their capital levels.

We recognize that achieving comparability between the federal insurance funds requires us to factor in the Share Insurance Fund deposit-based funding mechanism. Thus, our reform proposal incorporates a revised method for calculating the net worth ration for PCA purposes by adjusting for the deposit credit unions maintain in this insurance fund.

However, our proposed treatment of the Share Insurance Fund deposit for purposes of regulatory capital standards in no way alters its treatment as an asset under generally accepted accounting principles or our steadfast support of the deposits-based nature of the Share Insurance Fund.

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 all credit unions. 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.

Concerning other provisions in the proposal, as I have previously testified, an important technical amendment is needed to the statutory definition of net worth. NCUA anticipates that the Financial Accounting Standards Board will act soon to the 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. This change will, in effect, discourage credit unions from moving forward with mergers which are clearly in the best interest of their members.

Specifically, the change will provide that when two credit unions merge, the retained earnings of the discontinuing credit union would not be included with the post-merger net worth. This resulting lower net worth ratio has adverse implications on the statutory prompt corrective action regulations, and it will discourage voluntary mergers.

On occasion, this will make NCUA-assisted mergers more difficult and costly to the national Share Insurance Fund. Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost. FASB has indicated it supports a legislative solution and that such a solution will not impact their standard-setting activities.

There are other provisions within the regulatory reform that are suggested that NCUA fully supports, including allowing check cashing, wire transfer and other money transfer services to be offered, especially in areas where in a field of membership those who are not members but are eligible for membership would be able to use these services, particularly helpful in areas of low income where they are susceptible to higher rates. It would assist them in becoming familiar and comfortable working with an insured institution.

We also support improving and lifting the limitations and restrictions on the 12-year maturity limit that is currently reducing or limiting loans made on second homes, recreational vehicles and other conventional maturities that are commonly accepted in the market today.

Mr. Chairman, we have reviewed all of the additional credit union provisions not originating from NCUA but included in previously mentioned bills, and we have no safety and soundness concerns with these provisions.

Thank you for the opportunity to appear before you today. On behalf of NCUA and the credit unions and the 84 million credit union members, I am pleased to respond to any questions that you may have or be a source of additional information.

[The prepared statement of Hon. JoAnn Johnson can be found on page 79 in the appendix.]

Chairman BACHUS. Thank you, Chairman Johnson.

Let me say this: I think next week it is our intention to take an amendment to the statutory definition of net worth to the floor.

Ms. JOHNSON. That is good news. Thank you.

Chairman BACHUS. Probably on suspension. And we hope to do that.

Commissioner James, we welcome you. Anybody from the State of Texas is welcome to our committee.

STATEMENT OF RANDALL S. JAMES, COMMISSIONER, TEXAS DEPARTMENT OF BANKING, ON BEHALF OF CONFERENCE OF STATE BANK SUPERVISORS, INC.

Mr. JAMES. Thank you, and good morning, Chairman Bachus and members of the subcommittee.

For the record, my name is Randall James. I am the Texas banking commissioner, and I am very pleased to be here today on behalf of the Conference of State Bank Supervisors.

Thank you for inviting CSBS to be here to discuss strategies for reducing the unnecessary regulatory burden on all of our nation's banks. We especially appreciate the 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.

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 is locally-oriented, it is responsive, it is meaningful, and it is flexible, and that matches the way these banks do business.

Our current regulatory structure and statutory framework may recognize some differences among financial institutions, but too often mandates an overarching one-size-fits-all requirement for any institution that can be described by the word "bank." These requirements are often unduly burdensome on smaller and community-based institutions.

My colleagues and I see growing disparity in our nation's financial services industry. The industry is becoming increasingly bifurcated between large and small institutions, and Congress must recognize this reality and the impact this bifurcation has on our economy.

As Vice Chairman John Reich's testimony clearly points out, stifling economic incentives for community banks with excessive statutory burdens slows the 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.

CSBS endorses approaches such as Congressman Ryun's Communities First Act but 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, if you will allow me, I would like to highlight a few specific changes to federal law that would help reduce regulatory burden on financial institutions. We ask that the committee include these provisions in any legislation it approves.

First, CSBS believes that the Federal Reserve should have the flexibility it needs 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. Current law limits the activities of state-charted 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.

Second, CSBS believes that the state banking regulator should have a vote on the Federal Financial Institutions Examination Council. The council's State Liaison Committee includes state bank, credit union and savings bank regulators. The chairman of this committee has input at council meetings but is not able to vote on policy that affect the institutions we charter and supervise. We ask that Congress change the state position on this council from one of observer to that of a full voting member.

Finally, 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 the healthy financial institutions we have.

Therefore, we do ask Congress to extend the mandatory federal examination cycle from 12 months to 18 months for healthy well-managed banks with assets of up to $1 billion.

As you consider additional ways to reduce burden on 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 different size and specialties to meet the needs of the world's most diverse economy and society.

While federal intervention may be necessary to reduce burden, relief measures should allow for further innovation and coordination at both the State and Federal levels for institutions of all sizes and especially to recognize the important role community banks play in our local economies.

State supervisors are sensitive to regulatory burden, and constantly look for ways to simplify compliance.

Your own efforts in this area, Chairman Bachus, have greatly reduced unnecessary regulatory burden on financial institutions. We commend you, Chairman Bachus, Congressman Hensarling and Moore and members of the subcommittee, for your efforts in this area.

We thank you for the opportunity, and I will be glad to try to respond to any questions as you see fit.

Thank you.

[The prepared statement of Randall S. James can be found on page 63 in the appendix.]

Chairman BACHUS. Thank you.

Commissioner Latham, we welcome your testimony.

And, Mr. James, we would welcome your comments I think in enforcement of what Vice Chairman Reich said about the difference between the large banks and small banks. So I think you have it bifurcation is your word?

Mr. JAMES. Yes, sir.

Chairman BACHUS. Deputy Commissioner Latham, we welcome your testimony.

STATEMENT OF GEORGE LATHAM, DEPUTY COMMISSIONER, BUREAU OF FINANCIAL INSTITUTIONS FOR THE STATE OF VIRGINIA, ON BEHALF OF NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS

Mr. LATHAM. Thank you, sir.

Good morning, Chairman Bachus and distinguished members of the subcommittee. I am George Latham——

Mrs. KELLY. Sir, please pull your microphone to you and turn it on.

Mr. LATHAM. Okay. Can you hear me now?

Chairman BACHUS. Yes.

Mr. LATHAM. I am George Latham, deputy commissioner of financial institutions for the Commonwealth of Virginia. I am also a past chairman of the Board of NASCUS, the National Association of State Credit Union Supervisors, who I am speaking on behalf of here today.

NASCUS's priorities for regulatory relief legislation focuses on reforms that will strengthen the State system for credit union supervision and enhance the capabilities of state chartered credit unions.

Capital reform continues to be a critical concern for the nation's credit unions. NASCUS strongly urges the subcommittee to adopt or amend the prompt correction action provision of the Federal Credit Union Act. This section would require federally insured credit unions to include all forms of capital when calculating the required net worth ratio.

Under the Federal statute, credit union net worth is defined as and is limited to retained earnings. Therefore, the Federal Credit Union Act needs to be amended. In addition, amending the definition of that word cures the unintended consequences for credit unions of the Financial Accounting Standards Board standard number 141.

As NASCUS testified before this subcommittee in April of this year, the retained earnings of a merging credit union would no longer be combined with those of the continuing credit union. This creates a potential significant dilution of statutory net worth and an unintended impediment to credit union mergers.

Mergers are a safety and soundness tool regulators sometimes use to protect funds deposited by American consumers. This tool also preserves the vitality of the National Credit Union Share Insurance Fund.

Chairman Bachus and members of the subcommittee, NASCUS applauds the introduction of H.R. 1042, the Net Worth Amendment for Credit Unions Act. Your bill allows the retained earnings of a merging credit union to be counted with that of a surviving credit union. We recognize and also appreciate that a similar provision was introduced into H.R. 2317, the Credit Union Regulatory Improvement Act.

NASCUS has a long-standing policy supporting risk-based capital; therefore, NASCUS supports the risk-based capital plan presented in title one of H.R. 2317.

NASCUS supports capital reform beyond risk-weighted capital. We believe credit unions should have access to alternative capital that is complimentary to their proposed risk-based system.

As a regulator, I believe it makes sound economic sense for credit unions to access other forms of capital to improve their safety and soundness. Strengthening the capital base of this nation's credit unions is a priority.

Strong capital reform requires that State and Federal regulators work together. In 1998, the Credit Union Membership Access Act, H.R. 1151, mandated that NCUA consult and cooperate with state regulators in constructing prompt corrective action and member business lending regulations. NASCUS stands ready to meet this mandate.

We firmly believe that the cooperation between regulators yields better regulation and a safe and sound credit union system. It is therefore vital that credit union member business lending is available to consumers. Section 201 of H.R. 2317 raises the statutory limit on credit union member business loans to 20 percent of total assets. This facilitates member business lending without jeopardizing credit union safety and soundness.

And I know from Mr. Riccobono's testimony that they seek similar limit at 20 percent, and so there is agreement there between regulators, which is a good thing.

Further, NASCUS supports section 202, which amends the definition of a member business loan by increasing the current amount from $50,000 to $100,000. Both of these provisions provide credit unions with regulatory relief and were included in H.R. 3579 which was introduced in the 108th Congress.

NASCUS supports section 311 in CURIA that provides federally insured credit unions the same exemptions as banks and thrift institutions from Federal Trade Commission pre-merger notification requirements and fees.

NASCUS also supports 312 of CURIA. Federally insured credit unions should have parity treatment with commercial banks with regard to exemptions from Securities and Exchange Commission registration requirements. Without this parity treatment, the powers granted to state-chartered credit unions by state legislatures might be unnecessary preempted by SEC regulation.

The 108th Congress recognized these provisions when they were included in H.R. 1375. NASCUS firmly believes that non-federally insured credit unions should be eligible to join the federal home loan banks. There are 86 insurance companies, none of which are federally insured that already belong the federal home loan bank system.

And, finally, recent preemptive actions by federal banking agencies could have a potentially significant impact on the dual chartering system for commercial banks. Unless Congress intervenes, NASCUS has concerns that the federal credit union regulator could use as precedent to initiate preemptive actions. Congress should resolve these preemption conflicts rather than delegate these fundamental issues to federal regulators.

This concludes my remarks, Chairman Bachus, and NASCUS appreciates this opportunity to testify today, and we welcome further participation and dialogue concerning regulatory relief. I will be happy to respond to any questions that the subcommittee has.

[The prepared statement of George Latham can be found on page 111 in the appendix.]

Chairman BACHUS. I thank you.

At this time, I would like to introduce into the record the SARs activity reviewed by the numbers that was just issued by FinCEN, which again shows a substantial increase in the number of SARs and I think bolsters some of the testimony we have heard today, without objection.

At this time, Ms. Kelly, you are recognized for questions.

Mrs. KELLY. Thank you very much, Mr. Chairman.

Ms. Williams, my subcommittee has taken a deep interest in the situation regarding the Government's actions with regard to Arab Bank. I certainly respect the limits of what you can say about the OCC actions in light of its ongoing nature, but I am wondering if you can share with the committee some of your thoughts about this situation and what impact it has had on the operation of the OCC.

Are you able at this time to comment on claims that the branch was consistently given good grades by regulators in the years leading up to this action? That is my first question.

My second question is, can you explain to the committee the timeline of events regarding Arab Bank from the OCC's perspective? I believe that there are many of us who have been watching this, and we have developed a strong interest in making sure this issue is resolved, and I mean fully resolved with a unified, fair response that will further strengthen efforts to secure the international financial system.

Ms. WILLIAMS. Congresswoman Kelly, we share the concerns that you expressed in the latter part of your statement. I must limit my response to your questions about Arab Bank, because the OCC has an open pending enforcement case against the federal branch of Arab Bank.

However, I can make the following statement: First, it is important to recognize that our authorities and jurisdiction with respect to BSA compliance that national banks and federally licensed branches of foreign banks is to assess a bank or branch's BSA systems and controls and to assure that they meet applicable standards.

Specifically, in the case of the federal branch of Arab Bank, we supervise the federal branch. We do not supervise Arab Bank itself.

During the course of a recent BSA examination of the branch, we determined that the branch did not have adequate systems and controls in place to monitor international wire transactions despite the high-risk nature of that activity.

During the course of our work, in order to test that branch's system, the OCC compiled a list of individuals and entities with the same or similar names as reputed terrorists or terrorist organizations using publicly available information sources, such as criminal indictments, testimony before congressional committees and media reports.

We ran that list against the branch's system. This process was extraordinarily challenging given the huge number of wire transfer transactions processed through the branch on a daily basis and significant language barriers. Nevertheless, our review disclosed that the branch had handled hundreds of suspicious wire transactions involving individuals and entities with the same or similar names as suspected terrorists and terrorist organizations and that many of these individuals and entities were customers of Arab Bank or its affiliates.

Consequently, we issued a cease and desist order that required termination of this suspicious wire activity because the branch's systems were obviously insufficient to monitor and control it. We also required the conversion of the branch into a federal agency with limited banking powers pending further OCC evaluation of the branch's overall systems and controls. The order also required the branch to preserve its assets and books and records as well as to adopt other remedial measures.

The penalty phase of this matter is currently pending and the OCC and FinCEN are coordinating. That is why I must limit my statement to the foregoing.

Mrs. KELLY. I thank you. I look forward to working with you and learning more about this.

I would like to ask this entire panel, in repeated testimony before this committee, I have been told that the freedom to change charters is one of the few options a financial institution has to impact its regulatory environment. While the press accounts suggest that the number of charter changes is increasing, there is also anecdotal evidence that the regulatory barriers to charter changes are also increasing.

Please tell me what steps your agencies are taking to make the process of changing charters for financial institutions less burdensome. And, Mr. Riccobono, in particular, I am interested in what you have to say here.

I wonder, let me just put it this way, since nobody's quickly jumping in here and I am running out of time. Mr. Riccobono, you regulate some of the credit unions that have converted to savings banks charters, right?

Mr. RICCOBONO. Yes.

Mrs. KELLY. Okay. And as a supervisor, the converted institutions have performed within—I assume they have performed within acceptable ranges?

Mr. RICCOBONO. Oh, yes, absolutely.

Mrs. KELLY. When you evaluate a credit union application for a savings association charter, what are the factors that the OTS considers?

Mr. RICCOBONO. We treat the conversion of a credit union to a federal savings bank the same as you would a de novo application, although one with some history, having been in the banking business. In other words, an application is filed both with us as well as the FDIC for deposit insurance, and we conduct eligibility exams, both the OTS and the FDIC, before accepting the institution.

Mrs. KELLY. The purpose of this hearing is to discuss regulatory burdens and how Congress needs to take steps to lower the burden on financial institutions. From your standpoint, as a regulator of converted credit unions, what steps could be taken to make the converting from a credit union to a savings bank simpler and less burdensome while maintaining appropriate supervisory oversight?

Chairman BACHUS. Actually, time has expired but maybe a brief answer would be——

Mrs. KELLY. Thank you.

Mr. RICCOBONO. Can I give my answer?

Chairman BACHUS. Absolutely.

Mr. RICCOBONO. I think the process with respect to banks becoming savings associations and savings associations becoming banks has over time been itself very streamlined. When a thrift, and we have had many of them, decides to convert to a state commercial bank or national bank, it simply files a notice with OTS. There will be a vote, the stock institution shareholder vote, taken once.

If it is a mutual institution, which represent around just slightly under 40 percent of the institutions that we are responsible for, they would take a vote of the membership—just one. And then it would be simply the obligation of the regulator receiving the charter to do their homework and to have dialogue with the previous regulator to make sure the institutions are run in a sound manner and in this case like a credit union coming over deposit insurance would be necessary.

The current system that exists today is, I would believe, more burdensome with respect to credit unions becoming mutual charters simply because of the process of taking a membership vote.

Chairman BACHUS. On that note, Chairman Johnson, if you want to comment on that.

Ms. JOHNSON. Thank you, Mr. Chairman. As the regulator of credit unions, we have been charged by Congress to proceed with the process when a conversion is to take place and to have rules for that process, that conversion process. NCUA has taken action to put forth some rules pertaining to disclosure.

There is a difference in credit unions within the structure of credit unions with one member, one vote, and the disclosure gives the credit union member the opportunity to have the information to be informed to make a good decision of whether they want to move from that type of a structure, from one member, one vote, where the equity is actually put on the table and they give up ownership of that equity.

If the member understands what is going to happen to their equity, that it will be set aside and basically they lose that equity, they have the opportunity to understand that and want to move forward, indeed that is their right to do so, because it is certainly legal for a credit union to convert to a mutual savings bank. But putting forth information that the members should have to make an informed decision, putting it out in the sunshine is right way to go for consumer protection.

Chairman BACHUS. Commissioner Latham, is that——

Mr. LATHAM. Yes. I would just add that the subcommittee consider that a conversion from a credit union to a bank or a savings and loan type of institution is a conversion from a non-stock type of corporation to a stock corporation, and there are some inherent structural differences that require due to corporate governance and laws, State laws, federal laws, that require the application of getting a stock chartered corporation underway. So I am not sure how much regulatory relief can be granted to get around that process, but that needs to be taken into consideration.

Chairman BACHUS. Right.

Mr. RICCOBONO. Mr. Chairman, just to correct that, we do have a mutual form of organization at the federal level, and many states have the same, so you can go from mutual to mutual or you could go from mutual and then eventually to stock.

Chairman BACHUS. All right. Thank you.

The gentleman from Texas, Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman. And I thank also the ranking member equally as well. I thank the two of you for hosting these very important hearings.

I would like to, if I may, ask that the outstanding members of the panel allow me to proceed en banc, meaning I will ask a couple of questions and your silence will give consent.

[Laughter.]

And if you differ, we beg that you would speak up.

I am very much concerned about the CRA, Community Reinvestment Act. And my first question to you is, do you agree that the CRA has been beneficial in combating invidious redlining? By the way, all redlining, in my opinion, is invidious; I say it this way to make my point transpicuously clear—as well as onerous discrimination. Again, I am being a bit superfluous. But do you agree that the CRA has been beneficial in eliminating redlining and discrimination?

I take it from your silence that you all agree?

Do you agree that the CRA will benefit us as we move forward even in the world of electronic banking?

I take it from your silence that you all agree, although I read body language quite well, and based upon your body language—my glasses are not as good as they should be, I suppose—this is Mr. Randall S. James, is that—no, it is Mr. Latham.

Mr. Latham, your body language connotes at least an equivocation.

Mr. LATHAM. Well, you are asking for my——

Chairman BACHUS. We will take a picture of the panel and include that.

[Laughter.]

Mr. LATHAM. You are asking my concurrence on the issue of using computers and so forth, electronic transfer, is that is a mechanism to get around redlining, and I am——

Mr. GREEN. Not really.

Mr. LATHAM. Okay.

Mr. GREEN. Let me be more specific.

Mr. LATHAM. Maybe I misunderstood.

Mr. GREEN. I am asking you in an age wherein we have Internet banking, national marketing, niche banks, does the CRA have a place in this age, sir?

Mr. LATHAM. Sorry, I misunderstood you on your question.

Mr. GREEN. Quite all right. I sometimes do not communicate as efficaciously as I should. Given that we agree that the CRA has been effective, would someone care to tell me how we can make it even more efficacious, not effective but efficacious? To be effective means you get the job done. To be efficacious means that you get it done with a minimum amount of wasted effort. So I do not want to impose upon you the standard of being effective but rather being efficacious. How can we make the CRA more efficacious as we move forward?

You see, you can kill a fly with an atomic bomb, that is being effective, but if you use a flyswatter, you can be efficacious. So how can we make it more efficacious as we move forward? And I would like to ask the first person who would like to respond to do so as quickly as you can. And if you can be terse, I would appreciate it.

Ms. WILLIAMS. Congressman, I will take a crack at that. I think we are trying to do that right now in connection with an open rulemaking proposal that the OCC, the Fed and the FDIC have on the table right at this time. So we are looking at that very issue in connection with the application of CRA to banks.

I do not feel comfortable commenting about exactly where we are with that or the particular issues that we are considering, because we are in the midst of a rulemaking.

Mr. GREEN. Let me ask this: At the end of the day, will we still have a CRA, pursuant to what you are attempting to do, that will fight redlining and invidious discrimination? That is important. Do you all agree that we still have discrimination taking place? If there is anyone who differs, kindly speak up.

Given that we still have discrimination taking place and we all agree that the CRA has been efficacious, effective as well as efficacious, I think we all ought to agree that we want a strong CRA as we go forward, not one that is overwhelming, not one that is burdensome but one that protects the minority population that is to this day being discriminated against. Because we have not eliminated discrimination in lending practices.

I suspect that everyone agrees that you cannot find a legitimate study that will show that minorities receive advantages that majorities do not. There probably is no study. If you have a study that shows that minorities are receiving favoritism, I would like to see it. But every study, legitimate study shows that minorities who are equally as qualified as majorities, every study shows, not one single study, every study shows that they still get discriminated when they apply for loans at lending institutions.

So I am just making an appeal to you to please let's do what we can to salvage the CRA.

My final CRA question, Mr. Chairman, if I may, is this: Do you agree that lending institutions performing the same function, regardless of the style of their name, performing the same function should have to adhere to the same CRA requirements? Anyone who differs? Performing the same function, the same function, no deviation in function, do you agree that they all should adhere to the same CRA requirements?

Ms. JOHNSON. Congressman, credit unions perform many of the same functions as other financial institutions, but Congress does not see fit to require CRA requirements for credit unions, that there was no need. As I understand, the CRA requirements were initiated when there was a deficiency cited in other areas but not for credit unions, so at this time there has been no call by Congress for those requirements.

Mr. GREEN. It is interesting that you would mention this. I happen to have a study that shows that right now the banks are outperforming the credit unions when it comes to lending to blacks, Hispanics, low-to moderate-income borrowers, generally speaking, to women, low-to moderate-income minorities, low-to moderate-income women, to minority tracks, low-to medium-income tracks.

So now right now the empirical data seems to indicate that we do need to do this.

Chairman BACHUS. Mr. Green?

Mr. GREEN. Yes, sir.

Chairman BACHUS. That is all right.

Mr. GREEN. If I may——

Chairman BACHUS. I guess I would just like to say in fairness I think there are studies that show that credit unions meet those needs very well. But, I mean, you know, there are studies—and I do not know who commissioned the study.

Mr. GREEN. If I may then, let's take studies off the table and let's just talk about the same function and talk about the fact that we know that invidious discrimination exists. Do we only want to require one set of institutions to fight discrimination or should all institutions performing the same function?

Chairman BACHUS. It is almost 10 minutes, and I know these are very important. We will have a second round, and I will allow you to——

Mr. GREEN. Yes, sir. I yield back. Thank you.

Chairman BACHUS. Thank you.

Mr. Ryun? And on the Republican side, we go by who was here first, and the order is Mr. Ryun, Mr. Hensarling, Mr. Pearce, Ms. Biggert and Mr. Neugebauer and then Mr. Patrick McHenry.

Mr. RYUN. Mr. Chairman, thank you for your time.

Thank you to the panelists for coming today, and let me just express my appreciation for what you all do and my gratefulness for what you are trying to do in terms of providing additional regulatory relief for financial institutions.

I have introduced H.R. 2061, the Communities First Act, and it is aimed at targeting regulatory relief to our community banks. In fact, I am going to borrow a quote, I think, from Mr. James who earlier said that our financial institutions are the engine of economic growth, and that is one of the reasons that I feel strongly about what we are doing here.

Mr. James, I also appreciate your support and your comments and your opening statement.

Now, I am going to pose an easier question to you, if I may, but before I do that, I want to touch on a couple of statistics that I think will reiterate part of where I am going and what I would like to do.

As was well pointed out a moment ago with some of the charts, the last 2 decades have seen a number of community banks with less than a billion dollars in assets decline from 17,000 in 1984 to just over 8,000 today. And along with that, the assets shared by these same banks have fallen from 33 percent to 14 percent during this period of time.

With these particular figures in mind, and I know all of you have had opening comments in which you have given some support for regulatory relief, what I generally want to do is to go back one last time and say, are there any other measures you would like to see as we move forward in terms of providing regulatory relief, especially in accomplishing these goals and helping our small institutions move forward in serving our communities in a better fashion?

So I am going to leave it as a general question to all of you for any comment you would like to make.

Mr. REICH. I would start, Congressman Ryun, by responding that there are a number of additional measures that some of us would like to see added to the current list that we are submitting. I indicated that out of our EGRPRA sessions we had a total of about 136 items that came out of the nine outreach sessions that we have had with the banking industry. We had a meeting with our interagency task force, with the representatives of all the bank trade associations and reached a consensus agreement on approximately 70 of those 136 items that all of the trade associations would support.

Next, we circulated each of those items to each of the regulatory agencies and asked how many of those items that they can support. That work is underway. We have reached agreement on 12. There is a larger number that most of the agencies either support or do not object to, but all of our agencies have not had an opportunity to review all of these approximately 70 items, and therefore we have chosen not to make more specific recommendation as a part of our testimony today. We wanted to present a united front, and I am confident and optimistic that we will add some significant items to the 12 that we have before you today.

Mr. RYUN. I look forward to those. Anyone else who would like to comment?

Mr. Chairman, that is the only question I wish to pose, and I yield back my time to the chair.

Chairman BACHUS. Thank you.

At this time, Ms. Moore, do you have questions?

Ms. MOORE OF WISCONSIN. Well, thank you, Chairman Bachus, and thank this distinguished panel for convening here.

I know the FDIC really has been the lead agency in developing some recommendations for Congress about regulatory relief after kind of an exhaustive bit of outreach meetings with bankers in eight cities in 2003-2004. But I really appreciate that, and I think that there were efforts to get community input before you put these recommendations before Congress. So I really do appreciate it.

I could tell you that I heard it stated earlier in this meeting that the whole point was to provide regulatory relief, but I think that we have got to have regulatory relief that really is balanced with safety and soundness and fiduciary responsibility. I have not forgotten the difficulty with the thrift industry earlier, and I will have some questions for the gentleman from the thrift industry in a moment.

But as I look over the top 10 things that you all came up with, the HMDA data, CRA, as Congressman Green has indicated, the truth-in-lending right to rescission, Truth-In-Lending in Real Estate Procedures Act, flood insurance, I am curious as to why we as Members of Congress should provide more regulatory relief.

For example, I will just take one out of the blue, truth-in-lending right to rescission, your findings were that bankers say that few if any customers really exercise this right and that they are frustrated when they have to wait 3 days before receiving their loan proceeds. But then on the other hand, you say that they are frustrated with the truth-in-lending in real estate settlement procedures, they are frustrated by the volume and complexity of documents they must sign to get a mortgage.

Well, people need kind of a cooling off period to make sure they are not being a victim of a predatory lender, that they can read the fine print so that they can go and show a friend. The last closing, real estate closing that I was at was when I was selling my property to my daughter, and I was not frustrated by all of the paperwork. I wanted to see that the deal was going down the way I wanted it to go down so that my daughter would have a decent interest rate, so that she would not be a victim of predatory lending.

And so I am wondering, quite frankly, what your discussions were other than just relieving yourselves of regulatory burden how balanced these things are with the examples that I have given.

What would be wrong with the 3 days and saying to people, “This 3 days is for a cooling off period. We are sure that we are giving you the best product possible, and you might want to call your lawyer or your broker and look over and walk through one more time before you sign all these papers just so that you know that there are not balloons in there, that you know.” So please share with me what you think would be a balancing act.

And then I do want to reclaim some of my time, because I do want the gentleman from the thrift industry to explain to us why he thinks that they should be held to a different standard for CRA. Thank you.

Mr. KOHN. Congresswoman, the Board of Governors shares some of your misgivings about removing this right of rescission just for the reasons that you articulated. These are very complex document. You are under a good deal of pressure at a closing to get the closing done.

We think that perhaps Congress could work at structuring something such that if you were given the material ahead of time, a definite, say, 3 days ahead of the closing with some definite commitments by the lenders about what the closing costs would be and how they would be structured, then you could have the consultations that you suggested. People would come to closing and they could get their money at closing.

So I think there may be ways of working around these issues to give both the immediate access to funds but also the time to consider them.

Mr. REICH. Let me just say, Congresswoman Moore, two points to clarify.

One is, I think you are reading from a top 10 list of issues that have been brought to our attention, the issues of greatest concern to bankers around the country. The top 10 list is not the regulatory burden relief recommendations that we are making today. They are simply a listing by bankers, a prioritization on their part of regulations that are most burdensome to them.

With regard to right of rescission, let me say that at virtually every outreach meeting, we have had bankers stand up and say, “I have been in the banking business for 35 years, I have been lending money that entire time. No one has ever asked to exercise their right of rescission.”

That has been repeated at all of our outreach meetings across the country. They are not necessarily saying, “Let’s do away with the right of rescission,” but they are suggesting, “Is there a way that we can perhaps give a customer who does not want to wait a day or 2 or 3 an opportunity to have his money by waiving his right of rescission?

Chairman BACHUS. Thank you.

Ms. WILLIAMS. Congresswoman, I think you raise two really good points that are closely related, but there are two different issues. One is the right of rescission and the issue about access to funds. The other is the volume of information that you as a seller of a house in a particular type of transaction were given in connection with that transaction. And that gets to one of the points that I mentioned in my opening remarks.

We have got a huge volume of information that is being provided to consumers in connection with various types of retail transactions. There must be away to distill down some of the key information so that you could get that and it would not take you 3 days to figure out if you have got a problem. I think that is an area in and of itself that is worth tackling.

Chairman BACHUS. Thank you.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman, and I would like to continue on with this discussion about CRA, and I want to thank my friend and colleague and fellow Texan for enlightening me on the nuance of efficacious versus effective.

Let's talk about being efficacious in CRA. A Congressional Research Service report estimates that a streamlined CRA exam can save 40 percent of a bank's overall compliance costs. I do not know their methodology, but that is a very, very significant number.

The question I have, and anybody on the panel feel free to speak up, do you have any study, any data points that would show that banks participating in the streamlined small bank CRA exam are serving their communities less than those who are subject to the more expensive, burdensome, larger test? Anybody who would care to participate?

Mr. Reich?

Mr. REICH. We do not have any studies that I am aware of, Congressman Hensarling. All I can say is that regardless of the size of institution, whether it is a streamlined exam or a complete examination, CRA is the law of the land. Our examiners look for CRA compliance at every institution that they go in to, whether it is large or small.

The bankers that are not subject to the streamlined examination complain about the reporting burdens and the time it takes. The 40 percent that CRS has suggested, that total compliance cost might be relieved by 40 percent because of the burden of CRA, I think sounds highly excessive to me. I do not think the compliance costs in any organization, in my own view, would approach 40 percent for CRA compliance.

Mr. HENSARLING. But nonetheless, it is still a costly requirement. I guess to put a fine point on the question, do any of you all have any data to show that banks who are subject to the small bank CRA exam discriminate more, less or about the same as those subject to the larger? If you have no data, perhaps you can shake your head in the horizontal fashion and let me know you have no data.

Ms. WILLIAMS. Congressman——

Mr. HENSARLING. Yes.

Ms. WILLIAMS.——we have a tremendous amount of data about performance by all of the banks and savings institutions under the CRA. Under the current regulations, the way in which banks or thrifts of given sizes perform and how they are measured is different. So they do well across the board in serving the needs of their communities under the different tests that exist today in providing that kind of access to credit services but in different ways based on their different sizes.

Mr. HENSARLING. Thank you. Moving on to a different subject, and certainly continuing to be a very expensive part of regulatory compliance, BSA. Clearly, we are all on the front lines of the war on terror, but at the same time, in conversations I have had with a number of financial institutions, they certainly cite BSA compliance as one of their more costly elements of their regulatory regime.

I know that FinCEN is not represented here, but, for example, if I recall right, BSA was enacted in 1970, you had a CTR threshold of $10,000. That has never been inflation adjusted. Do any of you all have an opinion to try to—and this is all a question of balance, and I know it has to be balanced with legitimate law enforcement needs. B ut do you have an opinion on whether or not this committee should explore indexing for inflation this CTR threshold amount?

Seeing none, I will move on—oh, there is one.

Ms. WILLIAMS. I will tackle it. I think the threshold level, as you point out, has not been addressed in a long time, and it is probably appropriate to look at that. Exactly how you adjust it is a question that we have not gotten into the details of.

Mr. HENSARLING. Thank you.

Chairwoman Johnson, a question for you, and I know that you are aware of this, but Community Credit Union of Plano, Texas, is in the midst of attempting to convert to a bank.

Your agency on May 13 issued a letter that nullified their voting procedure, and as I understand it, fairly recently your agency promulgated new rules that required a certain box disclosure to go to the members of the credit union, and I believe it is your language that said it must be prominent and conspicuous in every mailing. And I believe it is also part of your regulation that there must be a minimum of three mailings, I believe, three solicitations of the vote.

And I believe, as I understand it, I am going to have a two-part question here, that it comes down to a controversy of whether or not the box disclosure in one of the communications appeared on the front side or the back side of a piece of paper. I personally do not know how to judge the front side from the back side, because I do not see a logo, it does not say page one or page 2, but as I understand it then, it may actually come down to your agency holding up a possible $1.4 billion transaction based upon how a piece of paper was folded, even though the disclosures otherwise meet your requirements and all members of the credit union will receive a minimum of three different copies of this particular disclosure.

I have lots of friends in the banking community, and I have lots of friends in the credit union community. I do not know why these particular people want to convert. In a free society, I suppose that is their business.

But my two-part question is this: Number one, do I have my facts correct, and if I do, then please explain to me and other members of this committee why we should not conclude that your agency is simply trying to make conversions more difficult and more burdensome and more costly.

Ms. JOHNSON. Thank you, Congressman, and I am happy to address your question. First of all, no, your information is not entirely correct. NCUA has put into regulation disclosure requirements that are required prior to the time when a credit union, if they choose to convert to a mutual savings bank, which they are allowed to do, these disclosures must be presented and they must be presented in a way that the member has a reasonable opportunity to see those disclosures.

There were many conversations that went on between our attorneys and the attorneys representing the credit unions, and this discussion centered on how to make these disclosures prominent and conspicuous to abide by our rules.

The process that evolved was the agreement that the NCUA disclosure would be the first piece to meet the eye after the cover letter to the credit union members. We did not require the disclosure on the cover letter, the very first piece of paper, but we did require after the cover letter that the NCUA disclosure would be the next piece of information.

The attorneys for the credit union lobbied long and hard to put their rebuttal on the back of our disclosure and we agreed to that. It was to be their cover letter to the member, our disclosure, their rebuttal. And, true, they did not number the pages, which would have been easy thing to do, nor did they put their disclosure on a separate piece of paper and number the pages, which would be easy to do.

Upon receiving complaints from a number of credit union members, we investigated the actual package to the members. Upon opening the package, the first piece of paper was the disclosure letter to the member. The second piece, folded the same way as the letter to the member, was the rebuttal, "Your credit union wants you to know the facts." You turn the paper over, and there is the NCUA disclosure.

This is not about how a piece of paper was folded, Congressman, this is about a disclosure and following an agreement in the order of that disclosure to go in the package to the members.

And that is where we are at. We have disavowed the vote because the first two mailings were sent out in this form with the letter to the credit union, the rebuttal, flip it over, NCUA disclosure, and that was not the agreement agreed to by the attorneys from NCUA and the attorneys representing the credit union.

Chairman BACHUS. Thank you.

Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman. Thank you for holding these important hearings. I am sorry I had to go to International Relations and I am glad to be back.

We seem to be focused here on the process by which a credit union would convert to another kind of organization and I will spare you further questions about how a particular document was folded and look more at the broader legislative issue of what kind of quorum is required or what level of participation is required.

Under present law, can a credit union, following perhaps its own bylaws written decades ago, convert in some sort of vote in which less than 10 or less than 20 percent of the members even cast a vote one way or the other?

Ms. JOHNSON. Currently, the way the law is, that is correct, it is only a simple majority of those who vote in the election that are required to make the conversion. There is no threshold.

Mr. SHERMAN. I know how dedicated you are to this issue of how disclosures are folded. I know everyone on that panel is involved in detailed analyses of what disclosures should be given to those of us who are members or customers. I hate to disabuse you. I am very, very quick in throwing away everything my bank sends me that is not the checking statement itself and my canceled checks. I have got free trips to Bermuda in my trash can in less than 2 seconds.

So one thing we have some expertise on here is voting. As a matter of fact, they are going to call votes on the floor pretty soon. And I would advise my colleagues that you would be surprised how much legislation we could pass if we just did not have that quorum requirement. Sometimes I stay in town on a weekend. I can get access to the floor. Mr. Chairman, you do not want to see the legislation I would pass if I was the only member on the floor.

And so I would hope legislatively that we would require that if a credit union is going to do something as big as cease to be a credit union that we get 50 percent participation. Trust me, to rename a post office, I need 50 percent participation in the Congress, and I would hope that we would take a look at those quorum requirements.

I leave to others the exact details of how the disclosure should be folded, because as I see this whole debate about the folding and whatever, it all relates to did the credit union members get information that they needed and make a decision? Well, if you get 50 percent of them to vote, then my guess is that a very large percentage of that 50 percent actually took a look at the paper and decided which way they wanted to vote. It is when you send this mailing and you have got 2, 3, 4 percent response, I do not know what it was in this particular matter, but you have to start worrying about how things were folded.

I want to shift to another issue, and I guess anybody could answer this question. We have got the 3-day rescission by consumers under the truth-in-lending right of rescission. Which loans does that apply to, what kind of loan? Anybody know?

Mr. REICH. Real estate mortgages. Loans secured by real estate.

Mr. SHERMAN. So there is a 3-day delay in the process of closing that home loan.

Mr. REICH. Correct.

Mr. SHERMAN. And maybe we would want to explore whether that was—I see another panelist——

Mr. RICCOBONO. I believe it is on refinances. It is any time that you put your house, your existing home, on the line.

Mr. SHERMAN. Okay.

Mr. RICCOBONO. So a purchase money mortgage it would not. If it were a refinance, I believe the original purposes of the law had to do a lot with the type of home improvement and purchasing merchandise and putting your home on the line. That was the cooling off period.

Mr. SHERMAN. Okay. Let me go back to Ms. Johnson. You are proposing a level of capital similar to what banks have; that is to say 5 percent plus a look at a risk-based review of the individual institution. And since I work for the federal government and harken back to the 1980s, I am of course worried about, well, if it is not enough, is the federal government on the line?

Now, obviously, the insured fund itself has capital, but correct me if I am wrong, the entire net worth of every insured credit union in the country stands between a default of the insurance fund and when the taxpayers have to come in. Is that correct?

Ms. JOHNSON. Congressman, what we are looking to do is to incorporate a risk-based approach to capital and allowing credit unions to better manage their capital and then in reducing this leverage ration from 7 percent where it is currently to 5 percent. Five percent is what the other federally insured financial institutions have——

Mr. SHERMAN. I understand all that. I think I understand all that. Go ahead.

Ms. JOHNSON. And that is what we are seeking for credit unions.

Credit unions typically have low loss rates, and the system that we currently have does not recognize the credit unions' more conservative approach.

Mr. SHERMAN. I got that from your testimony. If, God forbid, there were not only insufficient capital in a particular credit union but insufficient capital in the insurance fund itself and there had to be more money to take care of depositors, would other credit unions around the country have to chip in from their capital or would this insufficiency be made up from the U.S. taxpayer?

Ms. JOHNSON. The question, yes, it would be contributed by the credit unions. The government does stand back because they are federally insured, but it would come from credit unions.

Mr. SHERMAN. Okay. So the first line of defense——

Ms. JOHNSON. Is the credit union.

Mr. SHERMAN.——is the credit union's own capital.

Ms. JOHNSON. Insurance fund, yes.

Mr. SHERMAN. And that first line is one thing you want to modify. The second line of defense is the assets in the insurance fund. The third line of defense is every nickel of net worth of every insured credit union in the country, and the federal government is the fourth line of defense. So those on the third line of defense have much more reason to make sure that your new system is a good one——

Ms. JOHNSON. That is correct.

Mr. SHERMAN.—than the federal government does. And the very fact that the credit union industry is willing to say that they are putting their net worth on the line as to the adequacy of your system is convincing and the chairman's indulgence is magnanimous.

Ms. JOHNSON. Might I point out that the system that we are proposing is not an industry giveaway. In fact, some of the credit unions, most would remain at their capitalized level that they currently are. There would be some that would go up and also some that would go down. So it is not a static.

Mr. SHERMAN. I realize that, but it is good for you to point that out.

And I yield back.

Chairman BACHUS. Thank you, Mr. Sherman.

Mr. Pearce?

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Reich, you had mentioned that you are on some timetable receiving comments back, and you have received 12 so far. When do you think that work will be complete? And, secondly, can you regulatorily unspool the things where there is great consensus?

Mr. REICH. We have published four requests for comments, we have two to go. One will come out shortly after the 1st of July, and the final one will come out early next year. We will finish this project, my expectation is, in the middle to the fall of next year, 2006.

Mr. PEARCE. And you can do that regulatorily, you do not need legislation on the items of great consensus?

Mr. REICH. The items that we are dealing with today are going to require a legislative fix.

Mr. PEARCE. Okay. Fine.

Ms. Williams, you indicated that you are ongoingly, in page 6 of your testimony, streamlining your processes. If you were to estimate the percentage reduction in regulations that you have streamlined out, give me an estimate?

Ms. WILLIAMS. Well, going back to our first major——

Mr. PEARCE. All the way back to 1990 when you——

Ms. WILLIAMS.——would be in the mid-1990s. Gosh, it is hard to ballpark it, but in terms of things that we have eliminated or areas where we have had streamlining initiatives, I would say between half and——

Mr. PEARCE. So we have reduced about 50 percent the regulations, but if you were to guess the workload that you have actually reduced, would it be also 50 percent?

Ms. WILLIAMS. I think probably not that high.

Mr. PEARCE. Yes. So we have taken a lot of the messy ones loose, but maybe the bulk of the work remains. And I am not being picky, I am just trying to get an idea. And I do appreciate that unraveling. As a small business owner, I can tell you that the burdensome paperwork is one that always lies heavy, and I appreciate your ongoing efforts.

Mr. Riccobono, I noticed your testimony said you are doing the same thing. If you were to consider Representative Ryun's bill, 2061, as I look at those thresholds of $1 billion and $5 billion, as I go back into my district of southern New Mexico and the largest town is maybe 70,000 to 80,000, that is going to be almost—it will include a lot of banks across my district that would then fall under the parameters of the new legislation.

Mr. Reich and Mr. Kohn, would you all give observations about that $1 billion and $5 billion threshold in that 2061, if you have opinions?

Mr. REICH. My own view is that the $1 billion threshold is a reasonable threshold.

Mr. PEARCE. Mr. Kohn?

Mr. KOHN. I am not familiar with the details of the bill, but I would say I think a lot of our joint recommendations and a lot of what we are considering is raising various thresholds for small banks in order to reduce regulatory burden.

Mr. PEARCE. And you feel that we can get the transparency that we need and the oversight that we need, even in—because it is a measure that I would love to support but I also do not want to go home and sled through every single community with people saying, “Why did you do that,” too. And I am working with not enough knowledge and background in the banking business, and so we are learning our way along.

But I appreciate your indulgence, Mr. Chairman. I appreciate the concise comments.

Mr. MCHENRY. [Presiding.] Thank you, Congressman Pearce.

Now I would like to recognize the chairman of the committee, our good friend from Alabama.

Mr. Chairman, we have a 5-minute time limit.

[Laughter.]

But in terms of me actually holding the gavel for any more than 2 minutes, I would like to hear whatever you would like to ask for as long as you would like to ask.

Chairman BACHUS. Thank you. And I actually put Mr. McHenry in the chair because he kept holding up his watch over here.

I am going to focus my questions on one area and one area alone, one limited focus, and that is the suspicious activity report. Now, when I have talked to staff, when I have talked to regulators, when I have talked to industry, the stock answer that we have so many SARs being filed that we all know it is clogging our efforts to our money laundering efforts. I mean, everyone will privately admit that. It is basically shutting down our money laundering efforts because just the volume of these reports.

And everyone also agrees privately that a lot of the reports could be avoided if there is really no good reason for filing them. But everybody says because of 9/11, because of antiterrorism efforts, because no one wants to stand up and say, “Do not file a certain report,” because down the line if we raise the limit, there might be a report that was not filed and somebody could say that the regulators did not require it to be filed of thus and such.

But having said that, and there is always that chance, but right now that is a chance. The reality is there are so many of these being filed they are not being reviewed, which is a far worse situation.

So while hypothetically we might if we raise the limit or exempted certain filings it might result in missing something. We are doing that right now because FinCEN has complained there are too many being filed, and our law enforcement says they cannot get to them, they cannot look at them. We have all heard those stories.

And with that in mind, and I would hope that we would all kind of come to an honest understanding and regulators, industry, law enforcement admit that the present system is not working because of the horrendous volume of SARs being filed, many of them unnecessary, to change the system.

And I would just start by asking you about the ABA. They made some, I think, very good common sense recommendations on how we can eliminate some of these which law enforcement says we need to limit the number, regulators have recognized that, and industry has urged us to do that. But, you know, the banks are not going to do it, because they are afraid not to file these things.

But, anyway, the first one, this is to me just good common sense: Eliminate CTR filings for seasoned customers. Now, when we talk about terrorists, we are not talking about American businessmen who have established businesses. That is not what we are talking about. I do not think there has been one example of an established business in the United States, particularly when they filed these all the time. They are not being reviewed anyway.

A second one is eliminate the identify verification for monetary instruments conducted by customers. And what they say, "In view of the passage of the Patriot Act and the regulations implementing section 326 requiring a customer identification program, we recommend that the verification requirements be eliminated since bank customers purchasing these instruments have already been identified through the institution's CIP program." Now, that is common sense.

A third one, eliminate notification to directors or designees of SARs. What good does that do? The regulators are instructing banks whenever it files a SAR, the management of the bank shall promptly notify its board of directors or a subcommittee of board of directors or executive officers designated by the board of directors to receive the notice. What good does that do?

Another one is, I do not see it here but the serial filing, eliminate those. It is in here someplace.

And then they also talk about, and I know that FinCEN is coming out with some more clear directions I think the end of this month, but two other recommendations are include FFIEC exam instructions to invoke FinCEN help line and include FFIEC exam instructions on conducting transaction analysis.

I am not going to ask you to answer these now because I do not want to be gaveled out, but I do want to submit these recommendations to you. I want to submit them for the record, and I would like each of you as regulators to respond in writing as to whether or not some of these recommendations can be instituted or something like them.

A recommendation of the ICBA, another organization, is to increase from 10,000 to 30,000 the threshold, and I would like you to look at that.

And I ask you to look at in the spirit of knowing this: That FinCEN has actually said that defensive filings by banks are clogging their databases. Several law enforcement agencies have said the sheer number and volume of these SARs are making their anti-money laundering efforts almost impossible. So given that.

And, finally, the third one would be that FinCEN has actually complained that the financial institutions are filing SARs in doubtful circumstances. They are doing it to avoid criticism and to avoid enforcement action by the Government and to enforce sanctions and to avoid fines, because I know of banks that have done it. They have not done it thinking they were meeting the guidelines and then some U.S. attorney someplace has brought action against them and fined them considerable amounts of money.

And for the sake of defending our country from terrorists, this is something we need to address.

And I will close by what FDR said, "The only thing we have to fear is fear itself." And I think that is the only thing that is stopping us from moving against this. The terrorists have really achieved their purposes by scaring us into basically indulging in activity that wastes millions of dollars every year needlessly.

So with that, I will close. Thank you.

Mr. MCHENRY. Thank you, Mr. Chairman. Certainly appreciate it.

And I would be very, very kind to you going forward, and I will never tap my watch again, because you are making me sit up here.

Chairman BACHUS. I was just kidding you.

I know Mr. Green is——

Mr. MCHENRY. Yes.

Congressman Green, I do have a question to wrap up the panel, but I will let you go first, then I will ask the final set of questions.

Mr. GREEN. Thank you, Mr. Acting Chairman.

Friends, I will not have another question. I think I will simply make a comment. In these meetings, we tend to go head-to-head. My comment hopefully is heart-to-heart.

We have come a long way in this country in fighting discrimination, segregation. We really have come a long way. And we now have an opportunity to continue the path forward or to possibly do something that may turn us around. I am going to beg that you please keep us moving forward when it comes to integration in this country.

You have a great opportunity before you. This is your watch. This is your opportunity to make a difference, and I am just going to beg that you do what you can to protect the one need that we have right now when it comes to banking: To keep us from making a gigantic step backwards.

That CRA is very important to people who do not have power, who are trying to get their share of the American dream. Homeownership, borrowing money is a means by which we get this done. If you want people to pull themselves up by their bootstraps, provide them bootstraps, provide them the loans which can afford them the opportunity.

I just thank you for giving me the chance to appeal to your hearts, not your heads. Do what you can. Thank you.

I yield back the rest, remainder and residue of my time.

Mr. MCHENRY. Thank you, Congressman Green.

With that note of thinking of our hearts and our heads, the mind cannot bear what the feet cannot stand, and so with that, I will try to keep my question very quick, and I just used up 7 seconds there, so I better get fast here.

Chairman Johnson, I wanted to direct my question to you to follow up with what Congressman Hensarling questioned about the conversion process of the credit union in Texas. I am not from Texas, I do not wear big hats or big shoes, none of them are here to say that or to target me now that I have said that, but in terms of the conversion process, you have a lot of large credit unions that have taken on a lot of bank-like functions. And with the new PCA, capital regime, expanded business lending and a lot more access to secondary capital markets, a lot of these credit unions have taken on a lot of bank-like functions.

And part of this discussion today is about regulatory relief. It certainly seems with your explanation of this interesting mailing, the front and the back, that it seems like excessive regulations on that process. That just seems like one example of excessive regulations, and Congressman Hensarling explained the front and back and all this stuff. I am not going to go through that again, and I really do not care to hear any more details about that in particular, but can we take it to the larger focus?

Don't you think allowing a more reasonable regulatory process for conversion is a good thing? Don't you think that because we allow it, don't you think it should be a streamlined process so that these large credit unions can continue to provide the proper function for their communities? Do you think there is a lot to that or something to that?

Ms. JOHNSON. Congressman, the providing of an adequate disclosure to the members is not a burdensome process, and to do anything less than full disclosure I think is very shortsighted. Consumer protection is very important.

Mr. MCHENRY. So there is no regulatory relief that we should discuss with you about today in this process?

Ms. JOHNSON. In the process of——

Mr. MCHENRY. Conversion.

Ms. JOHNSON. I would be more than happy to visit with you about our process and the steps that are required, but it is all centered on providing disclosure to the members and having the members understand—having the opportunity to understand, because there is no guarantee that a disclosure is ever read, we know that. But giving the member at least the opportunity to understand in order to make an informed decision about the future direction of their institution and should they convert or not.

But I would be more than happy to visit with you about our process. I do not believe that it is a burdensome process, but it is absolutely necessary for the member to have full disclosure.

They are making some major decisions. They are changing from a one member, one vote member-owned institution to an institution where it is not one member, one vote, it is on the amount of deposits held within the institution.

Mr. MCHENRY. Well, not always. I mean, you are talking about each person having a vote.

Ms. JOHNSON. In converting to a mutual. In moving to a mutual.

Mr. MCHENRY. And they certainly would have a say-so in that process and would have a vote in that process. And it seems to me that just judging from this perspective that when you are talking about the front side versus the back side of a piece of paper, this goes to the heart of bureaucratic blundering and overregulation and excessive regulation.

And my follow-up question to this, and, certainly, I would love to talk to you more about it, but just by your own testimony, it seems to me obsessive regulation and a little bit out of control when you are talking about how a piece of paper is folded. It seems to me to be ri-freakin'-diculous, as some would say.

Ms. JOHNSON. Congressman, if I may respond, this is not about the way a piece of paper is folded. This is about an agreement that was made between the attorneys on how the disclosures would be presented. That was not upheld to.

Mr. MCHENRY. Okay. Front and back pieces of paper.

Ms. JOHNSON. The order of appearance was in the package to the members.

Mr. MCHENRY. Okay. Which the order of appearance is based on whether or not it is on a front side of a piece of paper or a back side of a piece of paper.

Ms. JOHNSON. Our disclosure requires prominent and conspicuous. The agreement, the agreement that was reached to was not adhered to.

Mr. MCHENRY. Okay. And I am almost out of time, and so I did have a follow-up question because OTS has said that they would certify the votes of these two converting credit unions in Texas.

And so I sort of have a follow-up question for Mr. Riccobono on this process. Is it because of the two separate regulatory and rulemaking regimes that we have problems here?

Mr. RICCOBONO. Actually, our authority with respect to the actual process, the voting of the membership by the credit union, is given to us by the NCUA's own rules. The Credit Union Administration has said that once a vote is taken in favor of conversion, then OTS must certify the vote. And if we believe a new vote had to be taken, we could order that to be done.

And at this point, it would be too premature to say that you would, but I can tell you if today that vote was taken with having given that disclosure three times already to the members and that vote was taken and it was in favor of converting that credit union, OTS would verify the vote and allow them to convert.

This is a very expensive process. It is in excess of a half a million dollars to conduct the voting, and the thought that they would have to go out and spend another $500,000 to $600,000 simply because of what piece of paper the member saw first, I cannot disagree with the chairwoman that disclosure is extremely important, it must be clear and conspicuous, that was all met, I believe, by having that piece of paper in the envelope regardless of what order it was in, and it was given to the members three times. And to go back out and require at that expense another voting three times I just think is terrible and I have to say that I feel very strongly about this.

I should disclose I am a member of the Treasury Department Federal Credit Union, I think there is very little in baking that is as close to apple pie and motherhood as the credit union movement, but better than that is the freedom of charter choice, and I think it is extremely important that we not have artificial rules and regulators not making good judgment calls balancing the benefits and costs involved in these processes.

Mr. MCHENRY. Thank you. Thanks for your testimony and very happy that we were able to end on a note where we can actually look for ways to reduce regulation, the burden we are putting on institutions.

Thank you all so much for your testimony.

Let's see, the Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions for these witnesses and to place the responses in the record.

Thank you so much for your testimony. Thank you for being here today. I know it is always exciting and eventful to be before a congressional committee, even one as sleepy and nice as ours.

Thanks so much. Have a wonderful day.

And this meeting is adjourned.

[Whereupon, at 12:15 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 9, 2005

Opening Statement
Chairman Michael G. Oxley
Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit
"Financial Services Regulatory Relief: The Regulators' Views"
June 9, 2005

I want to thank Chairman Bachus for holding this second hearing in this Congress on financial services regulatory relief. Having heard last month from the regulated community, today we will hear from both Federal and State regulatory authorities charged with ensuring the safety and soundness of our nation's banking, thrift and credit union industries.

As the testimony at last month's hearing underscored, the financial services industry is laboring under an enormous regulatory burden. While many of the regulations imposed on the industry are necessary to protect consumers, combat terrorist financing, or serve other worthy public policy objectives, others are clearly outdated or needlessly burdensome.

For this reason, shortly after I assumed the chairmanship of this Committee, I asked the Federal and State financial regulators and financial services industry trade associations to give us their best advice on what this Committee could do to ease the crush of regulatory requirements faced by depository institutions. The goal was to reduce regulatory burden and improve productivity, as well as make needed technical corrections to current statutes. It was clear then, as it is today, that there needs to be a counterbalance to the significant compliance responsibilities placed on insured depository institutions by the USA PATRIOT Act as well as other government efforts to counter terrorist financing.

Last Congress, the Committee ultimately produced a comprehensive regulatory relief bill (H.R. 1375) that passed the House by a vote of 392-25. H.R. 1375, which incorporated suggestions from the Federal and State financial regulators as well as the financial services industry, contained a wide range of provisions that would have relieved unneeded or outdated regulatory restrictions on banks, thrifts and credit unions. While the Senate failed to take up H.R. 1375, I am pleased that two respected members of the committee, Mr. Hensarling and Mr. Moore, have indicated their willingness to introduce legislation later this Congress that will build on the provisions that won such overwhelming support in the House last year.

I thank the regulators for appearing here today and I look forward to their thoughts and comments on how best to free depository institutions from unduly burdensome regulation so they can better serve their customers and their communities.

**OPENING STATEMENT OF
CHAIRMAN SPENCER BACHUS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT
"FINANCIAL SERVICES REGULATORY RELIEF: THE
REGULATORS' VIEWS"
JUNE 9, 2005**

Good morning. Today's hearing on regulatory relief will provide Federal and State banking, thrift and credit union regulators an opportunity to provide the Subcommittee with recommendations on altering or eliminating unduly burdensome or outdated regulatory requirements. Specifically, the subcommittee seeks to explore ways to reduce the regulatory burden on insured depository institutions by lowering costs and improving productivity. This hearing is a follow-up to a hearing last month at which the Subcommittee received input from the financial services industry on ways to reduce regulatory burden.

In testimony before the Subcommittee in May 2004, John M. Reich, Vice Chairman of the Federal Deposit Insurance Corporation (FDIC) who is testifying before us today and is head of an interagency task force on reducing regulatory burden, stated that while "there are no definitive studies of the total cost of regulation, . . . a survey of the evidence by a Federal Reserve Board economist in 1998 found that total regulatory costs account for 12 to 13 percent of banks' non-interest expense, or about $36 billion in 2003." Vice Chairman Reich also noted that in the 15 years since the enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the Federal banking and thrift regulatory agencies had promulgated a total of 801 final rules, often requiring "computers to be reprogrammed, staff retrained, manuals updated and new forms produced."

Understandably, a large portion of that regulatory burden is justified by the need to ensure the safety and soundness of our banking institutions; enforce compliance with various consumer protection statutes; and combat money laundering and other financial crimes. However, not all regulatory mandates that emanate from Washington, D.C. or other state capitals across the country are created equal. Some are overly burdensome, unnecessarily costly, or largely duplicative of other legal requirements. Where examples of such regulatory overkill can be identified, Congress should act to eliminate them.

Under Chairman Oxley's leadership, this Committee has been dedicated to freeing depository institutions from unduly burdensome regulations so that they can more effectively meet the credit needs of their communities. In 2001, the Chairman requested that Federal and State financial regulators and financial services industry trade associations recommend legislative items that would provide regulatory relief for insured depository institutions. The initiative was also intended to counterbalance the significant compliance responsibilities placed on insured depository institutions by the USA PATRIOT Act as part of the government's effort to thwart terrorist financing. The Committee ultimately produced a comprehensive regulatory relief bill (H.R. 1375) that passed the House during the 108th Congress by a margin of 392-25.

While the Senate took no action on H.R. 1375, Mr. Hensarling and Mr. Moore, two Members of the Subcommittee, have indicated their intention to draft comprehensive regulatory relief legislation in this Congress that draws from the provisions of that bill. Other Members of the Subcommittee have introduced legislation to afford regulatory relief to specific sectors of the financial services industry. On May 3, 2005, Mr. Ryun introduced H.R. 2061, the "Community Banks Serving Their Communities First Act," which contains regulatory and tax relief proposals targeted at small community banks.

Last month, Mr. Royce and Mr. Kanjorski introduced H.R. 2317, the "Credit Union Regulatory Improvements Act" (CURIA), which would modify credit union capital requirements and make other changes to credit union powers, governance, and regulatory oversight. I applaud the goals of these bills which would allow banks and credit unions to devote more resources to the business of lending to consumers and less to the bureaucratic maze of compliance with outdated and unneeded regulations.

At today's hearing we will hear from a distinguished panel of regulators, including Federal Deposit Insurance Corporation Vice-Chairman John M. Reich, Federal Reserve Governor Donald L. Kohn, Acting

Comptroller of the Currency Julie L. Williams, Acting Director of the Office of Thrift Supervision Richard M. Riccobono, National Credit Union Administration Chairman JoAnn Johnson, Texas Department of Banking Commissioner Randall S. James on behalf of the Conference of State Bank Supervisors and Virgina Bureau of Financial Institutions Deputy Commissioner George Latham on behalf of the National Association of State Credit Union Supervisors. I look forward to hearing from today's witnesses and thank them for taking time from their busy schedules to join us. In particular, I want to commend Vice Chairman Reich for heading up the interagency effort to reduce regulatory burden.

I am now pleased to recognize the Ranking Member, Mr. Sanders, for an opening statement.

Opening Statement

Congressman Paul E. Gillmor (R-OH)

Subcommittee on Financial Institutions and Consumer Credit

June 9, 2005

Hearing entitled: *"Financial Services Regulatory Relief: The Regulators' Views."*

I want to thank Chairman Bachus for calling this hearing today. There is no doubt that our financial regulatory structure has contributed to the United States becoming the model for the world when it comes to financial services, but without constant attention to the burdens of outdated rules and regulations, the markets can be dragged down by unnecessary costs. Last Congress, the House passed H.R. 1375 with bipartisan support and I hope that this Congress, our Committee will again pass measures that provide regulatory relief to our banks, thrifts and credit unions.

Much of the problem with the current regulatory structure is that small banks are treated as large banks in a "one-size-fits-all" approach. Whether it is provisions of the USA-Patriot Act or Sarbanes-Oxley, small banks have faced enormous new cost in complying with regulations that may not contribute to overall market stability.

I look forward to working with Chairman Oxley and Chairman Bachus in again passing regulatory relief measures so that our depository institutions may remain the most efficient in the world.

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REMARKS OF THE HONORABLE RUBEN HINOJOSA
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
"REGULATORY RELIEF: THE REGULATORS' PERSPECTIVE"
JUNE 9, 2005

Chairman Bachus and Ranking Member Sanders, I want to express my sincere appreciation for you holding an additional hearing on the need for regulatory relief for financial institutions.

This is a very important topic, and we need to ensure that whatever legislation is drafted with the help of my colleagues Congressman Dennis Moore and my fellow Texan Congressman Jeb Hensarling, with our input, provides equal treatment for all financial institutions and reduces as many of their regulatory burdens as possible while protecting consumer interests.

I want to take this opportunity to welcome a fellow Texan, Mr. Randall S. James, Commissioner of the Texas Department of Banking, who is testifying today on behalf of the Conference of State Bank Supervisors, Inc. I look forward to hearing your testimony and that of all of today's witnesses. Commissioner James, I hope that you enjoy your stay in Washington. You are always welcome.

At this point, Chairman Bachus, I would like the attached documents to be included as part of my opening remarks: a letter from Harold E. Feeney, Commissioner of The State of Texas Credit Union Department, to Ms. Dominique M. Varner, Attorney at law; a copy of the mandatory disclosure paper the Community Credit Union (CCU) provided to members announcing the vote on whether to convert to a federal mutual savings institution charter; a copy of a letter from the American Bankers Association to me regarding the CCU conversion; and a copy of a letter from America's Community Bankers to me regarding the same issue.

The letter from Commissioner Feeney to Dominique Varner pertains to the CCU's failed attempt to convert to a federally chartered mutual savings institution. If the content of this letter is accurate, I find it odd that NCUA nullified the vote by CCU members to switch charters based on how a document was folded, especially since there are no rules, regulations or guidance on how to fold such document. Mr. Chairman, this action may have created a very awkward regulatory situation that may need to be addressed in the near future.

Having said that, Mr. Chairman, I yield back the remainder of my time.

CREDIT UNION DEPARTMENT

Harold E. Feeney
Commissioner

James R. Deese
Deputy Commissioner

May 31, 2005

Via Email and U.S. Mail

Ms. Dominique M. Varner, Attorney at Law
Hughes, Watters, Askanase
Three Allen Center
333 Clay Street, 29th Floor
Houston, Texas 77002

Re: Conversion of Community Credit Union (CCU) to a Federally Chartered Mutual Savings Institution

Dear Ms. Varner:

The Department has researched and investigated the issues raised in your letter dated May 16, 2005, alleging various violations and procedural deficiencies with the election process for CCU's proposed charter conversion (Protest Letter). The Department has confirmed that four members of your client, the Coalition for Member Trust, are members of CCU and do have standing to request that the Department investigate the election process. Those members are hereinafter referred to as the Protesting Members. I will address each of the concerns of the Protesting Members in the order in which they were raised in your letter.

<u>Inadequacy of Disclosure</u>

a. <u>All Applicable State Regulations Apply Because NCUA Does not Preempt State Regulation Where Such Regulation is More Restrictive.</u>

The Department fully understands that a state is not required to defer to NCUA on disclosure requirements in all instances. However, in this instance, NCUA declared that the federal regulation on conversion disclosures was stricter than the Texas rule and that its rule governed. This does not mean that we did not review the disclosures to ensure that they complied with the Texas conversion rule. We reviewed all of the disclosures, made comments on them and reviewed all revised versions of the disclosures. The disclosures that were sent to CCU members complied with all applicable State rules with the exception of 7 T.A.C. Section 91.302(c) (3), which was specifically preempted by NCUA.

In your Protest Letter, you stated that "If you as the Texas Credit Union Commissioner feel that insufficient disclosures have been made to safeguard and protect the rights of Credit Union members within your state, you have the right to take affirmative action, and demand disclosures above and beyond those required by NCUA." This statement is not accurate. As Commissioner I only have the authority to enforce and apply the statutes adopted by the Texas Legislature and the corresponding rules promulgated by the Texas Credit Union Commission. I do not have the authority to unilaterally transform or otherwise convolute the Commission's rules. Any application received, whether it be for a conversion or any other authorized activity, is approved or denied in accordance with applicable law and the Commission rules in place at the time of its submission. If you or your clients feel the current rule on conversions should be modified or somehow expanded, you are welcome to request that the Commission consider changes to the rule. The Commission will then go through its normal prescribed rulemaking process. I would like to note that the Legislative Advisory Committee of the Commission has requested that I study the current conversion rule to see what, if any, revision is necessary. I will be holding a public hearing in coming months and would welcome your or your clients' input on the rule.

b. <u>The Credit Union Failed to Comply with Applicable Federal Disclosure Requirements.</u>

This issue should more appropriately be addressed to NCUA. However, since you have asked me to find that CCU failed to comply with all applicable disclosure requirements; I will give you my opinion. NCUA reviewed and requested revisions to the original CCU disclosure material over a period of 90 days. This Department received a copy of a letter from NCUA to CCU dated March 31, 2005, that approved the disclosure material and the procedures to be used. Therefore, I have no basis to find that the disclosure material failed to comply with federal disclosure requirements.

c. <u>The Credit Union Rendered its Disclosures Defective by Concealing and Contradicting Such Disclosures.</u>

Again, this issue should more appropriately be addressed to NCUA. The required NCUA disclosure (Boxed Disclosure) is not required under Texas law; however, I think it is worth noting that the rule requiring the Boxed Disclosure was adopted by NCUA after submission of CCU's application and under the Texas regulatory scheme would not have applied to this particular application.

You have specifically asked me to find that CCU failed to comply with all applicable disclosure requirements due in part to your client's claim that the Boxed Disclosure was inappropriately printed on the reverse side of a two-sided sheet that included a response to the Boxed Disclosure prepared by CCU. I cannot make such a finding. This Department and NCUA reviewed and approved the content of CCU's response sheet and the placement of that document on the reverse side of the Boxed Disclosure. This Department has reviewed a sample of the disclosure packets mailed to CCU members and do not agree that the Boxed Disclosure was printed on the reverse side of the two-sided document. There is no question that the Boxed Disclosure itself met all of the statutory requirements of Part 708a.4 (e) and it was placed as the second document in the packet as approved by NCUA. Nothing in either our rules or those of the NCUA dictates how a document should be folded. Further, there were no specific folding instructions in either Agency's approval letter authorizing the use of the two sided Boxed Disclosure and CCU response sheet. Based upon the samples reviewed, it certainly appears to this office that the document containing the Boxed Disclosure was folded in the standard manner, i.e. first page facing up, folding the bottom 1/3 up and then the top 1/3 over. Following this standard convention of folding documents, the Department must conclude that the Boxed Disclosure was indeed the front sheet of the two-sided document. To date, this Department has received no questions, comments or complaints regarding the disclosure material, including the Boxed Disclosure, from any member other than the Protesting Members in your Protest Letter.

d. The Credit Union Failed to Give a Fair and Balanced Presentation of the Arguments For and Against Conversion and Stifled Open Debate Among its Members.

The Department's investigation did not substantiate the Protesting Members claim that CCU failed to give a fair and balanced presentation of the arguments for and against conversion or that they stifled open debate among its members. The dicta cited in the Protest Letter concerning the need for a "fair and balanced" presentation of the issues surrounding a conversion were made by NCUA officials as their justification for the adoption of the Boxed Disclosure. CCU was required to present the Boxed Disclosure to their members and therefore the fair and accurate presentation was made. As permitted by NCUA regulation, CCU specifically requested that they be allowed to submit a response to the Boxed Disclosure. NCUA and this Department reviewed, revised and ultimately approved that response and its placement on the back of the Boxed Disclosure. These two documents, combined with all of the statutory disclosure requirements contained in the disclosure materials sent to CCU members did constituted a fair and accurate presentation.

Ms. Dominique M. Varner, Attorney at Law
Hughes, Watters, Askanase
May 31, 2005
Page 4

Further, NCUA requires that any and all additional information the Credit Union provides its members, beyond the Boxed Disclosure, to be "factually correct and not misleading in any way". CCU submitted all such information, including proposed responses to various questions that it anticipated receiving from the media and members about the conversion for review by this Department and NCUA to ensure that NCUA agreed that they were factually correct and not misleading. NCUA and this Department approved the use of the information and those responses. Therefore, it appears to this Department that CCU has complied with and continues to try to comply with both the letter and spirit of all applicable regulations regarding factually correct and not misleading disclosures.

In connection with the issue of stifling debate, I would like to make several observations. First, there is no federal or state requirement for a credit union to provide a mechanism for members to share their opinions on the conversion with each other and the credit union, other than the requirement to hold a special meeting on the conversion where members may vote on the proposal. Second, CCU has established a "conversion hotline" to respond to inquiries and comments received from its members about the proposed conversion. Although CCU has not kept specific statistics regarding this hotline, the individuals who staffed the hotline estimate that they have handled 300-500 calls to date. CCU has asserted to us that the majority of questions have dealt with administrative matters regarding the return envelopes for the ballot. Finally, the specific instances cited in the Protest Letter as attempts to stifle debate all occurred at CCU's annual meeting which was held to elect directors to three open positions and conduct other routine credit union business. The annual meeting was not posted as a forum for discussion of the conversion proposal. CCU had previously scheduled and notified its members in the disclosure materials and elsewhere that there will be a special meeting on June 21, 2005, to take up and consider the charter conversion. Having made that distinction, the Department understands that members wishing to speak on or about the proposed conversion were provided an opportunity to address the members attending the annual meeting.

I will now address what our investigation revealed about the three specific instances named in the Protest Letter. We are not aware of any other instances.

1. Regarding the members who were locked out. There are no regulations that specifically address whether a credit union can lock a member out of a meeting. How the annual meeting is run is governed by the credit union's bylaws and policies. Annual meetings are for members only and the public may be excluded. It is my understanding that it has been CCU's policy in recent years to verify membership prior to allowing admittance into the meeting. Their stated rationale for this is that elections are conducted by voice vote at the annual meeting and there is no other way to reasonably assure that only members are voting. Any members who arrived after the annual meeting commenced and the verification booth had closed were not admitted because their membership could not be verified. Given the presence of non-members who had

already tried to gain admittance prior to the start of the meeting, CCU may have been a little faster on the timing of closing of the verification booth than in years past; however, that can not be legitimately construed as an attempt to stifle debate on a matter, which was not even a posted item on the meeting's agenda.

2. Regarding the member who was escorted out of the meeting. This member violated posted notices that campaign materials could not be distributed with 100 feet of the meeting. According to CCU, this has been the credit union's policy for many years and warning signs were appropriately posted. Our review of the statement from the police officer, who informed the member that she was violating the posted policy, revealed that it was the police officer's decision to remove that member from the meeting, after she began arguing with him and he felt she was attempting to cause a disturbance.

3. Regarding the motion to dismiss the conversion proposal. The matter of the proposed charter conversion was not on the official agenda for the annual meeting so the presiding officer at the meeting was correct in ruling the motion to be out of order. As noted earlier, a special meeting on the charter conversion had already been called and notice of that meeting given to all CCU members. In addition, federal and state regulations are in place which dictates the only method permitted to facilitate a vote for or against a conversion proposal and this was not the prescribed venue.

e. <u>Method of Conducting the Balloting.</u>

Although NCUA's regulation does not prohibit members from being allowed to change their vote during the process, the secret balloting system NCUA required CCU to follow functionally prohibits their ability to do so. Further, under 7 T.A.C. Section 91.302(a), the board of directors of a credit union is given the authority to establish election rules. Nothing in Rule 91.302 or elsewhere in our rules prohibits a credit union from instituting a policy of irrevocable ballots in any election. This is particularly practical in secret ballot elections such as the procedure set up for this conversion vote. Precedent exists in other elections for irrevocable votes and we do not feel the Commission has overstepped its authority in not prohibiting irrevocable votes.

Without commenting on the validity of your claim that Texas common law gives members a right to change their vote so long as the result has not been finally announced, I do not have the authority to invoke Texas common law for enforcement purposes. As stated earlier, I only have the authority to enforce and apply the statutes adopted by the Texas Legislature and the corresponding rules promulgated for Texas Credit Unions by the Credit Union Commission.

f. <u>Access to the Credit Union Membership List.</u>

Without commenting on the validity of your arguments raised and for the same reason stated above, I do not have the authority to apply Texas common law over statutes and rules adopted by the Texas Legislature and the Credit Union Commission. I will, however, address the Commission's authority to require the release of membership lists under Texas Finance Code Section 125.402 and 7 T.A.C. Section 91.608.

Subsection 125.402 (b) and (c) should be read together:

"(b) The commission may authorize the disclosure of information relating to a Credit Union member under circumstances and conditions that the commission determines are appropriate or required in the daily operation of the Credit Union's business."

"(c) The commission may adopt reasonable rules relating to the:
(1) confidentiality of the accounts of credit union members; and
(2) duties of the credit union to maintain that confidentiality."

The Commission when it adopted Rule 91.608 under the authority granted in Subsection 125.402(c) did authorize the disclosure of member information for circumstances that it determined were *appropriate or required* in the *daily operation* of the credit union's business under Subsections 91.608 (a) (1)-(6). Membership information released to other members for voting campaign purposes is not on that list. We can only conclude that at the time of adoption, the Commission either didn't feel that the release of the membership list was "appropriate or required" or that it was not in the "daily operation" of the Credit Union's business. The Commission, through the rule making process, exercises the authority given to it by the Legislature. Subsection 125.402 (b) is a general grant of authority for the Commission to issue a general rule on the matter. It was not intended to allow any member of any credit union to petition the Commission at any time to get access to other members' information. The rule making process is a public process and if you or your clients feel that Rule 91.608 needs to be revised, either under (a) or (b), to allow for release of member information to other members who are campaigning for a vote, you are welcome to make such a request to the Commission and the Commission can decide to review that rule. If the Commission decides that your request has merit, it will have to go through the normal rulemaking process.

However, again as I stated earlier, CCU is subject to the statutes and rules that are in place on the date that they submitted this application. If CCU released the membership list to members, they would be in violation of Rule 91.608. Further, Subsection 91.608(d) specifically states that this rule "shall not be construed as altering or affecting any applicable federal statute, regulation or interpretation that affords a member greater protection than provide under the section." Therefore, if the Commission did decide to revise the rule to allow for disclosure of member lists to other members, each credit union that received such a request would have to analyze all applicable federal regulations to determine if stricter privacy standards apply. In this case, as a financial institution, that would include the Gramm-Leach-Bliley Act and the Bank Secrecy Act.

g. **The Breach of Fiduciary Aspect.**

I do not believe the directors of CCU have breached their fiduciary duties in connection with their vote to seek membership approval of the conversion proposal or with the disclosures that have been provided to the membership. Congress has clearly expressed that credit unions should have the freedom to choose the form of organization that best meets their strategic and market objectives. The board of directors of a credit union has the authority to recommend a different form of organization to the membership. It is not a breach of fiduciary duty under Texas Finance Code Sections 122.061 or 122.062 for them to make this recommendation.

While Subsection 122.061(a)(1) prohibits a director from the deliberation of or determination of a question affecting the person's pecuniary interest, Subsection 122.061(b) states that "an interest only as a member of the credit union that is shared in common with all other members is not a pecuniary interest within the meaning of Subsection (a)(1)." The decision to convert to another type of charter is determined by a vote of the membership and is a matter that is shared in common with all other members. The credit union will either convert to another type of charter or it won't but the act of conversion will affect all members in the same manner. Activities or events that might occur in the future and which are also subject to an additional membership vote do not disqualify CCU's directors from proposing the conversion to the membership.

Further, this Department and NCUA reviewed and approved the disclosure material as to any possible monetary benefits the directors could enjoy as a result of this conversion. The disclosure materials clearly state that Directors of the Savings Institution will be paid the same fee for their services as Directors are currently paid as Directors of the Credit Union. Payment of the Directors fees to Credit Union Directors is authorized under Texas Finance Code Section 122.062 and 7 T.A C. Section 91.502. If the credit union converts, it will be governed by the Office of Thrift Supervision (OTS) and any future activities of the institution will be governed by applicable law and OTS regulations.

Ms. Dominique M. Varner, Attorney at Law
Hughes, Watters, Askanase
May 31, 2005
Page 8

The disclosure material approved by this Department and NCUA sets out the possibility of future compensation for directors in the form of stock benefits and notes that these benefits could only be realized after additional votes and approvals are obtained by members and regulators. If CCU's membership approves the conversion to a mutual savings bank and the subsequent institution believes that a mutual-to-stock conversion is in its best interest, the Federal Deposit Insurance Corporation and the OTS have a regulatory scheme in place to deal with questions related to management abuse, enrichment of insiders, and fairness to depositors. Lastly, I would like to note that there is no guarantee that the directors who participated in the vote to recommend to the membership that a conversion take place will be the directors following any subsequent membership votes and regulatory approvals allowing for stock benefits for directors.

If you have any questions, please do not hesitate to call me or the Department's General Counsel, Kerri Galvin.

Sincerely,

Harold E. Feeney
Commissioner

HEF:KTG/iv

cc: Mr. Garold R. Base, President
Community Credit Union

Mr. Cue Boykin, Assistant Attorney General
Office of the Attorney General

Ms. Jane Walters, Regional Director
National Credit Union Administration

The National Credit Union Administration, the federal government agency that supervises credit unions, requires Community Credit Union to provide the following disclosures.

1. **OWNERSHIP AND CONTROL.** In a credit union, every member has an equal vote in the election of directors and other matters concerning ownership and control. In a mutual savings bank, **ACCOUNT HOLDERS WITH LARGER BALANCES USUALLY HAVE MORE VOTES AND, THUS, GREATER CONTROL.**

2. **EXPENSES AND THEIR EFFECT ON RATES AND SERVICES.** Credit unions are exempt from federal tax and most state taxes. Mutual savings banks pay taxes, including federal income tax. If Community Credit Union converts to a mutual savings bank, these **ADDITIONAL EXPENSES MAY CONTRIBUTE TO LOWER SAVINGS RATES, HIGHER LOAN RATES, OR ADDITIONAL FEES FOR SERVICES.**

3. **SUBSEQUENT CONVERSION TO STOCK INSTITUTION.** Conversion to a mutual savings bank is often the first step in a two-step process to convert to a stock-issuing bank or holding company. In a typical conversion to the stock form of ownership, the **EXECUTIVES OF THE INSTITUTION PROFIT BY OBTAINING STOCK FAR IN EXCESS OF THAT AVAILABLE TO THE INSTITUTION'S MEMBERS.**

4. **COSTS OF CONVERSION.** The costs of converting a credit union to a mutual savings bank are paid from the credit union's current and accumulated earnings. Because accumulated earnings are capital and represent members' ownership interests in a credit union, the conversion costs reduce members' ownership interests. As of February 28, 2005, Community Credit Union estimates **THE CONVERSION WILL COST APPROXIMATELY $1,262,600 IN TOTAL.** That total amount is further broken down as follows: regulatory application processing fees - $5,400; printing - $230,000; postage - $304,000; mailing assembly - $90,000; inspector of elections - $26,000; membership awareness campaign - $150,000; consulting and professional fees and expenses - $105,000; legal fees and expenses - $200,000; staff time -$0; special meeting location - $3,200; signage and stationary changes - $230,000; cash prizes - $20,000; annual examination and operating fee benefit - ($101,000)(the difference between annual examination and operating fees as a mutual savings bank of $177,000 and as a credit union of $278,000).

YOUR CREDIT UNION WANTS YOU TO KNOW THE FACTS

The disclosures provided on the reverse side are required by the NCUA in its role as monitor of the Charter Change voting process. We wish to make the following statements in response:

1. OWNERSHIP AND CONTROL

After the Charter Change the maximum number of votes per member FDIC-insured account is 1,000 out of a total of more than 10,000,000 votes. **WE DO NOT BELIEVE THAT THIS CHANGE WILL GIVE ANY MEMBER OR GROUP OF MEMBERS SUBSTANTIALLY GREATER CONTROL THAN CREDIT UNION MEMBERS CURRENTLY ENJOY.**

2. EXPENSES AND THEIR EFFECT ON RATES AND SERVICES

Credit unions, like all financial institutions, pay rates on savings accounts and set loan rates and fees for services based on competitive market conditions, not their tax exemption. Based on our business plan filed with federal regulators, **THE EARNINGS ON THE ADDITIONAL CAPITAL TO BE RAISED AND THE EXPECTED INCREASE IN ASSETS OF THE INSTITUTION SUPPORTED BY THIS CAPITAL WILL ENABLE US, CONTRARY TO THE NCUA'S CONCERNS, TO MAINTAIN OUR COMPETITIVE RATES ON SAVINGS ACCOUNTS AND LOANS AND MODERATE SERVICE FEES, AS WE HAVE IN THE PAST.**

3. SUBSEQUENT CONVERSION TO STOCK INSTITUTION

Any future **CONVERSION TO A STOCK INSTITUTION, WHILE BENEFICIAL BECAUSE OF THE SUBSTANTIAL CAPITAL THAT CAN BE RAISED, REQUIRES A VOTE OF THE MEMBERS, AS DOES THE AWARDING OF STOCK BENEFITS.** Furthermore, the award of any stock-based compensation in connection with a conversion will be strictly regulated by the Office of Thrift Supervision, our new federal regulators upon completion of the Charter Change.

4. COSTS OF CONVERSION

Community is required by extensive federal and state regulations to go through a costly process to put the Charter Change proposal to a membership vote. Like all other investments, such as advertising our rates and services, building a branch, or adding personnel, **THE BOARD OF DIRECTORS BELIEVES THE COSTS WILL RETURN A GREATER BENEFIT TO THE MEMBERS.** The addition of new capital through a minority stock offering will allow us to add new branch offices, products and services as rapidly as demanded by our members and the community.

5. RETURN OF INSURANCE DEPOSIT

The NCUA, while an agency of the federal government, receives no taxpayer dollars to operate. The NCUA is entirely funded by annual operating fees paid by all federal credit unions and by fees paid to it by the National Credit Union Share Insurance Fund ("NCUSIF"), which the NCUA manages. The NCUSIF is funded entirely by federally insured credit unions, such as Community. **AS OF DECEMBER 31, 2004, COMMUNITY HAD $9,783,000 ON DEPOSIT WITH THE NCUSIF, WHICH GENERATED APPROXIMATELY $199,000 DURING 2004 FOR NCUSIF, OF WHICH APPROXIMATELY 60%, OR $119,000, WAS PAID TO THE NCUA TO SUPPORT ITS OPERATIONS AND ON WHICH NOTHING WAS PAID TO COMMUNITY.** If the conversion to a mutual savings institution is completed, the NCUSIF deposit will be returned to Community and invested by us for the benefit of our members, thereby creating more earnings to pay interest on savings accounts, keep interest rates low on loans and hold down service fees.

06/08/05 10:46:24AM From ABA To

AMERICAN BANKERS ASSOCIATION

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Washington, DC 20036

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World-Class Solutions, Leadership & Advocacy Since 1875

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June 8, 2005

The Honorable Ruben Hinojosa
House Financial Services Committee
U.S. House of Representatives
2463 RHOB
Washington, D.C. 20515

Dear Representative Hinojosa:

Congress gave financial institutions the right to decide which charter – commercial, savings, or mutual savings bank, among others – best serves their customers. Choice of charter creates a healthy dynamic, resulting in a wider range of products and services available to consumers, lower regulatory costs, and more effective supervision. This makes it all the more puzzling why the National Credit Union Administration (NCUA) is making it laboriously impractical, if not impossible, for credit unions to exercise choice of charter.

Currently, two large state-chartered credit unions in Texas[1] are in the process of trying to convert to mutual savings bank charters. The Office of Thrift Supervision (OTS) and the Texas Credit Union Department have already approved their applications. Federally mandated disclosures were mailed to each credit union's membership.

But after the voting commenced, NCUA decided to invalidate the results, in advance, saying it objected to ***how the mandatory disclosure paper had been folded*** in mailings to members. NCUA's objection contradicted reviews by OTS and Texas State Credit Union Supervisor Harold Feeney, who stated, "Nothing in either our rules or those of the NCUA dictates how a document should be folded."

On the surface, NCUA's blocking action may simply appear as regulatory nit-picking. But, unfortunately, it is the latest example of NCUA discouraging credit unions from exercising their rights under the Credit Union Membership Access Act, which explicitly permits all credit unions to choose their charter. Congress also requires that NCUA "freely and fairly" permit credit unions to convert their charter to a mutual savings bank with adequate disclosures.[2] To the detriment of credit union members, NCUA has used this statutory language to promulgate rules that would create significant barriers to choice of charter.

NCUA's actions fly in the face of congressional intent and serve to frustrate efforts of credit union members to act to change their charter. For this reason, and to preserve the important principle of charter choice, ABA encourages Congress to

[1] OmniAmerican CU, Fort Worth, TX; Community CU, Plano, TX.
[2] House Report No. 472 (1998), p. 21.

exercise its oversight jurisdiction to scrutinize NCUA's handling of credit unions that seek to exercise their right to convert to other financial institution charters.

Sincerely,

Edward L. Yingling
President and CEO

America's Community Bankers *Shaping Our Future*

June 8, 2005

The Honorable Michael Oxley
House Financial Services Committee
U.S. House of Representatives
2308 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Oxley:

The notion of charter choice is a fundamental tenant of our financial system. That is, all institutions should be able to select the charter under which they operate. However, the National Credit Union Administration (NCUA) has gone to extremes to ensure that credit unions cannot fully exercise their right to self-determination. Therefore, we respectfully request Congress to scrutinize the NCUA's recent policy and regulations regarding the conversion of credit unions to mutual savings banks.

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. For example, 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 were not properly folded.

Texas Credit Union Commissioner Harold Feeney disagreed with the NCUA's assessment, pointing out that no state or federal regulation dictates how the required disclosure materials should be folded.

It is unreasonable for any regulator to interfere with an entity's strategic, business decision based on how a piece of paper is folded. This is just the latest example of the NCUA exceeding its statutory authority to regulate credit union conversions. We further request that Congress ensure that credit unions' charter options are preserved.

Sincerely,

Robert R. Davis
Executive Vice President and
Managing Director, Government Relations

cc: The Honorable Barney Frank, Ranking Member
Members of the House Financial Services Committee

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Opening Statement
Rep. Ed Royce (CA-40)
9 June 2005
Financial Services Regulatory Relief: The Regulators' Views

Mr. Chairman, thank you for holding this hearing to address the issue of regulatory relief for the financial services industry -- relief that I believe is constructive and necessary. I support the efforts of this Subcommittee to reduce unwarranted statutory burdens placed on our nation's financial institutions.

One month ago Rep. Paul Kanjorski and I introduced H.R. 2317, the Credit Union Regulatory Improvements Act or "CURIA," which is an updated version of legislation we first offered in the 108th Congress. As of today, I am pleased that we have gained the support of 47 cosponsors from members of both parties.

CURIA in the 109th Congress contains significant modifications regarding the applicable prompt corrective action (PCA) standards and net worth requirements for credit unions. The most important changes replace the capital reform language contained in Title III of H.R. 3579 with the more comprehensive and robust capital provisions incorporated into Title I of the new CURIA. Title I of the new CURIA now contains the PCA capital reforms recently recommended by the National Credit Union Administration (NCUA), which oversees federally chartered credit unions and administers the National Credit Union Share Insurance Fund. The new PCA provisions in CURIA are modeled after FDIC capital standards applicable to banks and thrifts.

I would like to thank all of the distinguished witnesses today for their testimony. I would especially like to thank the NCUA and Chairman Johnson for the NCUA's recent letter in support of CURIA. I would just ask that as this Committee addresses regulatory relief provisions for financial institutions, I hope that the Chairman and other members strongly consider the needed reforms Mr. Kanjorski and I have put forward for credit unions.

I yield back.

TESTIMONY OF

RANDALL JAMES

TEXAS COMMISSIONER OF BANKING

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

before the

FINANCIAL SERVICES SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

UNITED STATES HOUSE OF REPRESENTATIVES

June 9, 2005

Good morning, Chairman Bachus, Representative Sanders and members of the Subcommittee. I am Randall S. James, Texas Banking Commissioner, 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.

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 Bachus, 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 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 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. 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 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 -- probably wide and fuzzy, and not sharp and clear 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 as important to small business as state-chartered banks.

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% of all employers, produces 13 times more patents per employee than large firms, generates 60 to 80% of new jobs, and employs 50% of the private sector. Small businesses must be served, and community banks are the primary source of that service. 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 the economic engine of small business in the U.S. 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 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 because they are not experiencing the kinds of problems these new requirements are trying to address.

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 onsite 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 three years, representing the new importance of financial information to our national security. Industry representatives, however, estimate that CTRs 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 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 six 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.

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.

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, which 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 (LLCs). 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 LLCs are eligible for federal deposit insurance if they meet established criteria designed to insure safety and soundness and limit risk to the deposit insurance fund.

Only a handful of states now allow banks to organize as LLCs, 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, with greater flexibility. Unlike Subchapter S corporations, LLCs 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 LLCs. An Internal Revenue Service regulation currently blocks pass-through tax treatment for state-chartered banks. We ask the Committee to encourage the IRS to reconsider its interpretation of the tax treatment of state-chartered LLCs.

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% of the nation's banks, and thus are vitally concerned with changes in federal regulatory policy and procedures.

Extended Examination Cycles for Well-Managed Banks under $1 Billion

We believe that advances in offsite monitoring techniques and technology, and the health of the banking industry, make annual onsite 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.

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 U.S. 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 with 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.

<u>**Challenges to Regulatory Burden Relief**</u>

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, 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 subcommittee, the regulatory environment for our nation's banks has improved significantly over the past ten 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. Your own efforts in this area, Chairman Bachus, 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, and the members of this subcommittee 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 subcommittee might have.

For release on delivery

STATEMENT

OF

THE HONORABLE JOANN M. JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"FINANCIAL SERVICES REGULATORY RELIEF: THE REGULATORS VIEWS"

BEFORE THE

SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 9, 2005

Chairman Bachus, Representative Sanders, and Members of the Subcommittee: 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

The Subcommittee on Financial Institutions and Consumer Credit has been taking the lead over the last several years in many areas of interest to consumers, financial institutions such as credit unions and their members. Legislation of the type being considered today epitomizes the real connection between, and benefits of, effective financial institutions efficiently delivering consumer credit to the public.

In July of 2004 I testified in favor of the credit union provisions included in the "Financial Institutions Regulatory Relief Act of 2004," (H.R. 1375), approved by the Financial Services Committee and passed by the House of Representatives by a vote of 392-25. That legislation was a significant bipartisan achievement that NCUA greatly appreciated and enthusiastically supported as it moved through the House of Representatives. They have merited your support in the past and NCUA supports inclusion of those credit union provisions in any new legislation that is introduced this year.

The recent introduction of the "Credit Union Regulatory Improvements Act of 2005," H.R. 2317 (CURIA), by Representatives Royce, Kanjorski, Sanders, LaTourette, Maloney, Gutierrez and Paul from the House Financial Services Committee to name a few, addresses some of the most compelling statutory and consequently, regulatory reform issues being discussed within the credit union industry today. HR 2317 also includes many of the same credit union provisions approved in H.R. 1375 last Congress. On May 25, 2005 NCUA provided a response and letter of support for CURIA which is included with this testimony.

CURIA of 2003 made the suggestion that NCUA should be authorized to design and implement a risk based prompt corrective system for federally insured credit unions. Without more details, policy makers and credit unions could not make an accurate assessment of the proposal, so NCUA went to work to demonstrate how such a system could be implemented. Title I of CURIA of 2005 now includes the necessary statutory changes required. I have provided the complete plan as an attachment to this testimony and would like to briefly discuss it here.

Prompt Corrective Action Reforms

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 (i.e., 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% for FDIC-insured institutions. 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% 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 evidenced 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% 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% 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.

We recognize, however, 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 is 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. 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. 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). Without this important change, 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 federally 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. Thus, our reform proposal provides for a revised definition of net worth to include any amounts that were previously retained earnings of any other credit union.

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.

PROVISIONS FOR REGULATORY REFORM SUGGESTED BY NCUA AND PREVIOUSLY APPROVED BY THE HOUSE OF REPRESENTATIVES

Check Cashing, Wire Transfer and Other Money Transfer Services

The Federal Credit Union Act authorizes federal credit unions to provide check cashing and money transfer services to members (12 USC 1757(12)). To reach the "unbanked," federal credit unions should be authorized to provide these services to anyone eligible to become a member. This is particularly important to federal credit unions in furthering their efforts to serve those of limited income or means in their field of membership. These individuals, in many instances, do not have mainstream financial services available to them and are often forced to pay excessive fees for check cashing, wire transfer and other services. Allowing federal credit unions to provide these limited services to anyone in their field of membership would provide a lower-fee alternative for these individuals and encourage them to trust conventional financial organizations. Representative Gerlach introduced this provision as H.R. 749 in the 109th Congress and it has been passed by the House of Representatives on April 26, 2005.

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

Increase One Percent Investment Limit in CUSOs to Three Percent
The Federal Credit Union Act authorizes federal credit unions to invest in organizations providing services to credit unions and credit union members. An individual federal credit union, however, may invest in aggregate no more than one percent of its shares and undivided earnings in these organizations (12 USC 1757(7)(I)). These organizations, commonly known as credit union service organizations or "CUSOs," provide important services. Examples are data processing and check clearing for credit unions, as well as services such as estate planning and financial planning for credit union members. When these services are provided through a CUSO, any financial risks are isolated from the credit union, yet the credit unions that invest in the CUSO retain control over the quality of services offered and the prices paid by the credit unions or their members. The one percent aggregate investment limit is unrealistically low and forces credit unions to either bring services in-house, thus potentially increasing risk to the credit union and the NCUSIF, or turn to outside providers and lose control. The one percent limit should be eliminated and the NCUA Board should be allowed to set a limit by regulation. Increasing the CUSO investment limit from 1 percent to 3 percent, is an improvement over the current limit, and NCUA supports the change.

Expanded Investment Options
The Federal Credit Union Act limits the investment authority of federal credit unions to loans, government securities, deposits in other financial institutions and certain other very limited investments (12 USC 1757(7)). This limited investment authority restricts the ability of federal credit unions to remain competitive in the rapidly changing financial marketplace. The Act should be amended to provide such additional investment authority as approved by regulation of the NCUA Board. This would enable the Board to approve additional safe and sound investments of a conservative nature which have a proven track record with state

chartered credit unions or other financial institutions. As drafted last Congress, the provision appropriately addresses the issues NCUA has presented in our recommendation, limits additional investment to corporate debt securities (as opposed to equity) and further establishes specific percentage limitations and investment grade standards.

Voluntary Merger Authority

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

Regulatory Relief from SEC Registration Requirements

NCUA is seeking a provision to provide regulatory relief from the requirement that credit unions register with the Securities and Exchange Commission as broker-dealers when engaging in certain de minimus securities activities.
The Gramm Leach Bliley Act, enacted in 1999, created exemptions from the broker-dealer registration requirements of the Securities and Exchange Act of 1934 for certain bank securities activities. Banks are also exempt from the registration and other requirements of the Investment Advisers Act of 1940. The principle established by these exemptions is that securities activities of an incidental nature to the bank do not have to be placed into a separate affiliate. The provision would provide similar exemptions for federally insured credit unions. NCUA supports these exemptions. Because of significant differences between broker-dealer capital requirements and depository institution capital requirements, it is virtually impossible for depository institutions, including credit unions, to register as a broker-dealer and submit to broker-dealer requirements. Without an exemption credit unions may find that although they are authorized under their chartering statutes to engage in particular securities-related activities, their inability to register as a broker-dealer would keep them from engaging in these activities. Recently, the Securities and Exchange Commission proposed a rule that would exempt credit unions from the definition of broker and dealer for a few of the activities exempted for banks under Gramm Leach Bliley, including third party brokerage arrangements and sweep account arrangements. NCUA supports the SEC proposal. We believe, however, that the SEC's proposal does not go far enough, and we continue to support legislative relief. The relief sought for credit unions would be more limited in scope and application than that which is available to banks and requested by thrifts. Credit union powers are limited by

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

Technical Corrections to the Federal Credit Union Act

Included and approved in H.R. 1375 last Congress, these provisions are purely drafting, numerical and incorrect references without any policy impact that need to be made to the Federal Credit Union Act.

ADDITIONAL CREDIT UNION PROVISIONS

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

NCUA has reviewed all of these additional credit union provisions and the agency has no safety and soundness concerns with these provisions. Among these are provisions which address leases of land on Federal facilities for credit unions; member business loans for non-profit religious organizations; criteria for continued membership of certain member groups in community charter conversions; credit union governance changes; revising the economic factors the NCUA Board must use when considering adjustments to the statutory 15% interest rate that can be charged by federal credit unions on loans; and an exemption from pre-merger notification requirements of the Clayton Act.

Conclusion

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 any additional information you may require.

National Credit Union Administration

Office of the Chairman

May 23, 2005

The Honorable Edward R. Royce
The Honorable Paul E. Kanjorski
United States House of Representatives
Washington, D.C. 20015

Dear Representatives Royce and Kanjorski:

Thank you for your May 18, 2005 letter requesting the views of the National Credit Union Administration (NCUA) on H.R. 2317, the Credit Union Regulatory Improvements Act of 2005 ("CURIA").

CURIA addresses several important areas impacting the 8,945 federally insured credit unions operating in this nation. In particular, CURIA's reforms of standards for capital, member business lending, credit union governance, and other regulatory modernization provisions will enable credit unions to remain competitive in the 21st century and better serve their members.

NCUA has reviewed the details of H.R. 2317 and NCUA can recommend and support the legislation. Where provisions impact NCUA, they are helpful to the agency in our supervisory role. Where they impact the operations of an insured credit union, they do so without adding undue risk to the share insurance fund.

Title I: Capital Reforms

Reform of capital standards is currently the most important legislative issue facing credit unions. A system of prompt corrective action (PCA) for federally insured institutions is good public policy and strongly supported by NCUA. However, the current PCA system for credit unions is too inflexible and, given the high leverage requirement, burdensome and not sufficiently risk based.

Setting PCA capital standards for credit unions at comparable levels for FDIC-insured institutions will ensure low-risk credit unions do not have to maintain the "excess" net worth they presently do. Further, this will facilitate application of meaningful risk-based capital standards to all credit unions, more closely relating capital levels to the risk profiles of each specific institution. The tandem leverage and risk-based net worth requirements of Title I of HR 2317 achieves this much needed capital reform while providing adequate safety and soundness safeguards. Also, it preserves net worth in mergers of two healthy credit unions given changes in generally accepted accounting standards for business combinations.

The risk-based prompt correction action provisions of Title I, combined with the use of a minimum leverage ratio as provided, maintains insured credit union comparability with the regulatory capital regime of other federally insured financial institutions. The construction of Title I of H.R. 2317 enables the NCUA Board to incorporate the relevant aspects of BASEL II's standard approach, or any derivations adopted for FDIC insured institutions, into the design of the risk-based net worth requirement for credit unions.

Title II: Economic Growth

The provisions included in this title all relate to allowing insured credit unions to better serve their members by alleviating, but not eliminating, current law limits on member business loans. Since its inception in 1934, the Federal Credit Union Act anticipated that credit unions should be granting business loans to their members as part of their traditional mission and purpose. It was only in 1998 that Congress limited the ability of federal and state chartered credit unions to offer member business loans if they are federally insured. NCUA has testified on several occasions that the agency has not seen any undue risk in this line of lending, before or after the limits were added, that cannot be prudently managed by the industry and NCUA. Therefore NCUA supports these provisions that seek to restore some authority for member business lending curtailed in 1998.

Title III: Regulatory Modernization

The provisions of this title have been previously approved by the House Financial Services Committee and the U.S. House of Representatives. NCUA has recommended some of them and NCUA has testified that all of them pose no safety or soundness concerns to the agency.

Sincerely,

JoAnn Johnson

JoAnn Johnson
Chairman

For release on delivery
10:00 a.m. EDT
June 9, 2005

Statement of

Donald L. Kohn

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

House of Representatives

June 9, 2005

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to testify on issues related to regulatory relief. 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 Oxley's request, the Board provided the Committee with a number of legislative proposals that we believe are consistent with this goal, 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 those that would provide the most meaningful regulatory relief.

For its part, the Board strives to review each of our regulations at least once every five 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 ten 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 ten-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 five 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, Reserve Requirements and Interest on Demand Deposits

I am pleased to note that some of the Board's most important regulatory relief suggestions--including those authorizing the Federal Reserve to pay interest on balances held by depository institutions at Reserve Banks, enhancing the Board's flexibility to set reserve requirements, and permitting depository institutions to pay interest on demand deposits--recently were passed by the House as part of H.R. 1224, the Business Checking Freedom Act of 2005. Let me briefly explain why the Board supports passage of these amendments, either in a stand-alone bill or as part of a broader regulatory relief bill. I will also discuss a little later why the Board does not support those aspects of H.R. 1224 that would, for the first time, authorize industrial loan companies that operate outside the supervisory framework established for other insured banks to offer interest-bearing transaction accounts to business customers.

For the purpose of implementing monetary policy, the Board is obliged by law to establish reserve requirements on certain deposits held at depository institutions. 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. H.R. 1224 would allow the Federal Reserve to pay depository institutions interest on their required reserve balances, which would remove a substantial portion of the incentive for depositories to engage in reserve avoidance measures. 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. H.R. 1224 would authorize the Federal Reserve to pay explicit interest on these balances as well. This authority would enhance the Federal Reserve's toolkit for efficiently conducting monetary policy.

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 could consider using the authority granted in H.R. 1224 to reduce--or even eliminate--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 Board also strongly supports the provisions of H.R. 1224 that would repeal the statutory restrictions that currently prohibit depository institutions from paying interest on demand deposits. 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.

H.R. 1224 contains a provision that is intended to address the potential federal budgetary impact of this proposal by requiring the Reserve Banks to transfer some of their capital surplus to the Treasury to cover the budgetary costs of paying interest on required reserves through 2009. As the Board has consistently pointed out, these transfers would not provide any true offsets to budgetary costs. Although these transfers would allow the Treasury to issue fewer securities, the Federal Reserve would need to lower its holdings of Treasury securities by the same amount to make the required transfers. Thus, the level of Treasury debt held by the public sector would be unchanged, and the Treasury's interest payments, net of receipts from the Federal Reserve, would be unaffected.

De Novo Interstate Branching

The Board has proposed an amendment that would remove outdated barriers to de novo interstate branching by banks. Since enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal Act), all fifty states have permitted banks to expand on an interstate basis through the acquisition of an existing bank in their state. Interstate banking is not only good for banks, it is good for consumers and the economy. While the number of banks has fallen in recent years, the number of branches has risen sharply to more than 71,000 in 2004 compared with approximately 50,000 in 1990. More than 2,000 branches were opened by banks in 2004 alone. The creation of new branches helps maintain the competitiveness and dynamism of the American banking industry and improve access to banking services in otherwise under-served markets. It results in better banking services for households and small businesses, lower interest rates on loans, and higher interest rates on deposits. Interstate branching also increases convenience for customers who live, work, and operate across state borders.

However, the Riegle-Neal Act permitted banks to open a branch in a new state *without* acquiring another bank only if the host state enacted legislation that expressly permits entry by de novo branching (an opt-in requirement). To date, twenty-one states and the District of Columbia have enacted some form of opt-in legislation, while twenty-nine states continue to require interstate entry through the acquisition of an existing bank.

This limitation on de novo branching is an obstacle to interstate entry for all banks and also creates special problems for small banks seeking to operate across state lines. Moreover, it creates an unlevel playing field between banks and federal savings associations, which have long been allowed to establish de novo branches on an interstate basis.

The Board's proposed amendment would remove this last obstacle to full interstate branching for banks and level the playing field between banks and thrifts. The amendment also would remove the parallel provision that allows states to impose a minimum requirement on the age of banks that are acquired by an out-of-state banking organization. These changes would allow banks, including in particular small banks near state borders, to better serve their customers by establishing new interstate branches and acquiring newly chartered banks across state lines. It also would increase competition by providing banks a less costly method for offering their services at new locations. The establishment and operation of any new interstate branches would continue to be subject to the other regulatory provisions and conditions established by Congress for de novo interstate branches, including the financial, managerial, and community reinvestment requirements set forth in the Riegle-Neal Act.

Small Bank Examination Flexibility

Another amendment that the Board has supported 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 twelve 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 eighteen-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 eighteen-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 eighteen-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 eighteen-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 twelve or eighteen 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.

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 and allowing banks to branch de novo across state lines. The Board, however, opposes proposals that would allow industrial loan companies (ILCs) to offer business NOW accounts, as H.R. 1224 does, or open de novo branches nationwide 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.

ILCs are state-chartered FDIC-insured banks that were first established early in the twentieth century to make small loans to industrial workers. As insured banks, ILCs 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 ILCs was initially granted in 1987, ILCs 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 ILCs 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 ILCs to exercise many of the same powers as commercial banks and have begun to charter new ILCs. Today, several ILCs are owned by large, internationally active financial or commercial firms. In addition, a number of ILCs themselves have grown large, with one holding more than $50 billion in deposits and an additional eight holding more than $1 billion in deposits.

Affirmatively granting ILCs the ability to offer business NOW accounts and open de novo branches across state lines would permit ILCs to become the functional equivalent of full-service insured banks and operate across the United States. This result would be inconsistent with both the historical functions of ILCs and the terms of their special exemption in current law.

Because the parent companies of exempt ILCs are not subject to the BHC Act, authorizing ILCs 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 ILCs 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. While H.R. 1224 attempts to address concerns related to mixing banking and commerce by placing certain limits on the types of ILCs that could offer business NOW accounts, the limits in H.R. 1224 do not adequately address this issue. For example, H.R. 1224 would allow *any* ILC that received FDIC insurance before October 1, 2003, or had an application for deposit insurance pending on that date, to offer NOW accounts to business customers so long as the institution does not experience a change in control. Thus, the bill would allow the commercial and retail firms that acquired an ILC before October 1, 2003, to transform the institution into the functional equivalent of a full-service insured bank. The bill also would allow any ILC that was established or acquired *after* October 1, 2003, to offer business NOW accounts so long as the ILC's appropriate state supervisor determined that the companies controlling the ILC derived at least 85 percent of their annual gross revenues from activities that are "financial in nature or incidental to a financial activity."

Importantly, the bill does *not* define these terms by reference to the GLB Act or otherwise establish any standards for a state authority to use in determining what activities are "financial in nature or incidental to a financial activity." Instead, the bill leaves this important determination--which has the potential to undermine the nation's longstanding policy of maintaining the separation of banking and commerce--to the discretion of the ILC's state supervisor. Moreover, unlike the grandfather provisions of the GLB Act on which the ILC provisions of the bill purportedly are based (*see* 12 U.S.C. § 1843(n)), H.R. 1224 would not require a company that acquires an ILC after October 1, 2003, to divest its non-financial, commercial activities within a specified period of time.

The limits contained in H.R. 1224 also do not address the other risks and issues presented by ILCs. For example, the bill fails to address the supervisory issues associated with allowing domestic firms or foreign banks that are not subject to consolidated supervision to own and control the functional equivalent of a full-service insured bank.

Let me be clear. The Board does not oppose granting ILCs the ability to offer business NOW accounts or open de novo branches if the corporate owners of ILCs 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 ILCs 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.

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 or de novo branching 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 Subcommittee, the full Committee, and their staffs as you move forward in developing and considering regulatory relief legislation.

Appendix to Statement of
Donald L. Kohn
Member
Board of Governors of the Federal Reserve System
June 9, 2005

Regulatory Relief Proposals Supported by the
Board of Governors of the Federal Reserve System[1]

1. **Authorize the Federal Reserve to pay interest on balances held at Reserve Banks***

    Amendment gives the Federal Reserve explicit authority to pay interest on balances held by depository institutions at the Federal Reserve Banks.

2. **Grant the Board additional flexibility in establishing reserve requirements***

    Amendment provides the Federal Reserve with greater flexibility to set the ratio of reserves that a depository institution must maintain against its transaction accounts below the current ranges established by the Monetary Control Act of 1980.

3. **Authorize depository institutions to pay interest on demand deposits***

    Amendment repeals the provisions in current law that prohibit depository institutions from paying interest on demand deposits. If adopted, the amendment would allow all depository institutions that have the authority to offer demand deposits to pay interest on those deposits.

4. **Ease restrictions on interstate branching and mergers in a competitively equitable manner**

    Amendment affirmatively authorizes national and state banks to open de novo branches on an interstate basis. Currently, banks may establish de novo branches in a new state only if the state has affirmatively authorized de novo branching. This existing limitation places banks at a disadvantage to federal savings associations, which currently have the ability to branch de novo on an interstate basis. The amendment also would remove a parallel provision that allows states to impose a minimum requirement on the age of banks that are acquired by an out-of-state banking organization.

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[1] Items identified with an asterisk (*) were included in H.R. 1375, the Financial Services Regulatory Relief Act of 2004, as passed by the House of Representatives.

The amendment would not allow industrial loan companies (ILCs) that operate under a special exemption in federal law from opening de novo branches on a nationwide basis. The corporate owners of these ILCs are not subject to the type of consolidated supervision and activities restrictions that generally apply to the corporate owners of other banks insured by the Federal Deposit Insurance Corporation (FDIC). Granting exempt ILCs nationwide branching rights also would be inconsistent with the terms of their special exemption in federal law.

5. Small Bank Examination Flexibility

Amendment would expand the number of small institutions that may qualify for an eighteen-month (rather than a twelve-month) examination cycle. Under current law, an insured depository institution must have $250 million or less in total assets to qualify for an eighteen-month examination cycle. *See* 12 U.S.C. § 1820(d). The amendment would raise this asset cap to $500 million, thereby potentially allowing approximately an additional 1,100 institutions to qualify for an extended examination cycle.

6. Permit the Board to grant exceptions to the attribution rule concerning shares held by a trust for the benefit of a bank holding company or its shareholders or employees*

The amendment would allow the Board, in appropriate circumstances, to waive the attribution rule in section 2(g)(2) of the Bank Holding Company Act (BHC Act). This attribution rule currently provides that, for purposes of the BHC Act, a company is deemed in all circumstances to own or control any shares that are held by a trust (such as an employee benefit plan) for the benefit of the company or its shareholders or employees. The amendment would allow the Board to waive the rule when, for example, the shares in question are held by a 401(k) plan that is widely held by the bank holding company's employees and the bank holding company does not have the ability to control the shares held by the plan.

7. Modification of the cross-marketing restrictions applicable to merchant banking and insurance company investments*

Amendment allows the depository institution subsidiaries of a financial holding company to engage in cross-marketing activities with portfolio companies that are held under the merchant banking authority in the Gramm-Leach-Bliley Act (GLB Act) to the same extent as such activities are currently permissible for portfolio companies held under the GLB Act's insurance company investment authority. The amendment also would allow the depository institution subsidiaries of a financial holding company to engage in cross-marketing activities with a portfolio company held under either the merchant banking or insurance company investment authority if the financial holding company does not control the portfolio company.

8. Allow insured banks to engage in interstate merger transactions with savings associations and trust companies*

The amendment would allow an insured bank to directly acquire, by merger, an insured savings association or uninsured trust company in a different home state without first converting the target savings association or trust company into an insured bank. As under current law, the insured bank would have to be the survivor of the merger.

9. Authorize member banks to use pass-through reserve accounts*

Amendment permits banks that are members of the Federal Reserve System to count as reserves the deposits in other banks that are "passed through" by those banks to the Federal Reserve as required reserve balances. Nonmember banks already are able to use such pass-through reserve accounts.

10. Shorten the post-approval waiting period for bank mergers and acquisitions where the relevant banking agency and the Attorney General agree the transaction will not have adverse competitive effects

Amendment allows the responsible federal banking agency, with the concurrence of the Attorney General, to reduce the post-approval waiting periods under the Bank Merger Act and BHC Act from fifteen days to as few as five days. The amendment would *not* alter the time period that a private party has to challenge a banking agency's approval of a transaction for reasons related to the Community Reinvestment Act.

11. Eliminate requirement that the reviewing agency request a competitive factors report from the other banking agencies in Bank Merger Act transactions*

Amendment would eliminate the requirement that the reviewing agency request a competitive factors report from the other banking agencies on Bank Merger Act transactions. The reviewing agency would, however, continue to be required to (i) conduct a competitive analysis of the proposed merger, and (ii) request a competitive factors report from the Attorney General and provide a copy of this request to the FDIC (when the FDIC is not the reviewing agency).

12. Streamline Bank Merger Act procedural requirements for transactions involving entities that are already under common control

The amendment eliminates the need for the reviewing agency for a bank merger involving affiliated entities to request a report on the competitive factors associated with the transaction from the other banking agencies and the Attorney General. The amendment also would eliminate the post-approval waiting period for Bank Merger Act transactions involving affiliated entities. The merger of depository institutions that already are under common control typically does not have any impact on competition.

13. a. Restore Board's authority to determine that new activities are "closely related to banking" and permissible for all bank holding companies

Amendment would restore the Board's ability to determine that nonbanking activities are "closely related to banking" under section 4(c)(8) of the BHC Act and, thus, permissible for all bank holding companies, including those that have not elected to become financial holding companies. Bank holding companies would still have to become a financial holding company to engage in the types of expanded activities authorized by the GLB Act--including full-scope securities underwriting, insurance underwriting, and merchant banking activities--as well as any new activities that the Board determines are financial in nature or incidental or complementary to financial activities under the GLB Act.

b. Allow bank holding companies to engage in insurance agency activities (Alternative to Item 13.a.)

Alternative amendment would allow all bank holding companies, including those that have not elected to become financial holding companies, to act as *agent* in the sale of insurance. Currently, bank holding companies that do not become a financial holding company may engage only in very limited insurance sales activities (primarily involving credit-related insurance). However, most *banks* are permitted to sell any type of insurance, either directly or through a subsidiary. The amendment would rectify this imbalance by permitting all bank holding companies to act as agent in the sale of insurance. Insurance agency activities involve less risk than insurance underwriting and other principal activities. Bank holding companies would continue to be required to become a financial holding company to engage in insurance underwriting activities.

14. Repeal certain reporting requirements imposed on the insiders of insured depository institutions*

Amendment repeals the provisions of current law that require: (i) an executive officer of a bank to file a report with the bank's board of directors concerning the officer's indebtedness to other banks; (ii) a member bank to file a separate report each quarter concerning any loans made to its executive officers during the quarter; and (iii) executive officers and principal shareholders of a bank to report to the bank's board of directors any loans received from a correspondent bank. The Board has found that these reporting requirements do not contribute significantly to the monitoring of insider lending. These amendments would not alter the statutory limits or conditions imposed on loans by bank to their insiders.

15. Provide an adjustment for the small depository institutions exception under the Depository Institution Management Interlocks Act (DIMIA)*

Currently, the DIMIA generally prohibits a management official of one institution from serving as a management official of any other non-affiliated depository institution or depository institution holding company if the institutions or an affiliate of such institutions have offices that are located in the same metropolitan statistical area. The statute provides an exception from this restriction for institutions that have less than $20 million in assets, but this dollar figure has not been updated since 1978. The amendment would increase this amount to $200 million.

16. Flood insurance amendments

These amendments would:

(a) Allow lenders to rely on information from licensed surveyors to determine whether a property is in a flood zone, if the flood map is more than ten years old;

(b) Increase the "small loan" exception to the flood insurance requirements from $5,000 to $20,000 and adjust this amount periodically based on changes in the Consumer Price Index;

(c) Reduce the forty-five-day waiting period required after policy expiration before a lender can "force place" flood insurance by fifteen days to coincide with the thirty-day grace period during which flood insurance coverage continues after policy expiration, which would better enable lenders to avoid gaps in coverage on the relevant collateral; and

(d) Give the federal banking agencies discretion to impose civil money penalties on institutions found to have engaged in a pattern or practice of violating the flood insurance requirements.

17. Periodic interagency review of Call Reports

Amendment requires that the federal banking agencies jointly review the Call Report forms at least once every five years to determine if some of the information required by the reports may be eliminated. The federal banking agencies would retain their current authority to determine what information must be included in the Call Reports filed by the institutions under their primary supervision.

18. Ensure protection of confidential information received from foreign supervisory authorities*

Amendment ensures that a federal banking agency may keep confidential information received from a foreign regulatory or supervisory authority if public disclosure of the information would violate the laws of the foreign country, and the banking agency obtained the information in connection with the administration and enforcement of federal banking laws or under a memorandum of understanding between the authority and the agency. The amendment would not authorize an agency to withhold information from Congress or in response to a court order in an action brought by the United States or the agency.

19. Restricting the ability of convicted individuals to participate in the affairs of a bank holding company or Edge Act or agreement corporation

Amendment would prohibit a person convicted of a criminal offense involving dishonesty, breach of trust, or money laundering from participating in the affairs of a bank holding company (other than a foreign bank) or an Edge Act or agreement corporation without the consent of the Board. The amendment also would provide the Board with greater discretion to prevent convicted individuals from participating in the affairs of a nonbank subsidiary of a bank holding company.

20. Clarify application of section 8(i) of the Federal Deposit Insurance Act*

Amendment clarifies that a federal banking agency may take enforcement action against a person for conduct that occurred during his or her affiliation with a banking organization even if the person resigns from the organization, regardless of whether the enforcement action is initiated through a notice or an order.

NASCUS
An Umbrella Organization

National Association of State Credit Union Supervisors
NASCUS Credit Union Council
NASCUS Foundation for the Preservation of Dual Chartering
National Institute for State Credit Union Examination

Testimony of George Latham
Deputy Commissioner of Financial Institutions
Virginia Bureau of Financial Institutions
On behalf of the
National Association of State Credit Union Supervisors
Before the Subcommittee
on Financial Institutions and Consumer Credit
United States House of Representatives
June 9, 2005

NASCUS History and Purpose

Good morning, Chairman Bachus, and distinguished members of the Subcommittee. I am George Latham, Deputy Commissioner of Financial Institutions for the Bureau of Financial Institutions for the state of Virginia. I appear today on behalf of the National Association of State Credit Union Supervisors. NASCUS represents the 48 state and territorial credit union supervisors and is advised by the NASCUS Advisory Credit Union Council, composed of more than 600 state-chartered credit unions dedicated to defending the dual chartering system for credit unions.

The mission of the National Association of State Credit Union Supervisors (NASCUS) is to enhance state credit union supervision and regulation and advocate policies to ensure a safe and sound state credit union system. We achieve those goals by serving as an advocate for a dual chartering system that recognizes the traditional and essential role that state government plays as a part of the national system of depository financial institutions.

NASCUS applauds the Subcommittee's continued commitment to providing ongoing regulatory relief, ensuring a safe and sound environment for credit unions and the consumers they serve. We appreciate the opportunity to share our legislative priorities for regulatory relief to help alleviate the regulatory burden for state-chartered credit unions, while ensuring a safe and sound state credit union system.

NASCUS Priorities for Regulatory Relief

NASCUS priorities for regulatory relief legislation focus on the reforms that will strengthen the state system of credit union supervision and enhance the capabilities of state-chartered credit unions. The ultimate goal is to meet the

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financial needs of consumer members while assuring that the state system is operating in a safe and sound manner.

In this testimony, I will address the following regulatory relief issues vital to credit unions:

- capital reform including amending the current Prompt Corrective Action (PCA) provision for credit unions, risk-based capital reform and amending the definition of net worth to include the retained earnings of a merging credit union when calculating net worth;
- member business lending, expanding the lending provision and amending the definition of a member business loan;
- regulatory modernization that provides parity for credit unions with other financial institutions;
- allowing non-federally insured credit unions to join the FHLBs;
- preservation of the dual chartering system and protection against the preemption of state laws.

Capital Reform

Capital reform continues to be a critical concern for the nation's credit unions. We believe three areas of capital reform need to be addressed to provide a safer capital system for credit unions.

NASCUS strongly urges the Subcommittee to amend the Prompt Corrective Action (PCA) provision of the Federal Credit Union Act (FCUA) to obligate federally insured credit unions to include all forms of capital when calculating the required net worth ratio. Under the current federal statute, credit union net worth is defined as and limited to retained earnings. The exclusive reliance on retained earnings limits a credit union's ability to implement new programs or expand services to meet the changing needs of American consumers in its membership. The failure to obligate these credit unions to include all forms of capital in their PCA net worth calculation distorts the credit union's actual financial position. More importantly, amending the definition of net worth cures the unintended consequences for credit unions of the Financial Accounting Standards Board (FASB) business combination accounting rules. FASB's Financial Accounting Standard No. 141 requires the acquisition method for business combinations and effectively eliminates the pooling method for the combinations of mutual enterprises. Chairman Bachus and members of the Subcommittee, NASCUS applauds the introduction H.R. 1042, which amends the definition of net worth to include the net retained earnings of a merging credit union with that of the surviving credit union. We recognize and appreciate that a similar provision was introduced in H.R. 2317, the Credit Union Regulatory Improvement Act, commonly called CURIA.

In short, as NASCUS testified before this Subcommittee in April, 2005, the acquisition accounting method would require the valuation of the target credit union at fair value, the recognition of identifiable intangibles (i.e., core deposit intangibles and/or goodwill), when relevant, and the application of a market-based acquisition model to a non-bargained transaction. The retained earnings of the merging institution would no longer be combined with those of the continuing credit union, creating a potentially significant dilution of statutory net worth and an unintended impediment to credit union mergers. Mergers are a safety and soundness tool regulators use to protect funds deposited by American consumers and to preserve the National Credit Union Share Insurance Fund.

If a credit union cannot be merged due to PCA concerns caused by the inability to add the capital of the merged credit union, then credit unions in a weakened condition might face liquidation. There may also be more requests for NCUA to provide financial assistance in merger transactions. An increase in liquidations may cause greater reputation risk, severe loss of confidence for the credit union industry, greater losses to the deposit insurance fund and increased costs to the industry and ultimately to consumers. This scenario spells disaster for credit unions. NASCUS supports both H.R. 1042 and Section 104 in H.R. 2317.

Risk-Based Capital

NASCUS endorses and has a long-standing policy supporting risk-based capital for credit unions. Risk-weighted capital reform should be flexible. NASCUS believes that any new regulations should be progressive and not designed to regulate to the lowest common denominator.

We believe risk-based capital is a sound and logical approach to capital reform for credit unions. We support a risk-based capital plan, such as presented in Title I of H.R. 2317, and believe additional enhancements would provide for a stronger bill, with even greater safety and soundness for credit unions. We further believe that alternative capital authority and a risk-based system are complementary capital reforms.

Alternative Capital Authority for Credit Unions

We support capital reform beyond the risk-weighted capital and FASB merger fix. NASCUS believes that an important part of capital reform is providing credit unions access to alternative capital. The combination of current PCA requirements and a changing economic landscape have created a regulatory dilemma for many state-chartered credit unions. As noted above, the FCUA defines credit union net worth as retained earnings. The NCUA has determined that it lacks the regulatory authority to broaden the net worth definition to include other forms of capital as a part of PCA calculations. Thus, credit unions require an amendment to the Act to rectify this statutory deficiency.

We firmly believe alternative capital is necessary for credit unions to continue meeting the financial needs of their members. This is especially true for credit unions providing services such as financing for home ownership, or financial education and credit counseling—each an important part in achieving the American dream. We believe, even with the lower leverage ratio and risk-based capital proposed in H.R. 2317, that some state-chartered credit unions may not be able to rely solely on retained earnings to meet the capital base required by PCA standards. As credit unions grow and serve more consumers in their fields of memberships, their assets will grow. As assets grow, credit unions experience reduced net worth ratios as earnings retention lags growth in assets.

As a regulator, it makes sound economic sense for credit unions to access other forms of capital to improve their safety and soundness. We should take every financially feasible step to strengthen the capital base of this nation's credit union system.

Strong capital reform requires that state and federal regulators work together. In 1998, the Credit Union Membership Access Act, H.R. 1151, provided that NCUA consult and cooperate with state regulators in constructing PCA and member business lending (MBL) regulations as required by the FCUA. NASCUS always stands ready to discuss and assist in the implementation of new regulations. We firmly believe that cooperation results in better regulation and a stronger and safer credit union system.

Member Business Lending

Regulatory relief is important for consumers in the area of member business lending. In today's fast-paced economy, it is vital that lending is available to consumers who want to start a new business. Entrepreneurship is part of fulfilling the American dream. NASCUS has a vision of providing well-thought-out regulations to best position credit unions to make members' dreams become reality.

Title II of H.R. 2317 provides an opportunity for economic growth for credit unions. Credit unions should be given greater authority to meet their member business lending needs. Raising the statutory limit on credit union member business loans to 20 percent of total assets, as proposed in Section 201 of CURIA, facilitates member business lending without jeopardizing safety and soundness at participating credit unions.

Further, we support Section 202, which amends the current definition of a member business loan by granting NCUA the authority to exempt loans $100,000 or less. This increases the definition of business loans subject to the current amount of $50,000 to $100,000. Prior regulatory relief bills have similarly expanded for federal savings institutions. We urge that the statutory definition of a credit union MBL be changed from the current $50,000 limit contained in the FCUA. In fact, we support redefining credit union MBLs to the Fannie/Freddie conforming loan limit of $359,650, increased in January 2005. We believe this is a safe and sound, well established and readily understandable index that has served lenders and the public interest well for many years.

Both of these provisions provide credit unions with regulatory relief as it concerns member business lending, and were included in H.R. 3579, introduced in the 108th Congress.

Regulatory Modernization

It is time to update regulations reflecting parity of treatment between credit unions and other financial institutions. It makes sound business sense and provides for equitable competition; parity of treatment is only logical.

NASCUS supports Section 311 of H.R. 2317 that provides all federally insured credit unions the same exemptions as banks and thrift institutions from Federal Trade Commission pre-merger notification requirements and fees. In fact, we believe this provision should be expanded to include all state-chartered credit unions.

Additionally, NASCUS is pleased Section 312 is part of CURIA. We support providing federally insured credit unions and savings institutions parity treatment with commercial banks with regard to exemptions from SEC registration requirements that banks were provided in the Gramm-Leach-Bliley Act.

Our major concern is that, if state-chartered credit unions are not accorded the same SEC treatment as commercial banks and savings institutions, the powers granted to credit unions by state legislatures and state regulators might be unnecessarily preempted by SEC regulation. Unless appropriate regulatory relief is provided, credit unions offering these services may be subject to redundant and costly examination. We urge that credit unions be accorded similar regulatory treatment as other financial institutions.

The 108th Congress recognized these provisions when they were included in H.R. 1375 as Sections 312 and 313, respectively.

Privately-Insured Credit Unions Should Be Eligible to Join Federal Home Loan Banks (FHLBs)

At this time, all credit unions do not operate with access to the same benefits. Federally insured credit unions have access to the FHLBs, while privately-insured credit unions do not. NASCUS supports non-federally insured credit unions being eligible to join the FHLBs. While this is not included in H.R. 2317, this provision was included during the 108th Congress in H.R. 1375.

Today, there are approximately 375 credit unions that are non-federally insured. All of these credit unions are regulated and examined by state regulatory agencies to ensure they are operating in a safe and sound manner. Regulatory functions are a primary determinant of the safety and soundness of the credit union system. The function of the credit union regulator is to assure consumers that their deposits are safe. The credit union regulator performs this mission by:

- issuing rules to assure safe and sound financial practices in credit unions;
- ensuring that violations of those safety and soundness rules are corrected;
- performing safety and soundness examinations of credit unions under their supervision;
- requiring correction of financial and operational deficiencies identified during the examination process; and
- taking enforcement actions to assure that financial remedies are implemented by the credit union (including letters of understanding and agreement, closure of the credit union, etc.).

Federal and private share insurance systems have been established to protect credit union shareholders. To manage and price insurance risk, each share insurer relies significantly on the examination reports of the institution's primary regulator. Most state credit union agencies use the NCUA/AIRES examination platform when they examine state-chartered credit unions for safety and soundness purposes. NASCUS agencies participate in the development and testing of NCUA's examination program and procedures. In short, there is an excellent working relationship and substantially similar examination standards for both federally and state-chartered credit unions.

The private insurers, primarily American Share Insurance in the United States and a cooperative insurance fund in Puerto Rico, have established additional solvency standards to minimize risks in their insured credit unions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established a series of safety and soundness requirements both for entities that offer private deposit insurance to credit unions and for credit unions which would opt for private deposit insurance.

FDICIA also requires that privately insured credit unions must be certified to meet eligibility requirements for federal deposit insurance. Specifically, the Act states that no depository institution, which lacks federal deposit insurance, may use "the mails or any instrumentality of interstate commerce to receive or facilitate receiving deposits, *unless* the appropriate supervisor of the State in which the institution is chartered has determined that the institution meets all eligibility requirements for Federal deposit insurance ... ." (Emphasis added.) As a practical matter, this requirement applies to every state-chartered, privately insured credit union, as every such credit union uses some instrumentality of interstate commerce or the mails.

FDICIA also dictates the manner and extent to which institutions opting for private deposit insurance disclose fully that their deposits are privately insured. Therefore, there should be no concern that these credit unions are not operated in a safe and sound manner.

Permitting non-federally insured institutions to join the FHLBank system would not establish a new membership principle for the system. More than 50 insurance companies, chartered and regulated by state governments with no federal oversight or insurance, are now members of these Banks. Allowing FHLBank membership for privately-insured credit unions would provide additional opportunities for housing finance and not inflict any new or unusual exposure on the Bank System.

Moreover, an additional layer of financial discipline would be introduced. Each Federal Home Loan Bank has a sophisticated credit screening system to assure that any borrower, federally insured or not, is credit worthy. In addition, every advance is secured by marketable collateral. Indeed, even during the savings and loan debacle, we understand that no Federal Home Loan Bank suffered a loss on advances extended to their members.

In the past, Congress has expanded the membership eligibility for the Bank System to help local financial institutions meet the housing and home ownership needs of their communities. Enabling state-chartered, privately insured credit unions to be eligible to join the FHLBank system, is merely one more step in bringing home ownership opportunities to these credit union members.

We would appreciate your support by including this proposal in the Regulatory Relief legislation and urge the Committee to approve this provision, helping to achieve our nation's housing and home ownership goals.

Federal Preemption of State Regulation of Consumer Protection Practices

Lastly, as credit union regulators, we have a significant stake in the ongoing controversy between federal banking regulators and the National Governors' Association, the National Association of Attorney's General, the Conference of State Bank Supervisors, the National Conference of State Legislatures and others over the issue of expanding federal preemptions of state laws and regulations.

As a matter of policy, NASCUS does not take public positions on issues that only affect the commercial banking industry. However, we are concerned about the contagion impact on the credit union dual chartering system as the powers of the state banking regulators are significantly curtailed.

OCC and OTS regulations during the past several years have preempted dozens of state banking laws enacted to protect consumers, to provide fair lending and to ensure fair competition. These actions of federal regulatory agencies have a broad impact on the dual chartering system for banks. They may open the door to similar actions by the federal credit union regulator, NCUA, unless Congress intervenes to rein in additional federal preemption powers.

The trend in the last several years is that when an issue is one of consumer protection, some continue to demand that the federal banking authorities preempt state consumer protection. Such initiatives are touted as establishing exclusive national standards for regulating almost all aspects of consumer lending practices.

Historically, states have established predatory lending and other consumer protection statutes applicable to both state and federal depository institutions. In general, the rule has been that national banks are subject to such state statues to ensure the same level of protection for citizens opting to use the services of a federally-chartered financial institution.

In most cases, there are no comparable federal laws. Consumers have instead been left at the mercy of what is sometimes an abusive industry. State authority has been so abridged that state lawmakers are oftentimes powerless to curtail the growing number of new consumer abuses, including predatory lending, payday loans, and excessive fee structures.

NASCUS is not comfortable with such federal rulemaking. What the OCC has adopted overrides state law and concentrates regulatory power at the federal level. The Governors similarly oppose these rules. The National Conference of State Legislatures has expressed its concerns about the impact of these rules on state law. The Conference of State Bank Supervisors has opposed these rules. Consumer groups have opposed federal preemptions that would vitiate hard won victories in state legislatures that provide additional protection to all consumer borrowers in their states.

Determining the extent of such additional federal banking powers is an important matter for those who support the dual chartering system for all depository institutions. Congress should resolve the conflicts rather than delegate these fundamental issues to the federal financial institution regulators to determine.

Conclusion

In conclusion, NASCUS strongly supports the following issues for regulatory relief:

- NASCUS supports amendments to the Prompt Corrective Action (PCA) provision of the FCUA to obligate federally insured credit unions to include all forms of capital when calculating their net worth ratio.

- NASCUS supports both H.R. 1042 and Section 104 of CURIA that amends the definition of net worth to include the retained earnings of a merging credit union with that of the surviving credit union.

- NASCUS supports risk-based capital reform.

- NASCUS believes credit unions should be permitted to issue alternative capital.

- NASCUS supports Title II of H.R. 2317 that focuses on member business lending. Section 201 expands member business lending provisions to 20% of total assets of a credit union, furthering the goal of providing loans for consumer members.

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- NASCUS supports Section 202 of Title II of H.R. 2317 that amends the definition of a member business loan from $50,000 to an amount not to exceed $100,000.

- NASCUS supports Section 311 of H.R. 2317 that provides all federally insured credit unions the same exemptions as banks and thrift institutions from pre-merger notification requirements.

- NASCUS supports Section 312 of H.R. 2317 that provides federally insured credit unions parity of treatment with commercial banks with regard to exemptions from SEC registration requirements according to the Gramm-Leach-Bliley Act.

- NASCUS strongly believes non-federally insured credit unions should be eligible to join the FHLBs.

- We encourage Congress to intervene and block continuing preemption of state laws.

NASCUS appreciates the opportunity to testify today on regulatory relief. We support the provisions of CURIA that will ease regulatory burden and enhance the overall safety and soundness of credit unions. We welcome further participation in the discussion and deliberation of legislation that impacts regulatory relief for credit unions. We urge this Subcommittee to protect and enhance the viability of the dual chartering system for credit unions by acting favorably on the provisions we have discussed in our testimony.

Thank you.

STATEMENT OF

JOHN M. REICH
VICE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

REGULATORY BURDEN RELIEF EFFORTS

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

June 9, 2005 -- 10:00 AM
2128 Rayburn House Office Building

Mr. Chairman, Ranking Member Sanders, and Members of the Subcommittee, I very much appreciate the opportunity to testify and update you on efforts to reduce unnecessary regulatory burden on federally-insured depository institutions. I am here today as the leader of the inter-agency 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 experience, I commend the distinguished Members of this Subcommittee for your steadfast commitment to pursue meaningful regulatory relief legislation, while maintaining the safety and soundness of the banking industry and protecting important consumer rights. As I have said before, our nation's banks, 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, as well as the cumulative effect of regulations on our nation's bank and thrift institutions, particularly smaller community banks. I will also outline our efforts to review regulations and address, on an inter-agency basis, some of the existing regulatory burden, as mandated by EGRPRA. I will then describe some actions the Federal Deposit Insurance Corporation (FDIC) has taken internally to reduce burdens imposed by our own regulations and operating procedures. Finally, I will suggest certain specific legislative actions that can be taken to stem the ever-increasing tide of regulation on the banking industry.

THE IMPORTANCE OF BALANCING THE COSTS AND BENEFITS OF REGULATION

Our bank regulatory system has served us quite well, over many years, 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 these laws, I think it is incumbent upon public policy makers to ensure that the intended benefits of our regulations justify the considerable costs. I think we need to periodically take stock 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 Subcommittee 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 have promulgated a total of 801 final rules. Since I testified in May of last year, the agencies have 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 even 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 quite a challenge for bankers to maintain the capacity to respond to the steady stream of new regulations while continuing to comply with existing regulations. Some of the new regulations and reporting requirements facing the industry include those required by the FACT Act, USA PATRIOT Act, Sarbanes-Oxley Act, and Check 21 Act. These laws reflect important public policy choices concerning, for example, the quality of the credit reporting system, identity theft, national security and changes in technology. However, it is incumbent upon the regulators who write implementing regulations, as well as the Congress, to be mindful of the need to avoid unnecessarily increasing regulatory burden on the industry as we implement new reporting requirements mandated by legislation.

There were good and sufficient reasons for these laws and, in fact, some were actually sought by the industry. However, the cumulative effect of all of the rule changes is a lot for banks to digest, particularly smaller community banks with very limited staff. Rule changes 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 4,053 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 the myriad of 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' non-interest expense, or about $38 billion in 2004 ("The Cost of Bank Regulation: A Review of the Evidence," Gregory Elliehausen, Federal Reserve Bulletin, April 1998). At smaller banks, almost every employee has significant compliance responsibilities, from the tellers to the CEO. In testimony at the regulatory burden hearing before this Subcommittee last month, the American Bankers Association estimated that bank CEOs, in the aggregate, spend over 5.5 million hours per year on compliance -- an astonishing number.

However salutary or necessary any new law may be, it still carries a cost. Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 is a case in point. The North Carolina Bankers Association conducted a survey of its members to determine compliance costs. Non-accelerated banks (generally, banks other than those whose stock public investors own at least $75 million) have not yet been required to file Section 404-compliant annual reports with the SEC. These banks, with less than $250 million in assets, estimated costs at over eight percent of profits. Even larger, accelerated banks (which have already filed Section 404-compliant annual reports) reported high costs. These banks, with between $500 million and $1 billion in assets, estimated costs at over three percent of profits. Similarly, an article published by the Federal Reserve Bank of Philadelphia recently indicated that:

> Some bankers have stated that as much as five percent of earnings are being allocated toward section 404 compliance. Others have noted that the costs of documenting internal control reviews, which had been documented in the past but which now must be documented consistent with the standards necessary under section 404, has tripled.

("SVP Commentary on . . . Sarbanes-Oxley: Two Years Later," Michael Collins, *Federal Reserve Bank of Philadelphia SRC Insights*, Fourth Quarter 2004.)

The Elliehausen research indicates that, in general, start up costs for new or changing regulations may be very expensive and insensitive to the size of the changes. In other words, the process of learning about and adopting regulatory changes is expensive for banks, whatever the magnitude of the change. Frequent small, incremental changes may be much more expensive than large, one time changes.

Although regulatory burden has a disproportionate impact on community banks (as discussed below), we are committed to addressing the problem of regulatory burden for every insured financial institution. Banks, large and small, labor under the cumulative impact of regulations that divert resources and capital away from economic development, extension of credit and job creation. Most of the proposals we are examining would provide significant relief to all financial institutions.

THE IMPACT OF REGULATORY BURDEN ON COMMUNITY BANKS

In general, regulations cost smaller businesses more per employee, when compared with larger businesses. 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. Economies of scale associated with regulatory compliance have been confirmed in implementation cost studies of the Truth in Savings Act and the Electronic Funds Transfer Act, where the incremental cost of regulation declines as the number of transactions or accounts rise.

The magnified impact of regulatory burden on small banks is a significant concern to me. As a former community banker, I know the importance of community banks in our economy. Community banks play a vital role in the economic well-being of countless individuals, neighborhoods, businesses and organizations throughout our country, serving as the lifeblood of their communities. These banks are found in all communities—urban, suburban, rural and small towns. Whether a minority-owned urban neighborhood institution or an agricultural bank, community banks have several things in common. They are a major source of local credit. Data from the June 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 are the bankers for municipalities and school districts. They 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 twenty 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 1980s and the resulting large number of failures and mergers among small institutions serving neighboring communities also contributed to the decline in the smallest financial institutions. It is probable that together those factors were the greatest factors in reducing small bank numbers.

However, I believe that in the recent past, regulatory burden played an increasingly significant role in shaping the industry and the number and viability of community banks and I think it will continue in the foreseeable future. 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 wants and 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 nine percent to two 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 two 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 4,093 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 are 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 are 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 non-interest expenses absorb operating revenues. Throughout the early-1990s, 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 six 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 ten 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 non-interest 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. In some cases, the cost of complying with regulatory burden is pushing some smaller banks out of the market. As reported in the *American Banker* (May 25, 2004), regulatory burden was an important factor in the decision by two community banks to sell their institutions. 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 ten 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.

INTER-AGENCY 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 ten years, in an effort to eliminate any regulatory requirements that are outdated, unnecessary or unduly burdensome. For the past two years, I have been leading the inter-agency 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 inter-agency task force divided the agencies' regulations (131 rules in all) into 12 categories and agreed to publish one or more categories for public comment every six months, with 90-day comment periods, for the remainder of the review period (which ends in September, 2006). Spreading out comments over three years will provide sufficient time for the industry, consumer groups, the public and other interested parties to provide meaningful comments on our regulations, and for the agencies to carefully consider all recommendations.

The agencies 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 inter-agency 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 anti-money 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, a description of the agencies' action plan, information about our banker and consumer outreach sessions and a summary of the top regulatory burden issues cited by bankers and consumer groups. There also are direct links to the actual text of each regulation and comments can be sent to the EGRPRA website. Comments submitted through the website are automatically transmitted to all of the financial institution regulatory agencies. Comments are then posted on the EGRPRA website for everyone to review. 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 is also important to have face-to-face meetings with bankers and consumer group representatives so they have an opportunity to directly communicate their views on the issues. Over the past two 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. The meetings provided an opportunity for the agencies to listen to bankers' regulatory burden concerns, explore comments and suggestions, and identify possible solutions. So far, we have held banker outreach meetings in Orlando, St. Louis, Denver, San Francisco, New York, Nashville, Seattle, Chicago and Phoenix. Two more meetings are scheduled: June 22 in New Orleans and September 24 in Boston. To date, more than 450 bankers (mostly CEOs) 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. The banker outreach meetings have been extremely useful and productive in identifying regulatory burden concerns. 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. The first meeting was on February 20, 2004, in Arlington, Virginia, the second on June 24, 2004 in San Francisco and the third on September 23, 2004 in Chicago. 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 are tentatively planning to hold one additional meeting with consumer and community groups later this year in Boston, Massachusetts, and we are more than 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. One of the real benefits of focusing on the need to reduce regulatory burden is that we have generally heightened awareness of the issue. For example, I am told that regulatory burden on the industry is now routinely discussed when agency staff members formulate new rules. This was not always the case.

In fact, the banking and thrift regulatory agencies are working together closely and harmoniously on a number of projects to affirmatively address unnecessary burdens. In addition to eliminating outdated and unnecessary regulations, the agencies have identified more efficient ways of achieving important public policy goals of existing statutes. I think it is fair to say that although we have much work ahead of us, there has been significant progress to date. Here are some notable examples:

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 that 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, Securities and Exchange Commission, and the Commodity Futures Trading Commission, issued an Advanced Notice of Proposed Rulemaking (ANPR), seeking public comment on ways to improve the privacy notices required by the Gramm-Leach-Bliley Act. Although there are many issues raised in the ANPR, the heart of the document 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 and culminating with the recently enacted Privacy and FACT Acts, 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 Chart 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 "non-disclosure 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 in order to thwart terrorist financing efforts and money-laundering. Last year, bankers filed over 13 million Currency Transaction Reports (CTRs) and over 300,000 Suspicious Activity Reports (SARs) 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 CTRs and SARs 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 CTRs and SARs and make the reports that are filed more useful for law enforcement and to communicate with bankers more effectively.

In the next few weeks, the bank and thrift regulatory agencies are expected to issue detailed BSA examination guidelines 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 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. I have met on several occasions with FinCEN's Director, William Fox, and pledged to work with him to make reporting under the Bank Secrecy Act more effective and efficient while still meeting the important crime-fighting objectives of anti-terrorism and anti-money-laundering laws. We should never stop looking for ways to fulfill our important responsibilities more efficiently.

FDIC EFFORTS TO RELIEVE REGULATORY BURDEN

In addition to the above-noted inter-agency efforts to reduce regulatory burden, the FDIC, under the leadership of Chairman Powell, 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) As part of our MERIT examination program, we raised the threshold for well-rated, well-capitalized banks to qualify for streamlined safety and soundness examinations from $250 million to $1 billion so that the FDIC's resources are better focused on managing risk to the insurance funds;

2) Implemented more risk-focused compliance, 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 (FILs) to eliminate outdated or unnecessary directives and completely changed the basic format of the FILs 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 providing the *Money Smart Program* free-of-charge to all insured institutions;

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

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

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

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

LEGISLATION TO REDUCE REGULATORY BURDEN

Mr. Chairman, I wish to commend you, Congressman Hensarling, Congressman Moore and the other distinguished Members of your Subcommittee for your efforts to develop legislation to remove unnecessary regulatory burden from the banking industry. Since most of our regulations are, in fact, 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.

EGRPRA requires input from the industry and other interested parties. As reported above, we have made tremendous efforts to get input through the public notice and comment process as well as through outreach meetings held around the country. As a result, we have received many promising ideas for true regulatory burden reduction.

Almost a year ago, after testifying before this Subcommittee, I also testified, along with eighteen other witnesses, before the Senate Banking, Housing, and Urban Affairs Committee. 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 that we have "no objection" to or that we take "no position" on since the proposal did 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 our 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 proposals for regulatory burden relief:

1. Authorize Payment of Interest on Reserves
2. Provide Federal Reserve Flexibility to Set Reserve Requirement
3. Repeal Certain Reporting Requirements Relating to Insider Lending
4. Streamline Depository Institution Merger Application Requirements
5. Shorten the Post-Approval Waiting Period on Bank Mergers and Acquisitions Where There are No Adverse Effects on Competition
6. Improve Information Sharing With Foreign Supervisors
7. Provide an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act
8. Exempt Merger Transactions Between An Insured Depository Institution One or More of Its Affiliates from Competitive Factors Review and Post-Approval Waiting Periods
9. Amend the Flood Disaster Protection Act of 1973
10. Enhance Examination Flexibility
11. Streamline Call Reports
12. Authorize Member Banks to Use Pass-Through Reserve Accounts

These 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. The

EGRPRA process has produced a wealth of proposals. The synergism that has resulted from the EGRPRA process and my meetings with lawmakers makes me believe that there is real momentum behind the effort to reduce regulatory burden on the industry.

I was gratified to see the House of Representatives address some of the burden issues and pass H.R. 1375, the Financial Services Regulatory Relief Act last year. H.R. 1375 contains a number of significant regulatory relief provisions that could reduce regulatory burden. The bill also includes several provisions requested by the regulators, including the FDIC, to help us do our jobs better. The EGRPRA process has produced some additional proposals supported by both the industry and the regulators. The above-noted "bankers dozen" are just some of the ideas I am pursuing on an inter-agency basis to reduce unnecessary burden on the banking industry without diluting important consumer protections -- and I hope to pursue many others over the course of the EGRPRA regulatory review process. I 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

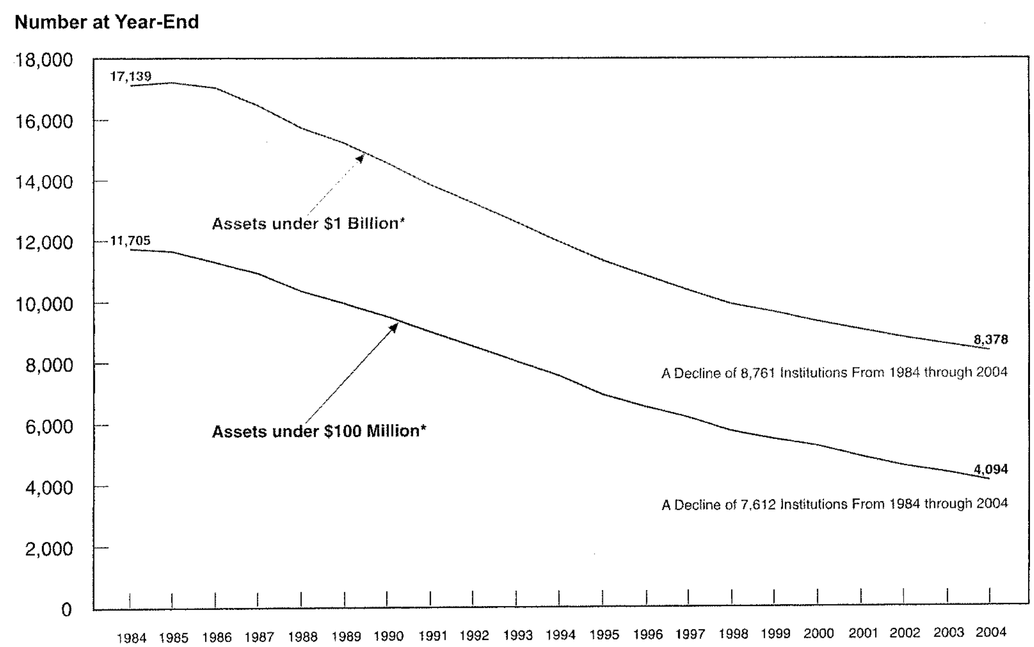
Mr. Chairman, as I stated at the outset, the EGRPRA process addresses the problem of regulatory burden for every FDIC-insured financial institution. Banks, large and small, labor under the cumulative weight of our regulations. However, I believe that if we do not do something to stem the tide of ever increasing regulation, a vital part of the banking system will disappear from many of the communities that need it the most. That is why I think it is incumbent upon all of us – Congress, regulators, industry and consumer groups – to work together to eliminate any outdated, unnecessary or unduly burdensome regulations. I remain personally committed to accomplishing that objective, no matter how difficult it may be to achieve.

I believe that now is the time to take action to address the accumulated 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 weakening important consumer protections.

Thank you for providing me with this opportunity to testify.

Chart 1

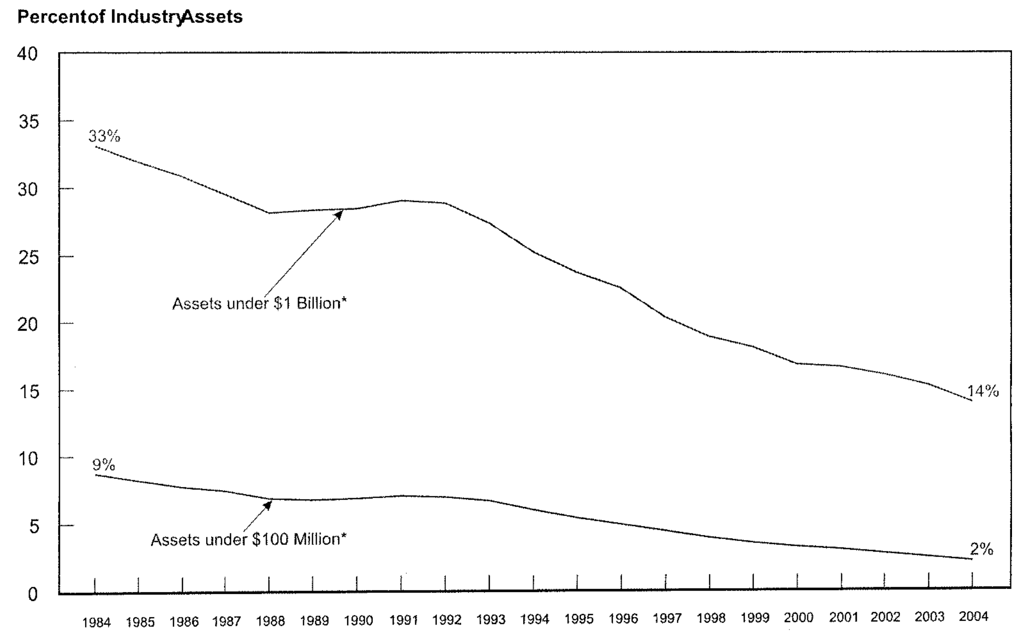
THE NUMBER OF COMMUNITY BANKS HAS BEEN DECLINING
FDIC-Insured Commercial Banks & Savings Institutions



* Based on 2004 Dollars; $100 Million in 2004 = $62.9 Million in 1984, $1 Billion = $629 Million in 1984

Chart 2

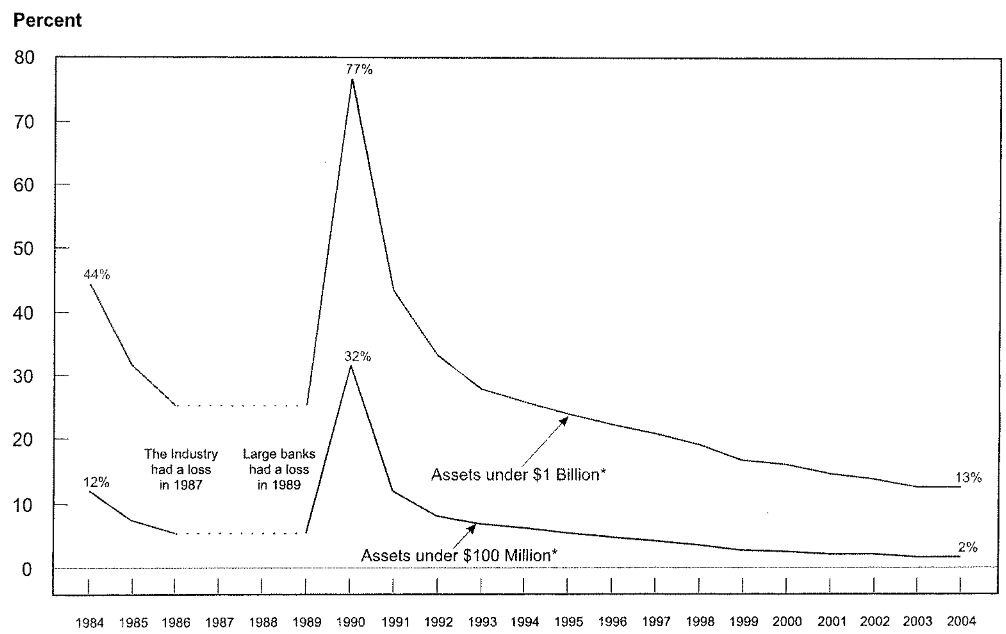
COMMUNITY BANKS' SHARE OF INDUSTRY ASSETS CONTINUES TO FALL
FDIC-Insured Commercial Banks & Savings Institutions



* Based on 2004 Dollars; $100 Million in 2004 = $62.9 Million in 1984, $1 Billion 2004 = $629 Million in 1984

Chart 3

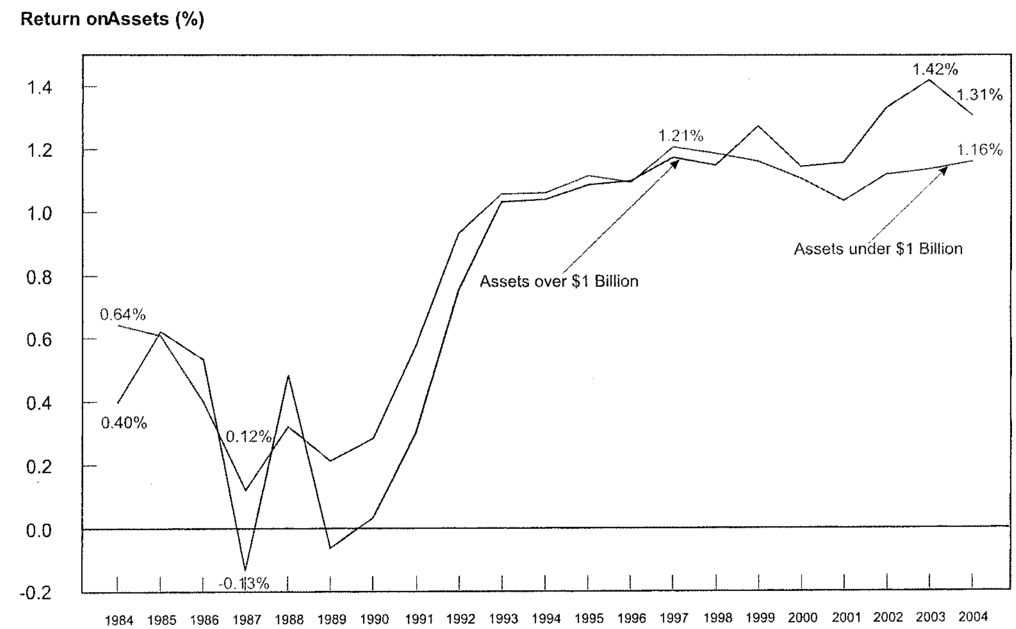
COMMUNITY BANKS' SHARE OF INDUSTRY EARNINGS IS DECLINING
Net Income of Institutions with Assets <$1 Billion as a Percent of Total Industry Net Income



* Based on 2004 Dollars; $100 Million in 2004 = $62.9 Million in 1984, $1 Billion in 2004 = $629 Million in 1984

Chart 4

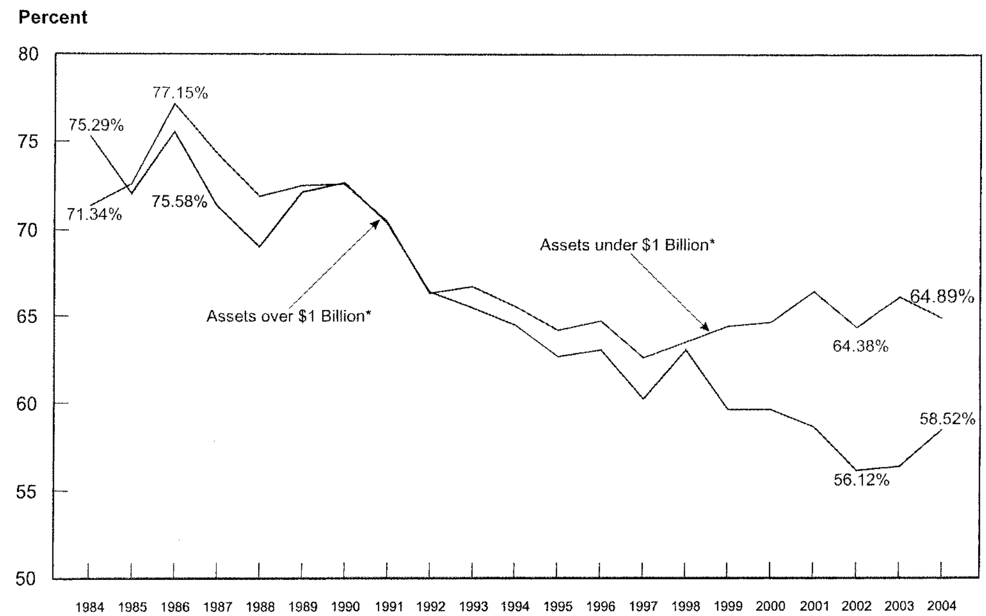
LARGE INSTITUTIONS HAVE BECOME MORE PROFITABLE THAN COMMUNITY BANKS
All FDIC-Insured Commercial Banks and Savings Institutions, 1984 - 2004



Asset size is based on 2004 Dollars; $1 Billion in 2004 = $629 Million in 1984.

Chart 5

OVERHEAD COSTS ABSORB A GROWING SHARE OF COMMUNITY BANKS' REVENUES
Noninterest Expense as a Percent of Net Operating Revenue*



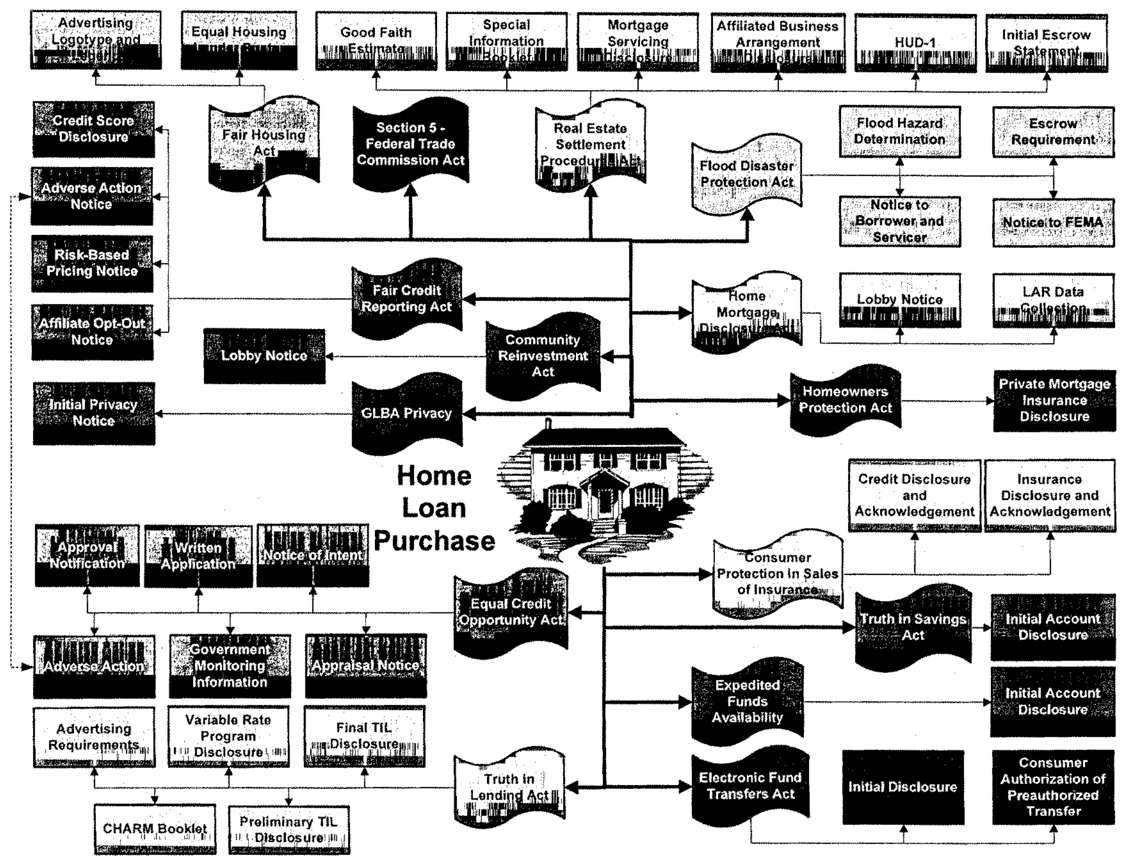
*Net operating revenue = net interest income + total noninterest income.
Asset size is based on 2004 Dollars. $1 Billion in 2004 = $629 Million in 1984.

851 Final Rules

Subject Matter Topics Covered by 851 Final Rules[1]

Issued by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Federal Home Loan Bank Board from the Passage of FIRREA on August 9, 1989 to April 30, 2005

[1] Westlaw Computer Search Conducted on May 3, 2004 and May 2, 2005



Advertising Logotype and
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Good Faith Estimate
Special Information Booklet
Mortgage Servicing Disclosure
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HUD-1
Initial Escrow Statement
Credit Score Disclosure
Fair Housing Act
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Real Estate Settlement Procedures Act
Flood Disaster Protection Act
Flood Hazard Determination
Escrow Requirement
Notice to Borrower and Servicer
Notice to FEMA
Adverse Action Notice
Risk-Based Pricing Notice
Affiliate Opt-Out Notice
Fair Credit Reporting Act
Community Reinvestment Act
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Truth in Savings Act
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Final TIL Disclosure
Truth in Lending Act
Electronic Fund Transfers Act
Initial Disclosure
Consumer Authorization of Preauthorized Transfer
CHARM Booklet
Preliminary TIL Disclosure

Embargoed until
June 9, 2005, at 10:00 am

Statement of

Richard M. Riccobono, Acting Director
Office of Thrift Supervision

concerning

Regulatory Burden Relief

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

House Financial Services Committee

June 9, 2005

Office of Thrift Supervision
Department of the Treasury

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Washington, DC 20552
202-906-6288

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Regulatory Burden Relief
before the
Subcommittee on Financial Institutions and Consumer Credit
of the
House Financial Services Committee

June 9, 2005

Richard M. Riccobono, Acting Director
Office of Thrift Supervision

I. Introduction

Good morning, Mr. Chairman, Ranking Member Sanders, and members of the Subcommittee. 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 Subcommittee and full Committee to address these issues.

Before proceeding to my testimony, Mr. Chairman, I want to recognize the tireless efforts of you and your 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 Mr. Reich 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 associtions 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.

Of these four items, two were included in H.R. 1375, which the House passed last year. Section 201 of H.R. 1375 provides relief to savings associations under the federal securities laws. Section 212 of H.R. 1375 updates the commercial and small business lending authority of savings associations. I will explain all of these items in more detail and describe several other initiatives that we are recommending for enactment.

II. Revising the Federal Securities Laws to Eliminate Duplicative Regulatory Burdens for Savings Associations

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 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—as set forth in section 201 of H.R. 1375—would free up significant resources for savings associations in local communities. It would also

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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.

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. 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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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).

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 Senate Banking Committee (SBC)) 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. During consideration of the amendment, the SEC represented to the SBC 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 such as the provision included in previous legislation, including H.R. 1375.

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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.

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-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, the new broker proposal would no longer treat savings associations 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 <u>all</u> 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

Another important regulatory burden legislative proposal for OTS is eliminating an anomaly that exists under HOLA relating to the current 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 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

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—such as that set forth in section 212 of H.R. 1375—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, and the availability of, small business and other commercial loans now and in the

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

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

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 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

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

7. 12 U.S.C. § 4.

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 federal banking agencies (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 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

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

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.

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

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

- 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, currently with over $9 trillion in 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

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

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 proposals would establish a uniform rule governing federal jurisdiction when a savings association is involved and, accordingly, reduce confusion and uncertainty.

D. Enhancing Examination Flexibility

Current law requires the FBAs to conduct a full-scale, on-site examination for the depository institutions under their jurisdiction at least every 12 months. There is an exception for small institutions that have total assets of less than $250 million and are well-capitalized and well-managed and meet other criteria. Examinations of these small institutions are required at least every 18 months.

When originally enacted in 1991, the small institution examination exception was available to institutions with assets less than $100 million (assuming the other statutory criteria were satisfied). This statutory threshold was raised to $250 million in 1994 for institutions in outstanding condition and meeting the other statutory criteria. In 1996, the FBAs were authorized to extend the $250 million threshold to institutions in good condition. Given the fact that the current threshold has been in place for more than eight years, OTS recommends considering whether the $250 million cap should once again be raised. If so, we 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

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

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 BHC under BHC Act.

From a regulatory burden perspective, it makes no sense to subject a SLHC structure to an additional bank regulator, i.e., supervising the 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

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

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

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—such as H.R. 1375—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 Subcommittee to shape the best possible regulatory burden relief legislation.

Regulatory Burden of SEC Proposed Exemptive Relief

Investment Advisor Registration

Type of Account or Service Provided	National or State Charter Banks and Trust Companies Exemptive Relief	SEC Proposed Exemptive Relief for Savings Associations
Accounts without Investment Management or Advice Responsibilities ▪ Trust Accounts ▪ Court Accounts ▪ Agency/Custodial Accounts	Yes Have exemptive relief	Yes Have exemptive relief – did not previously have to register
Trust Accounts (with investment management or advice responsibilities) ▪ Personal Trust ▪ Employee Benefit Trust ▪ Charitable Trust	YES Have exemptive relief	**NO** **Savings associations will not have exemptive relief or burden reduction**
Court Accounts (with investment management or advice responsibilities) ▪ Executor ▪ Administrator ▪ Guardian ▪ Conservator	YES Have exemptive relief	**NO** **Savings associations will not have exemptive relief or burden reduction**
Agency Accounts (with investment management or advice responsibilities) ▪ Individuals ▪ Personal Trusts ▪ Employee Benefit Plans and Trusts ▪ Corporate Entities ▪ Charities ▪ Mutual Funds ▪ Hedge Funds ▪ Common Trust Funds ▪ Collective Investment Funds	YES Have exemptive relief (unless providing investment advice to a mutual fund, in which case the department or division of the bank or trust company providing the advice must register as an investment adviser)	**NO** **Savings associations will not have exemptive relief or burden reduction**

August 18, 2000

The Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

As you are aware, on July 13, 2000, the Senate Banking Committee held a markup on S. 2107, The Competitive Market Supervision Act, among other legislation. Although I was unable to attend the markup, I submitted a written statement for the record. I thought you might be interested in seeing a copy of the statement, which I attached for you.

In my written statement, as a co-sponsor of S. 2107, I reiterated my belief of the appropriateness of the legislation and its benefits to Americans. Separately, I commented on the Securities and Exchange Committee's rulemaking initiative to exempt savings associations from the Investment Advisors Act. Savings associations should be provided a level playing field with banks, which historically have been exempt from the Act. Because SEC staff determined that this parity issue may be resolved through rulemaking and agreed to move forward with the rulemaking process, I withheld legislative action at the July 13 markup. I look forward to the SEC's timely resolution of this issue.

If I or my staff may be of assistance in this rulemaking effort or other matters, please do not hesitate to call.

Sincerely,

Evan Bayh

Evan Bayh

STATEMENT OF SENATOR EVAN BAYH
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
COMPETITIVE MARKET SUPERVISION ACT
SAVINGS ASSOCIATION EXEMPTION FROM THE INVESTMENT ADVISORS ACT
July 13, 2000

One of the bills that is before us today is the Competitive Market Supervision Act. This bill, which I have co-sponsored, does two important things for the people of the United States. First, the bill reduces securities fees for a large number of Americans. These fees, while relatively small, put an unnecessary burden on all investors, including those with retirement funds or pension funds. Second, the bill would provide for pay parity for Securities and Exchange Commission professional employees, by permitting the SEC to bring their pay in line with that of employees of other financial regulatory agencies. The SEC is charged with ensuring that investors receive the highest level consumer protections. This bill would help the SEC to attract – and retain – the best minds to fulfill its obligations to the American people.

On a separate issue, I have become aware of disparate treatment between savings associations and banks under the Investment Advisors Act. This Act exempts banks from its scope but does not exempt savings associations. This differing treatment puts savings associations at a competitive disadvantage, without reason. A similar disparity used to exist under a related law, the Investment Company Act of 1940; however, last year the Gramm-Leach-Bliley Act corrected the discordant treatment.

In the past few months, my staff has had discussions with the Securities and Exchange Commission and industry representatives. The SEC has determined that it has the statutory authority to exempt individual institutions and groups of institutions – including savings associations – from the scope of the Investment Advisors Act. Since the SEC has concluded that this parity issue may be resolved through rulemaking and has agreed to work with the industry to reach such resolution, I withhold legislative involvement. I appreciate their commitment and look forward to their resolution.

For Release Upon Delivery
10:00 a.m., June 9, 2005

TESTIMONY OF

JULIE L. WILLIAMS

ACTING COMPTROLLER OF THE CURRENCY

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

AND CONSUMER CREDIT

Of the

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

June 9, 2005

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

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

I. INTRODUCTION

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, I appreciate this opportunity to appear before you today to discuss the challenge of reducing unnecessary regulatory burden on America's banks. 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.

Over the years, this Subcommittee has consistently addressed the need to reduce unnecessary burden on our nation's banks. In the last Congress, this Subcommittee and the full Financial Services Committee approved a comprehensive regulatory burden relief bill, H.R. 1375, the Financial Services Regulatory Relief Act of 2004, which passed the House of Representatives. Many of the items that I will discuss in my testimony were included in H.R 1375. We appreciate your continued efforts to pursue regulatory burden relief legislation, as evidenced by this hearing today. We also want to take this opportunity to express appreciation to Congressman Hensarling and Congressman Moore for their commitment and dedication to this issue.

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.

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 Subcommittee and the full Committee in issues such as regulatory implementation of the Bank Secrecy Act and anti-money laundering standards. I would also like to thank this Subcommittee and the full Committee for its continuing involvement and oversight of the proposal by the Securities and Exchange Commission (SEC) to implement the so-called "push-out" provisions of the Gramm-Leach-Bliley Act (GLBA). The Committee's interest has been invaluable in encouraging the development of rules that are faithful to GLBA's intent and not so burdensome as to drive traditional 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; and
- Fifth, provide an overview of some other legislative items that the OCC supports that are included in a regulator/industry consensus package.

II. 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 first-hand 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, D.C. 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 sort of 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 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 carefully balanced 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.

III. 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

[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.

states that have affirmatively opted-in to allow the establishment of new branches in the state. Moreover, approximately 17 of these 23 states impose a reciprocity requirement.

In many cases, in order to serve customers in multi-state 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

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

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 on a multi-state basis.

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 this issue and concluded that a national bank is a citizen only of the state where it maintains its principal place of business.[6] Currently, there are petitions pending before the United States Supreme Court asking it to resolve the conflict between the Fourth and Fifth Circuits.

We support 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

[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).
[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, e.g., 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).

certainty on this issue would reduce burden on national banks and Federal thrifts, including the substantial costs associated with 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 two years. The amendment would ensure that

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

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 towards troubled condition. Other safeguards, such as Prompt Corrective Action, which prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 U.S.C. § 1831o(d)(1)) would remain in place.

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 limited liability companies (LLCs) under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends. Some states currently permit state banks to be organized as unincorporated LLCs and the FDIC adopted a rule allowing certain state bank LLCs to qualify for Federal deposit insurance. This amendment would clarify that the OCC can permit national banks to organize in an alternative business form, such as an LLC, in the same manner.

Paying Interest on Demand Deposits. The OCC supports amendments to the banking laws to repeal the statutory prohibition that prevents banks from paying interest on demand deposits.[9] The prohibition on paying interest on demand deposits was enacted approximately 70 years ago for the purpose of deterring large banks from attracting

[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.

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% to 15% 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% 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 U.S. as an office of a foreign bank. In this regard, the OCC is recommending amendments to reduce certain unnecessary burdens on Federal branches and agencies while preserving national treatment with national banks.

Implementing Risk-Based Requirements for Federal Branches and Agencies. A priority item for the OCC 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 approach 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 non-public 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, *e.g.,* 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 non-bank party to the agreement on a showing that the non-bank 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 (*i.e.*, an insured bank that has no ongoing business operations because, for example, all of the business operations have been transferred to another institution) is the subject of a change-in-control notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a 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.

IV. 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 <u>not</u> delivering the information that consumers need to make informed decisions about their rights and responsibilities, but they <u>are</u> 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 provide effective communications 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 decision making (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.

V. 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.

[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.

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;

[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.

(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; and
- Provide that the Federal banking agencies will review the requirements for banks' reports of condition under the FDIA every five years and reduce or eliminate any requirements that are no longer necessary or appropriate.

VI. 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.

APPENDIX #1

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

NATIONAL BANKS

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

Under the Riegle-Neal Act, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. While two states "opted out" at the time, interstate bank mergers are now permissible in all 50 states. By contrast, *de novo* branching by banks requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state and only approximately 23 states have opted in (17 of which require reciprocity). As a result, banks in many cases must structure artificial and unnecessarily expensive transactions in order to simply establish a new branch across a state border. However, Federal thrifts are not similarly restricted and generally may branch interstate without the state law "opt-in" requirements that are imposed on banks. Also, repeal of the state age requirement would remove a limitation on bank acquisitions by out-of-state banking organizations that is no longer necessary if interstate *de novo* branching is permitted.

Enactment of this amendment should enhance competition in banking services with resulting benefits for bank customers. Moreover, it will ease burdens on banks that are planning interstate expansion through branches and would give banks greater flexibility in formulating their business plans and in making choices about the form of their interstate operations. Community banks that seek to serve customers across state lines would especially benefit since they lack the resource base available to larger banks that is required to structure the more complicated transactions now required to accomplish that result.

Resolving Issues Concerning Federal Court Jurisdiction. The OCC supports amending the National Bank Act (12 U.S.C. § 1, *et seq.*) to resolve the issues concerning national banks' state citizenship for purposes of Federal court diversity jurisdiction. The OCC supports a parallel amendment to the Home Owners' Loan Act (HOLA) (12 U.S.C. § 1461, *et seq.)* that would provide the same rule for Federal savings associations. National banks and Federal thrifts are chartered by the Federal Government and not by any state and both charters have been subject to conflicting interpretations about state citizenship. As a result, it makes sense to treat all Federally chartered depository institutions the same and end the confusion.

National banks' diversity jurisdiction is governed by 28 U.S.C. § 1348. This statute provides that generally national banks are "citizens" of the states in which they are "located." However, the term "located" is not defined in § 1348, and the Federal courts have not defined the term consistently.

In 2001, a U.S. Circuit Court of Appeals concluded that a national bank is "located" in, and thus for diversity jurisdiction purposes a citizen of, the state of its principal place of business and the state listed in its organization certificate. *Firstar Bank, N.A. v. Faul*, 253 F.3d 982 (7^{th} Cir. 2001). The *Firstar* opinion created confusing jurisdictional issues. The state listed in a national bank's organization certificate may not necessarily be the state in which the national bank currently has its main office. Under Federal law, a national bank can relocate its main office to a state other than that designated in its organization certificate.[12] However, no new organization certificate would need to be issued. After the relocation, the national bank may no longer have any offices in the state listed in its organization certificate.[13] Under *Firstar*, however, the bank would continue to be deemed a citizen of that state for diversity purposes because it is the state listed in its organization certificate.

In 2003, a lower Federal court reached a different conclusion. It held that a national bank is "located" in the state where it has its principal place of business and in the state specified in its *articles of association*. The court reasoned that a national bank's articles of association must be updated to reflect the bank's current main office and, therefore, the articles of association and not the bank's organization certificate should be used to determine citizenship status in diversity cases. *Evergreen Forest Products v. Bank of America,* 262 F. Supp. 2d 1297 (M.D. Ala. 2003). Under this interpretation, a national bank also could potentially be a citizen of two states, but a different criterion is used to identify one of the two states.

Most recently, two Circuit Courts have reached opposite conclusions about how to determine the citizenship of national banks for purposes of diversity jurisdiction. In October 2004, the Fifth Circuit held in that a national bank is not "located" at its interstate

[12] 12 U.S.C. § 30.

[13] Separately, the OCC also has supported amending Federal law to clarify that, for corporate status purposes, a national bank's general business is transacted at its main office and not the place specified in its organization certificate.

branch locations for purposes of Federal court jurisdiction. *Horton v. Bank One, N.A.*, 387 F.3d 426 (5th Cir. 2004). In November 2004, the Fourth Circuit took a position that is contrary to the position taken by every other circuit court by finding that a national bank is "located" in *every* state in which it operates a branch or potentially any other type of permanent office. *Wachovia Bank v. Schmidt*, 388 F.3d 414 (4th Cir. 2004). Indeed, over 60 years ago, the Ninth Circuit concluded that a national bank is a citizen only of the state where it maintains its principal place of business. *American Surety Co. v. Bank of California*, 133 F.2d 160 (9th Cir. 1943). Currently, there are petitions pending before the United States Supreme Court asking it to resolve the conflict between the Fourth and Fifth Circuits.

The inconsistent interpretation of the same Federal statutory standard for diversity jurisdiction by different Federal courts has created substantial uncertainty for national banks. Under the Fourth Circuit's interpretation, a national bank would be denied access to Federal court under diversity jurisdiction when an 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 on a multi-state basis. Federal thrifts are subject to similar uncertainty because Federal law does not currently specify their citizenship for purposes of diversity jurisdiction.[14] We support amendments that would resolve the uncertainty for both national banks and Federal thrifts and provide a clear, uniform rule for determining the citizenship of both types of Federally chartered depository institutions.

National banks and Federal thrifts share the common attribute of being chartered by the Federal Government and not by any state. Thus, both types of Federally chartered depository institutions should be subject to the same standard for purposes of Federal diversity jurisdiction.

Providing Relief for Subchapter S National Banks. The OCC supports amending section 5146 of the Revised Statutes of the United States (12 U.S.C. § 72) to provide more flexible requirements regarding director qualifying shares for national banks operating, or seeking to operate, as Subchapter S corporations. The National Banking Act currently requires all directors of a national bank to own "shares of the capital stock" of the bank having an aggregate par value of at least $1,000, or an equivalent interest, as determined by the Comptroller, in a bank holding company that controls the bank. This amendment would permit the Comptroller to allow the use of a debt instrument that is subordinated to the interests of depositors, the Federal Deposit Insurance Corporation (FDIC), and other general creditors to satisfy the qualifying shares requirement for directors of national banks seeking to operate in Subchapter S status.

The requirement in current law creates difficulties for some national banks that operate in Subchapter S form. It effectively requires that all directors be shareholders, thus making it difficult for some banks to comply with the 100-shareholder limit that defines eligibility for

[14] *See, e.g., 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).

the benefit of Subchapter S tax treatment, which avoids double tax on the bank's earnings. Such a subordinated debt instrument would have features resembling an equity interest, since the directors could only be repaid if all other claims of depositors and nondeposit creditors of the bank were first paid in full, including the FDIC's claims, if any. It would thus ensure that directors retain their personal stake in the financial soundness of the bank. However, the holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S.

Simplifying Dividend Calculations for National Banks. The OCC supports amending section 5199 of the Revised Statutes of the United States (12 U.S.C. § 60) to simplify the formula for calculating the amount that a national bank may pay in dividends. The current law requires banks to follow a complex formula that is unduly burdensome and unnecessary for safety and soundness. The proposed amendment would retain certain safeguards in the current law that provide that national banks (and state member banks)[15] need the approval of the Comptroller (or the Board of Governors of the Federal Reserve System (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 two years. For purposes of the approval requirement, these Federal regulators would retain the authority to reduce the amount of a bank's "net income" by any required transfers to funds, such as a sinking fund for retirement of preferred stock.

The amendment would reduce burden on banks in a manner that is consistent with safety and soundness. Among other things, the amendment would ensure that the OCC (and the 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 towards troubled condition. Importantly, the amendment would not affect other safeguards in the National Bank Act (12 U.S.C. § 56). These provisions generally prohibit national banks from withdrawing any part of their permanent capital or paying dividends in excess of undivided profits except in certain circumstances.

Moreover, other safeguards, such as Prompt Corrective Action enacted in 1991, provide additional safety and soundness protections for all insured depository institutions. The proposed amendment would not affect the applicability of these safeguards. These additional safeguards prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 U.S.C. § 1831o(d)(1)).

Modernizing Corporate Governance. The OCC supports amending section 5144 of the Revised Statutes of the United States (12 U.S.C. § 61), which currently imposes mandatory cumulative voting requirements on all national banks. This law requires that, in all elections of national bank directors, each shareholder has the right to (1) vote for as many candidates as there are directors to be elected and to cast the number of votes for each candidate that is equal to the number of shares owned, or (2) cumulate his or her votes by

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

multiplying the number of shares owned by the number of directors to be elected and casting the total number of these votes for only one candidate or allocating them in any manner among a number of candidates. The OCC supports an amendment that would permit a national bank to provide in its articles of association the method of electing its directors that best suits its business goals and needs and would provide the OCC with authority to issue regulations to carry out the purposes of this section.

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

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

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

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

Paying Interest on Demand Deposits. The OCC supports repealing section 19(i) of the FRA (12 U.S.C. § 371a), section 5(b)(1)(B) of HOLA (12 U.S.C. § 1464(b)(1)(B)) and section 18 of the FDIA (12 U.S.C. § 1828) to permit member banks, thrifts, and nonmember banks, respectively, to pay interest on demand deposits.[16] In a joint report submitted to Congress in September 1996, the OCC, along with the other Federal banking agencies, concluded that the statutory prohibition against the payment of interest on demand deposits no longer serves a useful public purpose. See Joint Report: Streamlining of Regulatory Requirements (September 23, 1996). Because banks can pay interest on NOW accounts held by individuals, it is primarily business checking accounts that are subject to prohibition on paying interest on demand deposits. Banks, however, find ways around this prohibition for their business customers through such financial products as sweep accounts that sweep excess demand deposits into money market investments. These programs are costly for the banks to maintain, an inefficient use of the banks' resources, and an unnecessary burden on business customers to establish such accounts. Community banks also are disadvantaged since they have fewer resources to apply to supporting these alternative arrangements then do larger banks.

Repealing Obsolete Limitations on the OCC's Removal Authority. The OCC supports amending section 8(e)(4) of the FDIA (12 U.S.C. § 1818(e)(4)) relating to the procedures for the removal of an institution-affiliated party (IAP) from office or participation in the affairs of an insured depository institution. With respect to national banks, current law requires the OCC to certify the findings and conclusions of an Administrative Law Judge to the Fed for the Fed's determination as to whether any removal order will be issued. This amendment would repeal this certification and Fed approval process and allow the OCC directly to issue the removal order with respect to national banks.

The present system stems from historical decisions made by Congress on circumstances that are no longer applicable. Originally, the role of the OCC in removal cases was to certify the facts of the case to the Fed. The Fed then made the decision to pursue the case and made the final agency decision. At that time, the Comptroller was a member of the Federal Reserve Board and, therefore, participated in the Fed's final removal decision. However, Congress later removed the Comptroller from the Fed and gave the OCC the authority directly to issue suspensions and notices of intention to remove.

All of the Federal banking agencies, except the OCC, may remove a person who engages in certain improper conduct from the banking business. This amendment would give the Comptroller the same removal authority as the other banking agencies to issue orders to remove persons who have been determined under the statute to have, for example, violated the law or engaged in unsafe or unsound practices in connection with an insured depository institution. Like the other banking agencies, the Comptroller should make these decisions about persons who engage in improper conduct in connection with the institutions for which the Comptroller is the primary supervisor. This is a technical change to streamline and expedite these actions and has no effect on a person's right to seek judicial review of any removal order. The Fed also supports this amendment.

[16] This provision was included in H.R. 1224, the Business Checking Freedom Act of 2005, as passed by the House on May 24, 2005.

Repealing Obsolete Intrastate Branch Capital Requirements. The OCC supports amending section 5155(c) of the Revised Statutes of the United States (12 U.S.C. § 36(c)) to repeal the requirement that a national bank, in order to establish an intrastate branch office in a state, must meet the capital requirements imposed by the state on state banks seeking to establish intrastate branches.

This technical amendment would repeal the obsolete capital requirement for the establishment of intrastate branches by national banks. This requirement is not necessary for safety and soundness. Branching restrictions are already imposed under other provisions of law to limit the operations of a bank if it is in troubled condition. See 12 U.S.C. § 1831o(e) (prompt corrective action).

Giving National Banks More Flexibility in Main Office Relocations. The OCC supports amending national banking law to make several changes that will reduce unnecessary burdens on a national bank seeking to relocate its main office and will give a national bank more flexibility in structuring its business operations.

First, a national bank that is merging or consolidating with another bank *in the same state* does not have the same authority under current law to designate any office of the merged or consolidated entity as its main office as it would have if it were involved in an *interstate* merger or consolidation. *See* 12 U.S.C. § 1831u(d)(1). Under the Riegle-Neal Act, a resulting bank may, with the approval of its appropriate Federal banking agency, retain and operate any main office or branch of any bank involved in an *interstate* merger transaction as a main office or a branch of the resulting bank. *Id.*

The proposed amendment amends the National Bank Consolidation and Merger Act (12 U.S.C. §§ 215, 215a) to provide parity with respect to main office relocations. The amendments 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 a merger or consolidation between a national bank and another bank *located in the same state*. This change would give a national bank engaging in a merger or consolidation transaction with another bank in the same state more flexibility to designate its main office and manage its business operations in the same manner that the Riegle-Neal Act provides flexibility and more business choices to banks engaged in interstate transactions with respect to main office relocations.

It is not necessary to amend current law to give a resulting national bank the authority to retain and operate the branch offices of any of the banks involved in a merger or consolidation under § 215 and § 215a or the authority to retain and operate a main office of any other bank involved in the transaction. This authority is provided under current law, subject to certain restrictions. *See* 12 U.S.C. § 36(b)(2). The issue is simply enabling the bank to designate as a main office a location in the same state in which the merging banks are located, that is not currently the main office of either of the combining banks.

Second, the proposal would amend national banking law at 12 U.S.C. § 30 to give a national bank more flexibility when relocating its main office to a branch location within the same state. Under current law, with written notice to the Comptroller, a national bank may relocate is main office to any branch location within the limits of the city, town, or village in which it is situated. *See* 12 U.S.C.§ 30(b). If a national bank is seeking to relocate its main office to a branch location outside the city limits or to any other location within or outside the city limits, it must (1) obtain the vote of two-thirds of the shareholders, (2) obtain the Comptroller's approval, and (3) limit any such relocation to 30 miles outside the city limits. *Id.*

The proposed amendment continues to permit a national bank to relocate its main office to a branch location inside the city limits in which the main office is currently located with notice to the Comptroller. The amendment, however, changes current law in the following respects:

1. A national bank would be permitted to relocate its main office to a branch location that is within the same state as the main office *subject to the Comptroller's approval*. Shareholder approval would no longer be required for this business change in which no new deposit facilities are being established and the 30-mile relocation limit would not apply to these business decisions.
2. A national bank relocating its main office to a branch location inside the city limits or to a branch location in the same state would be permitted to operate the former main office as a branch if the bank could operate a branch at that location in accordance with 12 U.S.C. § 36(c). This limitation would ensure that a national bank would be able to convert its former main office to a branch under these amendments to 12 U.S.C. § 30 only if operating a branch at the same location would be permissible for state banks under § 36(c).

The amendment does not make any other changes to current law. Moreover, the amendment does not affect the Community Reinvestment Act requirements. The main office relocations that currently require an application to obtain Comptroller approval would still be subject to the same requirements.

Enhancing National Banks' Community Development Investments. The OCC supports increasing the maximum amount that a national bank can invest in community development activities. Under current law, 12 U.S.C. § 24(Eleventh) authorizes national banks to make investments designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families, either directly or by purchasing interests in an entity primarily engaged in making these investments (CDC investments). This statute limits these aggregate investments to 5% of a national bank's unimpaired capital and surplus, unless the OCC determines that a higher amount will pose no significant risk to the deposit insurance fund and the bank is adequately capitalized. However, in no case, may the OCC permit a bank's aggregate outstanding CDC investments to exceed 10% of the bank's unimpaired capital and surplus. In addition, the OCC has the authority to limit a national bank's investment in any one project, as well the aggregate investments. The OCC's regulations governing these investments are in 12 C.F.R. Part 24. By regulation, the OCC also prohibits a national bank from making such an investment if it would expose the bank to unlimited liability. *See* 12 C.F.R. § 24.4(b).

Thus, a national bank may exceed the 5% investment only if it is adequately capitalized and only if the OCC determines that a higher limit will not pose a significant risk to the deposit insurance fund. Many national banks that have satisfied this test are moving closer to or have reached the maximum10% of capital/surplus limit under current law.

This amendment would increase the maximum limit from 10% to 15%. The amendment would not change the requirements in current law for a national bank to be eligible for a higher investment limit under the CDC authority. Today, more than 90% of national banks' CDC investments are in low-risk, low-income housing tax credit (LIHTC) projects and funds, many of which have credit enhancements with AA or AAA ratings. Losses associated with LIHTC investments are minimal, according to a recent Ernst & Young study (only 0.14% of LIHTC projects financed since 1987 have gone into foreclosure). Under the amendment, as in current law, the OCC would continue to be required to determine that an aggregate CDC investment amount that exceeds 5% of capital/surplus poses no significant risk to the deposit insurance fund and the requirement that the bank must be adequately capitalized still would apply. This amendment would enhance the ability of national banks to support community and economic development through investments with a successful track record.

Clarifying the Waiver of Publication Requirements for Bank Merger Notices. The OCC supports amending sections 2(a) and 3(a)(2) of the National Bank Consolidation and Merger Act (12 U.S.C. § 215(a) and 215a(a)(2), respectively) concerning the newspaper publication requirement of a shareholder meeting to vote on a consolidation or merger of a national bank with another bank located within the same state. This change would clarify that the publication requirement may be waived by the Comptroller in the case of an emergency situation or by unanimous vote of the shareholders of the national or state banks involved in the transaction.

This amendment does not affect other requirements in the law. The current law also requires that the consolidation or merger must be approved by at least a 2/3 vote of the shareholders of each bank involved in the transaction. In addition, the shareholders of the banks generally must receive notice of the meeting by certified or registered mail at least ten days prior to the meeting. These provisions are not changed.

Repealing Obsolete References to the Main Place of Business of a National Bank. The OCC supports amending two sections of the Revised Statutes of the United States (12 U.S.C. §§ 22 and 81) to replace obsolete language that is used in these two sections with the modern term "main office."

The change to 12 U.S.C. § 22 would clarify that the information required to be included in a national bank's organization certificate is the location of its *main office*. The change of 12 U.S.C. § 81 would clarify that the general business of a national bank shall be transacted in its *main office* and in its branch or branches. Both statutes currently use obsolete terms to describe a main office of a national bank.

Deleting Obsolete Language in the National Bank Act. The OCC supports amending section 5143 of the Revised Statues of the United States (12 U.S.C. § 59) to delete obsolete language. Generally, 12 U.S.C. § 59 permits a national bank to reduce its capital and distribute cash or other assets to its shareholders that become available as a result of the reduction if approved by a vote of two-thirds of its shareholders and by the OCC. The current statute, however, also references two obsolete provisions. The first provision limits the amount of the capital reduction to a "sum not below the amount required by this chapter to authorize the formation of associations." This limitation refers to the obsolete minimum capital requirement for a de novo institution that was provided under 12 U.S.C. § 51; however, 12 U.S.C. § 51 was repealed in 2000 by the American Homeownership and Economic Opportunity Act of 2000, Pub. L. No. 106-569, Title XII, § 1233(c). The second obsolete provision limits the amount of a bank's capital that can be reduced to the "amount required for its outstanding circulation." The reference to "outstanding circulation" relates to the obsolete practice by national banks of issuing circulating notes to serve as currency.

This amendment would delete the obsolete language in the statute but would maintain the current relevant requirement that a national bank cannot reduce its capital and distribute assets to its shareholders unless approved by two-thirds of its shareholders and by the OCC.

SAFETY AND SOUNDNESS

Enforcing Written Agreements and Commitments. The OCC supports amending the FDIA (12 U.S.C. § 1811, *et seq.*) to add a new section that provides that the Federal banking agencies may enforce the terms of (1) conditions imposed in writing in connection with an application, notice, or other request, and (2) written agreements.

This amendment would enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses. This amendment is intended to reverse some court decisions that question the authority of the agencies to enforce such conditions or agreements against institution-affiliated parties (IAP) without first establishing that the IAP was unjustly enriched. In addition, the amendment would clarify that a condition imposed by a banking agency in connection with the nondisapproval of a notice, *e.g.*, a notice under the Change in Bank Act (CBCA), can be enforced under the FDIA.

Barring Convicted Felons From Participating in the Affairs of Depository Institutions. The OCC supports amending section 19 of the FDIA (12 U.S.C. § 1829) to give the Federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an *un*insured national or state bank or *un*insured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to *insured* depository institutions. The OCC believes that this amendment would help to enhance the safe and sound operations of uninsured, as well as insured, institutions.

Ensuring That Accountants of Insured Depository Institutions Are Held to the Same Standard as Other IAPs. The OCC supports amending section 3(u)(4) of the FDIA (12 U.S.C. § 1813(u)(4)) to remove the "knowing and reckless" requirement. This change would hold independent contractors to a standard that is more like the standard that applies to other IAPs. Under current law, independent contractor IAPs are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution. To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a Federal banking agency to take action against the accountant as an IAP for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency today must show that the accountant "knowingly and recklessly" participated in such a violation. This amendment would strike the "knowing and reckless" requirement. However, other requirements in the statute with respect to requiring a banking agency to show that the violation by the independent contractor caused or is likely to cause more than a minimal loss to, or have a significant adverse effect on, the institution would still apply.

The knowing and reckless standard in the current law is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in clearly negligent conduct. The amendment will strengthen the agencies' enforcement tools with respect to accountants and other independent contractors.

Strengthening the Supervision of Stripped-Charter Institutions. The OCC supports amending the CBCA in section 7(j) of the FDIA (12 U.S.C. § 1817(j)) to expand the criteria to allow a Federal banking agency to extend the time period to consider a CBCA notice. Under the CBCA, a Federal banking agency must disapprove a CBCA notice within certain time frames or the transaction may be consummated. Initially, the agency has up to 90 days to issue a notice of disapproval. The agency may extend that period for up to an additional 90 more days if certain criteria are satisfied and this amendment provides for new criteria that would allow an agency to extend the time period under this additional up to 90-day period. The new criteria that an agency could use to extend the time period can provide the agency more time to analyze the future prospects of the institution or the safety and soundness of the acquiring party's plans to make changes in the institution's business operations, corporate structure, or management. Moreover, the amendment would permit the agencies to use that information as a basis to issue a notice of disapproval.

The OCC believes that this amendment will address issues that have arisen for the banking regulators when a stripped-charter institution (*i.e.*, an insured bank that has no ongoing business operations because, for example, all of the business operations have been merged into another institution) is the subject of a CBCA notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a *de novo* charter and an application for deposit insurance.

In general, the scope of review of a *de novo* charter application or deposit insurance application is more comprehensive than the statutory grounds for the denial of a notice under the CBCA. There are also significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the Federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the requirement for prior approval and without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. The recommended amendment would expand the criteria in the CBCA that allows a Federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider the acquiring party's business plans and the future prospects of the institution and use that information in determining whether to disapprove the notice.

Providing a Statute of Limitations for Judicial Review of Appointment of a Receiver for a National Bank. The OCC supports amending section 2 of the National Bank Receivership Act (12 U.S.C. § 191) to provide for a 30-day period to judicially challenge a determination by the OCC to appoint a receiver for a national bank. Current law generally provides that challenges to a decision by the Office of Thrift Supervision (OTS) to appoint a receiver or conservator for an insured savings association or the FDIC to appoint itself as receiver or conservator for an insured state depository institution must be raised within 30 days of the appointment. 12 U.S.C. §§ 1464(d)(2)(B), 1821(c)(7). There is, however, no statutory limit on a national bank's ability to challenge a decision by the OCC to appoint a receiver of an insured or uninsured national bank.[17] As a result, the general six-year statute of limitations for actions against the U.S. applies to the OCC's receiver appointments. *See James Madison, Ltd. v. Ludwig,* 82 F.3d 1085 (D.C. Cir. 1996).

The six-year protracted time period under current law complicates resolution and winding up the affairs of an insured national bank in a timely manner with legal certainty. The recommended amendment would make the statute of limitations governing the appointment of receivers of national banks consistent with the time period that generally applies to other depository institutions. The amendment would not affect a national bank's ability to challenge a decision by the OCC to appoint a receiver, but simply require that these challenges must be brought in a timely manner and during the same time frame that generally applies to other depository institutions.

Allocating Examiner Resources More Efficiently. The OCC supports amending section 10(d) of the FDIA (12 U.S.C. § 1820(d)) to provide that an appropriate Federal banking

[17] Under current law, there is a 20-day statute of limitations for challenges to the OCC's decision to appoint a conservator of a national bank. 12 U.S.C. § 203(b)(1).

agency may make adjustments in the examination cycle for an insured depository institution if necessary for safety and soundness and the effective examination and supervision of insured depository institutions. Under current law, insured depository institutions must be examined by their appropriate Federal banking agencies at least once during a 12-month period in a full-scope, on-site examination unless an institution qualifies for the 18-month rule. Small insured depository institutions with total assets of less than $250 million and that satisfy certain other requirements may be examined on an 18-month basis rather than a 12-month cycle. The amendment would permit the banking agencies to make adjustments in the scheduled examination cycle as necessary for safety and soundness.

Such an amendment would give the appropriate Federal banking agencies the discretion to adjust the examination cycle of insured depository institutions to ensure that examiner resources are allocated in a manner that provides for the safety and soundness of insured depository institutions. For example, as deemed appropriate by a Federal banking agency, a well-capitalized and well-managed bank's examination requirement for an annual or 18-month examination could be extended if the agency's examiners were needed to immediately examine troubled or higher risk institutions. This amendment would permit the agencies to use their resources in the more efficient manner.

Enhancing the Ability of Banking Agencies to Suspend or Remove Bad Actors From Depository Institutions. The OCC supports amending section 8(g) of the FDIA (12 U.S.C. § 1818(g)) to clarify that the appropriate Federal banking agency may suspend or prohibit IAPs charged or convicted with certain crimes (including those involving dishonesty, breach of trust, or money laundering) from participating in the affairs of any depository institution and not only the institution with which the party is or was last affiliated. The amendment also would clarify that the section 8(g) authority applies even if the IAP is no longer associated with the depository institution at which the offense allegedly occurred or if the depository institution with which the IAP was associated is no longer is existence. Moreover, the amendment would allow the banking agency to suspend or remove an individual who attempts to become involved in the affairs of an insured depository institution after being charged with a covered crime. It makes little sense to allow the agencies to suspend or remove a person who is charged with such a crime while serving at an insured depository institution, but deny the agencies the ability to remove a person that becomes affiliated with an insured depository institution while under indictment for the same type of crime.

Under current law, if an IAP is charged with such a crime, the suspension or prohibition will remain in effect until the charge is finally disposed of or until terminated by the agency. If the individual is convicted of such a crime, the party may be served with a notice removing the party from office and prohibiting the party for further participating in the affairs of a depository institution without the consent of the appropriate Federal banking agency.[18] Before an appropriate Federal banking agency may take any of these

[18] Under another provision of the FDIA, any person convicted of any crime involving dishonesty, breach of trust, or money laundering may not, among other things, become or continue as an IAP with respect to any insured depository institution without the prior consent of the FDIC. 12 U.S.C. § 1829. As discussed above,

actions under section 8(g), the agency must find that service by the party may pose a threat to interests of depositors or impair public confidence in a depository institution. The statute further provides that an IAP that is suspended or removed under section 8(g) may request a hearing before the agency to rebut the agency's findings. Unless otherwise terminated by the agency, the suspension or order of removal remains in effect until the hearing or appeal is completed. Current law, however, applies only to the depository institution with which the IAP is then associated. This amendment will help to ensure that, if a Federal banking agency makes the required findings, the agency has adequate authority to suspend or prohibit an IAP charged with such crimes from participating in the affairs of any depository institution if any of the various circumstances described above should occur.

FEDERAL BRANCHES AND AGENCIES OF FOREIGN BANKS.

Implementing Risk-Based Requirements for Federal Branches and Agencies. The OCC supports an amending section 4(g) of the International Banking Act of 1978 (IBA) (12 U.S.C. § 3102(g)) concerning the Comptroller's authority to set the amount of the capital equivalency deposit (CED) for a Federal branch or agency. The CED is intended to ensure that assets will be available in the U.S. for creditors in the event of liquidation of a U.S. branch or agency. The current CED statute that applies to foreign banks operating in the U.S. through a Federal license may impose undue regulatory burdens without commensurate safety and soundness benefits. These burdens include obsolete requirements about where the deposit must be held and the amount of assets that must be held on deposit. As a practical matter, the IBA sets the CED at 5% of total liabilities of the Federal branch or agency and provides that the CED must be maintained in such amount as determined by the Comptroller. As a result, Federal branches and agencies often must establish a CED that is larger than the capital that would be required for a bank of corresponding size or for a similar size state-chartered foreign branch or agency in major key States.

The OCC recommends that section 4(g) be amended to allow the OCC, after consultation with the Federal Financial Institutions Examination Council (FFIEC), to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely parallel the risk-based capital framework that applies to national and state banks. The Federal Reserve Board has no objections to the OCC's amendment.

Allowing the Option for a Federal Representative Office License. The OCC supports amending section 4 of the IBA (12 U.S.C. § 3102) to permit the OCC to license Federal representative offices. Representative offices of foreign banks generally engage in representational functions. They do not engage in core banking activities, such as accepting deposits or lending money. Although the IBA sought to provide foreign banks

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the OCC also supports amending § 1829 to apply to *un*insured, as well as insured, depository institutions and to give the OCC the authority to keep these convicted felons out of uninsured national banks or Federal branches or agencies.

with a Federal option for their U.S. offices by giving the OCC the authority to license Federal branches and agencies, it did not provide the OCC with the authority to establish Federal representative offices. In this respect, the IBA does not fully implement the goal of national treatment for foreign banks seeking to establish a representative office in the United States.

The absence of a Federal representative office option has in some cases resulted in additional regulatory burden for those foreign banks that would want to have their entire U.S. operations under a Federal license. If foreign banks with an existing Federal branch or agency want to have a representative office, they are required to establish them under state law provisions, and thus gain an additional U.S. regulator.

The amendment supported by the OCC would provide foreign banks with the option of establishing Federal representative offices with OCC approval and under the OCC's supervision. Specifically, it would authorize the OCC to approve the establishment of a representative office, provided that state law does not prohibit this establishment. In acting on an application to establish a Federal representative office, the OCC generally would apply the same criteria that it applies when it acts on Federal branch or agency applications.

The amendment also would provide that the OCC would have the authority to regulate, supervise, and examine representative offices that it licenses. Finally, to ensure that the OCC has adequate authority to enforce this provision, the proposal would amend section 3(q) of the FDIA to include a Federal representative office as an entity for which the Comptroller serves as the appropriate Federal banking agency and, would further amend the FDIA to clarify that representative offices are subject to the enforcement authority of the Fed and OCC under 12 U.S.C. § 1818.

This amendment would not affect or in any way diminish the Fed's authority under current law to approve (in addition to the primary, or licensing, authority) the establishment of foreign banks' U.S. offices (Federal- or state-licensed branches, agencies, or representative offices) and to examine any of these entities under the IBA. Moreover, the Fed would have the same ability to recommend to the OCC that the license of a Federal representative office be terminated that it has under current law to recommend that the license of a Federal branch or agency be terminated.

Providing Equal Treatment for Federal Agencies of Foreign Banks. The OCC supports amending section 4(d) of the IBA (12 U.S.C. § 3102(d)) to provide that the prohibition on uninsured deposit-taking by Federal agencies of foreign banks applies only to deposits from U.S. citizens or residents. As a result, a Federal agency would be able to accept uninsured foreign source deposits from non-U.S. citizens. State agencies of foreign banks may accept uninsured deposits from parties who are neither residents nor citizens of the United States, if so authorized under state law. However, due to slight language differences in the IBA, the D.C. Circuit Court of Appeals has held that Federal agencies cannot accept any deposits, including those from noncitizens who reside outside of the United States. *Conference of State Bank Supervisors v. Conover*, 715 F.2d 604, 623 (D.C. Cir. 1983).

The amendment supported by the OCC would allow Federal agencies to accept the limited *uninsured* foreign source deposits that state agencies may accept under the IBA. As a result, Federal agencies would be able to offer the same services to foreign customers that may be offered by state agencies. Because these deposits are not insured, this amendment does not pose any risks to the deposit insurance fund.

Maintaining a Federal Branch and a Federal Agency in the Same State. The OCC supports an amendment to section 4(e) of the IBA (12 U.S.C. § 3102(e)) to provide that a foreign bank is prohibited from maintaining both a Federal agency and a Federal branch in the same state only *if* state law prohibits maintaining both an agency and a branch in the state. Current law prohibits a foreign bank from operating both a Federal branch and a Federal agency in the same state notwithstanding that state law may allow a foreign bank to operate both types of offices.

According to the legislative history of the current provision, this prohibition was included in the IBA to maintain parity with state operations. However, today some states permit foreign banks to maintain both a branch and agency in the same state. For example, Florida law permits a foreign bank to operate more than one agency, branch, or representative office in Florida (*see* Fla. Stat. Ann. § 663.06). This amendment would repeal an outdated regulatory burden in current law and permit a foreign bank to maintain both a Federal branch and a Federal agency in those states that do not prohibit a foreign bank from maintaining both of these offices. This change would enhance national treatment and give foreign banks more flexibility in structuring their U.S. operations.

INFORMATION SHARING

Improving Ability to Obtain Information from Regulated Entities. The OCC supports amending the FDIA (12 U.S.C. § 1811, *et seq.*) to permit the OCC, FDIC, Fed, and OTS to establish and use advisory committees in the same manner. The Federal Advisory Committee Act (5 U.S.C. App.) (FACA) generally requires that the meetings of advisory committees must be open to the public, and that advance notice of a committee meeting must be published in the Federal Register. The minutes of the meeting and all working papers and other documents prepared for or by the advisory committee also must be publicly available.

Under current law, 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 non-public 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.

Improving Information Sharing. The OCC supports amending the FDIA (12 U.S.C. § 1811, *et seq.*) to provide that a Federal banking agency has the discretion to furnish any confidential supervisory information, including a report of examination, about a depository institution or other entity examined by the agency to another Federal or state supervisory agency and to any other person deemed appropriate.

Such an amendment would give the other Federal banking agencies parallel authority to share confidential information that was given to the Fed in Sec. 727 of the Gramm-Leach-Bliley Act (GLBA). This provision is discretionary and nothing in this provision would compel a banking agency to disclose confidential supervisory information that it has agreed to keep confidential pursuant to an information sharing or other agreement with another supervisor. There is no reason why parallel provisions should not apply to all the Federal banking agencies.

APPENDIX #2

SUMMARY OF THE REGULATORY BURDEN RELIEF LEGISLATION SUPPORTED BY THE OCC, FED, FDIC, OTS AND INDUSTRY TRADE GROUPS[19]

Giving the Federal Reserve Authority to Pay Interest on Reserve Balances. The OCC together with the other Federal banking agencies and the industry trade groups support an amendment to section 19(b) of the FRA (12 U.S.C. § 461(b)) to give the Fed the authority to pay interest on balances held by depository institutions at the Federal Reserve banks.[20] Section 19(b) requires depository institutions to maintain reserves against their transaction accounts and certain other deposits (required reserves). Banks also may hold other types of balances in their accounts at Federal Reserve banks. To avoid the prohibition on payment of interest on required reserves, banks have created mechanisms to minimize required reserves. This amendment would permit the Fed to pay interest on all reserve balances on at least a quarterly basis at a rate not to exceed the general level of short-term interest rates. The Fed would have authority to issue regulations regarding the payment, distribution, and crediting of interest pursuant to this section.

Authorizing Member Banks to Use Pass-Through Reserve Accounts. The OCC together with the other Federal banking agencies and the industry trade groups support an amendment to section 19(c)(1)(B) of the FRA (12 U.S.C. § 461(c)(1)(B)). This amendment would permit member banks to use their deposits in affiliated or correspondent banks, which in turn are deposited by the affiliate or correspondent bank in a Federal reserve bank, for purposes of satisfying the member banks' required reserves. Under current law, only nonmember banks can use the pass-through arrangement. This amendment would permit member banks also to use pass-through deposits, which are considered the equivalent of deposits in a Federal Reserve bank, as a reserve management tool.

Providing the Fed with More Flexibility to Set Reserve Requirements. The OCC together with the other Federal banking agencies and the industry trade groups support amending section 19(b)(2)(A) of the FRA (12 U.S.C. § 461(b)(2)(A)) to give the Fed more discretion in setting reserve requirements and implementing monetary policy. Under current law, the reserve requirements must be set within a certain range but no lower than 8% or 3% depending on the size of the transaction account. This amendment would give the Fed the flexibility to set reserve requirements at a lower rate and even reduce the reserve requirements to zero.

[19] The industry trade groups include the American Bankers Association, America's Community Bankers, the Independent Community Bankers of America, and the Financial Services Roundtable.
[20] This provision was included in H.R. 1224, the Business Checking Freedom Act of 2005, as passed by the House on May 24, 2005.

<u>Reducing Reporting Burdens Relating to Insider Lending Reporting</u>. The OCC together with the other Federal banking agencies and the industry trade groups support amending section 22(g) of the FRA (12 U.S.C. § 375a) and section 106(b)(2) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. § 1972(2)) to eliminate certain reporting requirements concerning loans made to insiders. Specifically, the reports that would be eliminated are (1) the report that must be filed with a bank's board of directors when an executive officer of the bank obtains certain types of loans from another bank that exceeds the amount the officer could have obtained from his or her own bank, (2) the supplemental report a bank must file with its quarterly call report identifying any loans made to executive officers during the previous quarter, and (3) an annual report filed with a bank's board of directors by its executive officers and principal shareholders regarding outstanding loans from correspondent banks.

Nothing in these amendments affects the substantive insider lending restrictions that apply to banks or the banking agencies' enforcement of those restrictions. Under the OCC's regulations, national banks are required to follow the Fed's regulations regarding insider lending restrictions and reporting requirements (<u>see</u> 12 C.F.R. § 31.2). The Fed's regulations require member banks to maintain detailed records of all insider lending. In addition, the OCC has the authority under 12 U.S.C. § 1817(k) to require any reports that it deems necessary regarding extensions of credit by a national bank to any of its executive officers or principal shareholders, or the related interests of such persons. Thus, the OCC believes the amendment will not affect its ability to obtain the information needed to review a bank's compliance with insider lending laws.

<u>Streamlining Depository Institution Merger Application Requirements</u>. The OCC together with the other Federal banking agencies and the industry trade groups support amending the BMA (12 U.S.C. § 1828(c)) to provide that the responsible agency in a merger transaction, which is generally the Federal banking agency that has the primary regulatory responsibility for the resulting bank, must request a competitive factors report only from the Attorney General, with a copy to the FDIC. Under current law, this report must be requested from all of the other Federal banking agencies but the other agencies are not required to file a report. This amendment would appropriately streamline the agencies' procedures in processing BMA transactions.

<u>Shortening of the Post-Approval Antitrust Review Period</u>. The OCC together with the other Federal banking agencies and the industry trade groups support amending section 11(b)(1) of the BHCA (12 U.S.C. § 1849(b)(1)) and section 18(c)(6) of the BMA (12 U.S.C. § 1828(c)(6)) to permit the shortening of the post-approval waiting period for certain bank acquisitions and mergers. Under current law, the post-approval waiting period generally is 30 days from the date of approval by the appropriate Federal banking agency. The waiting period gives the Attorney General time to take action if the Attorney General determines that the transaction will have a significant adverse effect on competition. The waiting period under both the BHCA and BMA, however, may be shortened to 15 days if the appropriate banking agency and the Attorney General agree that no such effect on competition will occur. The proposed amendment would shorten the mandatory 15-day waiting period to 5 days.

The amendment would give the banking agency and the Attorney General more flexibility to shorten the post-approval waiting period as appropriate for those transactions that do not raise competitive concerns. If such concerns exist, the 30-day waiting period will continue to apply. This change will not affect the waiting periods for transactions that involve bank failures or emergencies. In those cases, the statute already provides for other time frames

Providing Streamlined Procedures for Mergers Between Affiliated Banks. The OCC together with the other Federal banking agencies and the industry trade groups support amending section 18(c) of the FDIA (12 U.S.C. § 1828(c)) to exempt merger transactions between affiliated insured depository institutions from certain requirements under the statute. These transactions would be exempt from the competitive factors review by the Attorney General and the other banking agencies and from the post-approval waiting periods in the law as described above. Because this is a merger between affiliated depository institutions, this is not generally the type of merger that would have an affect on competition. Thus, the requirements and the time delays in the statute that are intended to allow for anticompetitive review are not necessary. Such transactions would still, however, require an application and the prior written approval of the responsible Federal banking agency.

Improving Information Sharing With Foreign Supervisors. The OCC together with the other Federal banking agencies and the industry trade groups support amending section 15 of the IBA (12 U.S.C. § 3109) to add a provision that ensures that the Fed, OCC, and FDIC cannot be compelled to disclose information obtained from a foreign supervisor if public disclosure of this information would be a violation of foreign law and the U.S. banking agency obtained the information pursuant to an information sharing arrangement with the foreign supervisor or other procedure established to administer and enforce the banking laws. The banking agency, however, cannot use this provision as a basis to withhold information from Congress or to refuse to comply with a valid court order in an action brought by the U.S. or the agency.

This amendment would provide assurances to foreign supervisors that the banking agencies cannot be compelled to disclose publicly confidential supervisory information that the agency has committed to keep confidential, except under the limited circumstances described in the amendment. This authority is similar to the authority provided to the Securities and Exchange Commission under the securities laws (15 U.S.C. § 78q(h)(5)). Some foreign supervisors have been reluctant to enter into information sharing agreements with U.S. banking agencies because of concerns that the U.S. agency may not be able to keep the information confidential and public disclosure of the confidential information provided could subject the supervisor to a violation of its home country law. This amendment will be helpful to ease those concerns and will facilitate information sharing agreements that enable U.S. and foreign supervisors to obtain necessary information to supervise institutions operating internationally.

<u>Providing an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act (DIMIA)</u>. The OCC together with the other Federal banking agencies and the industry trade groups support amending section 203(1) of DIMIA (12 U.S.C. § 3202(1)). Under current law, generally a management official may not serve as a management official of any other nonaffiliated depository institution or depository institution holding company if (1) their offices are located or they have an affiliate located in the same MSA, or (2) the institutions are located in the same city, town, or village, or a city, town, or village that is contiguous or adjacent thereto. For institutions of less than $20 million in assets, the SMSA restriction does not apply. The amendment would increase the current $20 million exemption to $100 million. The OCC supports this amendment. This $20 million cap has not been amended since the current law was originally enacted in 1978. However, the asset size of FDIC-insured commercial banks between 1976 and 2000 has increased over five fold. Depository institutions of all sizes will continue to be subject to the city, town, or village test.

<u>Reducing Flood Insurance Burden.</u> The OCC together with the other Federal banking agencies and the industry trade groups support several amendments to the Flood Disaster Protection Act of 1973.

First, the group supports an amendment to section 102(c)(2)(A) (42 U.S.C. § 4012a(c)(2)(A)) that would increase the small loan exemption from $5,000 to $20,000 and provide for a 5-year increase based on increases in the Consumer Price Index. Under current law, loans that have an original outstanding principal balance of $5,000 or less and a repayment term of one year or less are exempt from the flood insurance requirements. The $5,000 maximum amount was put into place in 1994 and has not been increased since that time. This is an appropriate adjustment that will not impair the safety and soundness of financial institution lenders. The requirement that the loan must have a repayment term of one year or less will **not** be changed by the amendment.

Second, the group supports an amendment to section 102(e)(2) (42 U.S.C. § 4012a(e)(2)) relating to the forced placement of flood insurance by a lender. Under current law, if the lender determines that the property securing a loan is not covered by flood insurance, *e.g.*, the policy has lapsed, or is covered by inadequate insurance, the lender must purchase flood insurance on behalf of the borrower if the borrower fails to do so with 45 days after receiving notice. However, most policies only have a 30-day grace period and, thus, lenders are being forced to purchase expensive gap insurance from private insurers to cover the 15-day period before a new policy under the National Flood Insurance Program (NFIP) becomes effective. We propose to shorten this time period for the lender to purchase insurance from 45 days to 30 days so that a lender will be able to purchase effective NFIP insurance before the expiration of the 30-day grace period.

Third, the group supports an amendment that would repeal the mandatory civil money penalties (CMPs) that apply under current law if a lending institution has a pattern or practice of committing certain violations. This amendment would allow the supervisor of the institution to take other actions as appropriate on a case-by-case basis that may include CMPs or possibly a less severe action depending on the circumstances of a particular case.

Enhancing Examination Flexibility. The OCC together with the other Federal banking agencies and the industry trade groups support an amendment to section 10(d)(4)(A) of the FDIA (12 U.S.C. § 1820(d)(4)(A)) that would increase the small bank threshold from $250 million to $500 million for purposes of the 18-month examination requirement. Under current law, a small bank with total assets of less than $250 million that is well capitalized, well managed, and, if it has assets of over $100 million (which may be raised to $250 million by the banking agency), is also rated in an outstanding condition may be examined on an 18-month cycle, rather than an annual cycle. This proposal would raise the small bank threshold to $500 million but would make **no other changes in the requirements.** To be eligible for the 18-month cycle, the small bank would still need to be well capitalized, well managed, and satisfy the overall condition rating requirement.

Reviewing Call Report Burden. The OCC together with the other Federal banking agencies and the industry trade groups support an amendment to section 7(a) of the FDIA (12 U.S.C. § 1817(a)) requiring the Federal banking agencies to conduct a five-year review of call report information and schedules, with the first such review occurring one-year after enactment. The agencies, in consultation with each other, would be required to reduce or eliminate information or schedules if such information or schedules are not otherwise required by law and are no longer necessary or appropriate.

The SAR Activity Review

By the Numbers

Issue 4 May 2005

The SAR Activity Review - By the Numbers

Issue 4 (May 2005)

Table of Contents

Introduction

Welcome to the fourth issue of *The SAR Activity Review – By the Numbers,* a compilation of statistical data gathered from Suspicious Activity Report forms submitted by depository institutions since April 1996, casinos and card clubs since August 1996, certain money services businesses since January 2002, and certain segments of the securities and futures industries since January 2003. *By the Numbers* serves as a companion piece to the publication of the *Trends, Tips & Issues*, which provides information about the preparation, use, and utility of Suspicious Activity Reports.

By the Numbers is produced twice a year to cover two filing periods: January 1 to June 30 and July 1 to December 31. The statistical data from the filing periods is available for publication on the FinCEN website shortly after the end of each period, usually in the spring and fall. The last issue of *By the Numbers* was published in December 2004 and may be accessed through the following link: http://www.fincen.gov/sarreviewdec2004.pdf.

A review of the statistical data generated for Issue 4 of *By the Numbers* reveals some interesting facts. As of December 31, 2004, over 2.1 million Suspicious Activity Report forms[1] had been filed with FinCEN. Although the remainder of this publication provides detailed statistical data on those filings, some general observations are provided below for each type of form.

Number of Suspicious Activity Report Filings by Year[2]									
Form	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Depository Institution	52,069	81,197	96,521	120,505	162,720	203,538	273,823	288,343	381,671
Money Services Business	-	-	-	-	-	-	5,723	209,512	296,284
Casinos and Card Clubs	85	45	557	436	464	1,377	1,827	5,095	5,754
Securities & Futures Industries	-	-	-	-	-	-	-	4,267	5,705
Subtotal	52,154	81,242	97,078	120,941	163,184	204,915	281,373	507,217	689,414
Total	**2,197,518**								

[1] The combined number of filings from the four types of Suspicious Activity Report forms: Depository Institution Suspicious Activity Report (TD F 90-22.47); Suspicious Activity Report by Money Services Business (SAR-MSB/TD F 90-22.56); Suspicious Activity Report by Casinos and Card Clubs (SAR-C/ FinCEN Form 102); and Suspicious Activity Report by Securities and Futures Industries (SAR-SF/FinCEN Form 101).

[2] Suspicious Activity Report statistical data is continuously updated as additional reports are filed and processed. For this reason, there may be minor discrepancies between the statistical figures contained in various portions of this report or in previous reports.

Depository Institution Suspicious Activity Report / TD F 90-22.47
(from the mandated reporting date in April 1996 through December 31, 2004)

- Between April 1996 and December 31, 2004, 1,660,387 Suspicious Activity Reports were filed.
- The volume of Suspicious Activity Report filings in 2004 increased 32% over those filed in 2003.
- BSA/Structuring/Money Laundering continued to be the leading characterization of suspicious activity filed by depository institutions.
- Identity Theft was added as a suspicious activity characterization in July 2003. In 2004, 15,491 Suspicious Activity Reports were filed with this characterization box marked.
- Mortgage Loan Fraud increased 93% since 2003.
- Computer Intrusion decreased 59% since 2003.
- Debit Card Fraud increased 70% since 2003.

Suspicious Activity Report by Money Services Business / TD F 90-22.56
(from the mandated reporting date for using this form in October 2002 through December 31, 2004)

- A total of 511,519 Suspicious Activity Reports filed by money services businesses were received between October 1, 2002 and December 31, 2004.
- The volume of filings in 2004 increased 41% over those filed in 2003.
- In 2004, money transmitters filed 192,958 or 49% of all Suspicious Activity Reports, followed by issuers of money orders at 67,372 or 17%, and the United States Postal Service at 39,294 or 10%.
- Of the filings, 27% failed to identify the characterization of suspicious activity.
- Filers reported money transfers as the most frequent type of financial service involved in the suspicious activity.
- The characterization of suspicious activity, "comes in frequently and purchases less than 3,000," increased nearly 100% since 2003.
- The characterization of suspicious activity, "two or more individuals using similar/the same identification," increased 177% since 2003.

Suspicious Activity Report by Casinos and Card Clubs / FinCEN Form 102 and, previously, TD F 90-22.49 (from the mandated reporting date in October 1997 through December 31, 2004)[3]

- A total of 15,640 reports of suspicious activity were received from casinos and card clubs.
- The volume of filings in 2004 increased 13% over those filed in 2003.
- Structuring was the most reported characterization of suspicious activity.
- State licensed casinos submitted 82% of the total Suspicious Activity Report by Casinos and Card Clubs filings.

Suspicious Activity Report by the Securities and Futures Industries / FinCEN Form 101 (from the mandated reporting date of January 1, 2003 through December 31, 2004)

- A total of 9,972 reports of suspicious activity were received from the securities and futures industries.
- The filings in 2004 increased 34% over those filed in 2003.
- As of December 31, 2004, 22.50% or 3,366 of filers selected "Other" as the characterization of suspicious activity, followed by money laundering/structuring at 17%.
- In 2004, 3,040 filings reported cash or its equivalent as the type of instrument used in the suspicious activity.[4]
- In 2004, 2,265 filings indicated clearing brokers as the primary type of reporting institution, followed by introducing brokers at 1,858 filings.

The statistical data in this publication is presented in an Excel format to allow readers to download and manipulate the information to achieve maximum management and compliance needs for their institution or agency.

As always, we welcome your suggestions and comments. Questions regarding present, past, or future issues of *The SAR Activity Review – By the Numbers* may be directed to FinCEN's Analytics Division, Office of Regulatory Support at (703) 905-3863 or by contacting webmaster@fincen.gov.

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[3] Also includes 85 forms filed in August 1996.

[4] Note: Item 23 on the FinCEN Form 101 does not provide a category for Checks; therefore, some filers may report transactions in which checks were used by marking box "b" for Cash or equivalent.

ABA

Appendix

Recommended Changes in Regulation

Currently, the most burdensome of regulations are the combined anti-terrorist, anti-criminal financial information laws. Not only are the demands on banks enormous but they seem to change daily, which is its own form of burden. But there are many other areas that should be addressed. Below is a summary of some recommended areas for reform. ABA is pleased to offer more detailed information to the Subcommittee upon request on any of these points:

a. Bank Secrecy Act (BSA)/Anti-Money Laundering

- **Eliminate CTR Filings for Seasoned Customers**

  ABA and its members strongly believe that the current Currency Transactions Report (CTRs) standards have long departed from the statutory goal of achieving a high degree of usefulness. ABA members believe that CTR filing has been rendered virtually obsolete by several developments: formalized customer identification programs, more robust suspicious activity reporting and government use of the 314(a) inquiry/response process. We believe that maintaining the CTR threshold at the current level generates too many reports that capture extensive immaterial activity wasting banker and law enforcement time that could be spent on Suspicious Activity Report (SAR) detection and investigation. Consequently, we believe that the time has come to recognize the redundancy of CTR filings for seasoned customers with transaction accounts to eliminate this inefficient use of resources by bankers and law enforcement.

- **Eliminate Identity Verification for Monetary Instruments Conducted by Customers**

In view of the passage of the USA PATRIOT Act and the regulations implementing section 326 requiring a Customer Identification Program ("CIP"), we recommend that the verification requirement of 31 CFR 103.29(a)(ii) be eliminated, since bank customers purchasing these instruments will have already been identified through their institution's CIP program.

- **Eliminate Notification to Directors or Designees of SARs**

The federal banking agencies instruct a bank that "whenever [it] files a SAR ..., the management of the bank shall promptly notify its board of directors, or a Subcommittee of the board of directors or executive officers designated by the board of directors to receive notice." (See, e.g. 12 C.F.R. 21.11 (h).) No such requirement exists in the Financial Crimes Enforcement Network's (FinCEN) parallel SAR regulation.

ABA believes that this expectation imposes a role on directors and executive officers (that who not serve as an institution's BSA officer) that is inconsistent with rational risk management responsibilities and compromises the board's independence in evaluating management performance under the board approved BSA compliance program. The requirement diverts scarce board and executive resources from more significant strategic and policy oversight functions. At the same time, it adds further risk to information security issues without any concomitant benefit to the bank. Mandating notification of SAR filing to the board or executive level for all institutions is an unwarranted imposition on, and deleterious to, sound corporate governance.

- **Establish Standard for Suspending SARs on Continuing Activity**

There are many reasons that banks file continuing SARs when the underlying customer transaction activity is not considered inconsistent with reasonable banking behavior. For example, many institutions file SARs out of a literal interpretation of the structuring guidance and in an abundance of caution, when they have no conviction that the customer is engaging in activity that constitutes money laundering.

Accordingly, ABA proposes that when an institution would otherwise file serial SARs on repeatedly similar customer activity, they should be permitted by a clear regulatory interpretation to suspend further SAR filing when: an original and two additional SARs report continuing similar activity by the same customer have been filed; law enforcement has not requested the continued reporting of the identified activity; and when no substantively different conduct alters the nature, significance or criminality of the repeated activity, or merits a SAR identifying the activity as a different type or involving perpetrators not previously identified.

- **Include FFIEC Exam Instruction to Invoke FinCEN Helpline**

ABA considers the FinCEN Helpline to be a valuable source of BSA interpretive guidance. Many bank representatives and agency examiners utilize this service to obtain staff analysis to assist in evaluating compliance issues. This option has helped many bankers and examiners resolve their disagreements about BSA regulatory applications arising during an exam. However, other examiners resist using this resource when their interpretations are challenged by management.

ABA proposes that the FFIEC agencies include in their uniform exam procedures the following mandatory instruction to expedite exam dispute resolution without requiring a banking agency to compromise its supervisory judgment: "Whenever management submits a written rebuttal to an examiner's BSA exception pertaining to 31 CFR Part 103 and includes therein a request to call the FinCEN Helpline, the examiner shall then call the FinCEN Helpline and, in the presence of the institution BSA Officer, obtain a FinCEN staff advisory interpretation of the issue. If the advisory interpretation does not alter the examiner's judgment with respect to the exception, the FinCEN interpretation is to be recorded on the exception sheet along with any supplemental management position after the BSA Officer has heard the FinCEN interpretation."

- **Include FFIEC Exam Instruction on Conducting Transaction Analysis**

Despite agency requirements for a tailored risk-based BSA compliance program and mandatory testing of bank BSA controls, agencies request transaction files and conduct transaction analyses without finding fault with the bank's audit/testing of the same processes. This is not an appropriate use of resources by agencies and is unduly burdensome for banks.

The FFIEC should adopt the following uniform BSA exam instruction: "Examiners should not request a bank to assemble files or records for the purpose of conducting transaction testing, or engage in transaction testing, of any provision of a bank's BSA compliance program before evaluating the adequacy of the bank's audit or independent testing of the relevant program provision and concluding either (i) that the audit/independent testing is demonstrably not a reliable indicator of bank performance of the program provision being examined, or (ii) that deficiencies identified by bank audit or independent testing of the program provision have not been timely corrected."

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 has just 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.

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Office of Thrift Supervision
National Credit Union Administration

August 29, 2005

Honorable Spencer Bachus
Chairman, Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Chairman Bachus:

Thank you for providing the Federal banking and credit union regulatory agencies (collectively the "Federal Banking Agencies")[1] with an opportunity to comment on the changes suggested by the American Bankers Association (ABA) and the Independent Community Bankers of America (ICBA) with respect to the Bank Secrecy Act (BSA) and related regulatory issues. The ABA and ICBA made these suggestions during the hearing on regulatory relief proposals conducted by the Subcommittee on Financial Institutions and Consumer Credit on May 19, 2005.

The BSA establishes vital mechanisms for deterring and detecting money laundering and related financial crimes perpetrated against and through domestic financial institutions. Among other things, the recordkeeping and reporting requirements of the BSA build a forensic trail and provide law enforcement and other supervisory agents with information to further investigations of various financial crimes. The Federal Banking Agencies recognize that provisions of the BSA require considerable effort by the banking industry to obtain, document, and provide relevant financial information to support criminal investigations by law enforcement. There is also a tangible cost in the time, personnel, and equipment dedicated to this function of a financial institution's operations. Recent publicized BSA compliance failures at certain financial institutions have highlighted the civil penalties that are associated with chronic non-compliance with these regulations.

The concerns expressed by the financial services industry regarding the successful implementation and administration of the BSA highlight the need for continuing discussion and guidance in this area. The proposals offered by the ABA and the ICBA address some of the reporting and recordkeeping burden that is associated with the BSA. As the supervisors responsible for overseeing banking organizations' compliance with the BSA, the Federal Banking Agencies are of the opinion that the financial recordkeeping and reporting rules should be modified only with caution to ensure that modifications do not unintentionally impede the efforts of those conducting criminal investigations. The Federal Banking Agencies will continue to work closely with the Financial Crimes Enforcement Network (FinCEN), the administrator of

[1] The Federal Banking agencies are: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

the BSA, to support proposals and initiatives that streamline the reporting processes created by the BSA without diminishing the value of the information produced.

From this perspective, the Federal Banking Agencies jointly offer the comments set forth in the Appendix to this letter on the ABA's and the ICBA's recommendations.

Thank you for giving the Federal Banking Agencies a chance to comment on the changes suggested by the ABA and ICBA. The Federal Banking Agencies are committed to the development of a transparent financial system through effective implementation of the BSA, while also actively engaging in cooperative efforts to enhance the reporting process. The Federal Banking Agencies will continue to pursue constructive dialogue on these matters through active participation in industry outreach programs, including the Bank Secrecy Act Advisory Group, which remains an active and effective avenue for public and private entities to discuss BSA/Anti-Money Laundering-related matters.

Please do not hesitate to contact us if you have any comments or questions.

Sincerely,

Donald L. Kohn
Governor
Board of Governors of the Federal
Reserve System

John M. Reich
Director
Office of Thrift Supervision

John C. Dugan
Comptroller
Office of the Comptroller of the Currency

Donald E. Powell
Chairman
Federal Deposit Insurance Corporation

JoAnn Johnson
Chairman
National Credit Union Administration

Appendix

(1) Raise the Threshold for Currency Transaction Report (CTR) Filings in the Department of the Treasury's (Treasury) Regulations

CTRs, which report large currency transactions, are filed pursuant to requirements contained in rules issued by the Department of the Treasury through the Financial Crimes Enforcement Network (FinCEN). The Federal Bureau of Investigation (FBI) and other Federal law enforcement agencies are the primary users of CTR data. As verified by the FBI and other law enforcement bodies, CTR requirements serve as an impediment to criminal attempts to legitimize the proceeds of crime[2]. Moreover, they serve as a key source of information about the physical transfer of currency, at the point of the transaction.

The CTR Subcommittee of the Bank Secrecy Act Advisory Group (BSAAG), a group created at the direction of Congress to focus on issues relating to the Bank Secrecy Act (BSA), is currently studying suggestions for reforming the CTR filing process, including reducing the number of CTRs currently being filed. Because the BSAAG includes regulators, law enforcement, and industry representatives, all relevant perspectives are included in this dialogue, and any modifications of the CTR requirements will reflect the goals of all of the participants in the process.

(2) Eliminate Identity Verification for Monetary Instruments Conducted by Customers As Required by Treasury's Regulations

While the Federal Banking Agencies defer to FinCEN with respect to this suggested change to Treasury's regulations, the Agencies do not agree that the requirements of the Customer Identification Program (CIP) rule, which was jointly issued by FinCEN and the Federal Banking Agencies, duplicates the requirements for the purchase of monetary instruments.

For example, the identity verification requirement under Treasury's regulation covering the purchase of monetary instruments only applies to non-deposit accountholders. If a deposit accountholder purchases a monetary instrument, the institution must only verify that the customer has a deposit account; it does not have to verify the customer's identity. Thus, for deposit accountholders, the rule supplements but does not duplicate the CIP rule requirement to verify the customer's identity upon account opening.

In addition, there is no duplication between the two rules for persons who purchase monetary instruments who are not already accountholders. The CIP rule only applies when a customer opens an "account," which specifically excludes transactions where a formal banking relationship is not established, such as check cashing, wire transfer, or sale of a check or money order. A person who is only purchasing a monetary instrument would not be opening an account, so the CIP rule would not apply; however, the monetary instrument regulations would require identity verification for certain purchases.

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[2] FinCEN Annual Report FYE 2004.

(3) Eliminate Notification to Directors or Designees of Suspicious Activity Reports (SARs)

With the exception of the National Credit Union Administration, the Federal Banking Agencies' regulations require that a banking organization's board of directors, or a committee thereof, be notified of SAR filings.[3] The banking organization's board of directors must oversee the organization's operations to ensure that it operates in a safe and sound manner. The board must keep informed about the banking organization's operating environment, hire and retain competent management, and ensure that the banking organization has a risk management structure and process suitable for its size and activities. To make informed decisions regarding these matters, it is important that the board of directors, or a committee thereof, be aware of potential criminal activity because that activity could have a material impact on the overall condition of the institution.

(4) Establish a Standard for Suspending SARs on Continuing Activity

FinCEN recently issued tips on SAR form preparation and filing that specifically addressed the updating of SARs for continued suspicious activity. *See* FinCEN's "SAR Activity Review, Trends, Tips & Issues," Issue 8, April 2005. This guidance provides that for ongoing, suspicious activity, and to reduce the burden on financial institutions and law enforcement, financial institutions should file supplemental SARs about every 90 days. The Federal Banking Agencies believe it is important to provide clear guidance to financial institutions on this and other SAR filing issues, and will continue to work with FinCEN to do so.

(5) Include a Federal Financial Institution Examination Council (FFIEC) Exam Instruction to Invoke the FinCEN Helpline

Bank, savings association, and credit union examiners have extensive training on the requirements and examination procedures relating to the BSA. They are also well versed on safety and soundness issues and other matters affecting the financial institution under examination. Additionally, each Agency has BSA/Anti-Money Laundering (AML) experts that provide support to examiners. These experts not only respond to questions from field examiners, but they also play a role in reviewing BSA/AML findings to ensure accuracy and quality of reports of examination. These experts also ensure that Agencies coordinate regularly with FinCEN on interpretations of Treasury's BSA regulations and the issuance of interpretive guidance.

Examination conclusions that a financial institution does not agree with can be resolved directly with the supervisory agency through normal supervisory review processes, or through a formal appeal to an independent Ombudsman within each of the Federal Banking Agencies. These

[3] NCUA requires credit unions to comply with FinCEN's regulations for SAR filings. NCUA does not mandate that credit unions notify the Board of Directors. Many credit unions are very small with boards of directors that meet infrequently. Nevertheless, NCUA does recommend, as a matter of best practice, that credit union boards of directors be informed of potential criminal activities that could have a material impact on the credit union.

provide an avenue for resolution of disputed examination conclusions, including perceived erroneous conclusions by examiners of violations of law or regulation. It is important to note that the Federal Banking Agencies work closely with FinCEN and consult with FinCEN staff when incidents arise that require a novel interpretation of Treasury regulation.

(6) Include Exam Instruction on Conducting Transaction Analysis

While the Federal Banking Agencies instruct their examiners to review and consider internal audit work when scoping and planning a BSA/AML examination, the Agencies do not agree with the recommendation to limit transaction testing unless an evaluation of the adequacy of the institution's audit or independent testing of the relevant program provision has been conducted and certain findings made. Transaction testing is a fundamental component of examination practice and its use should not be subjected to limitations and restrictions. Transaction testing requires the examiner to look beyond policies and procedures and to review individual transactions to verify that systems and processes are in fact working as developed. Expanded transaction testing is generally conducted in areas that are considered to be higher risk or that warrant additional scrutiny where the examiner is not comfortable with initial findings. Independent testing of an institution's controls and procedures is a key component of a strong BSA/AML program; however, we believe that any limitations on transaction testing would significantly encumber the examination process and the ability of an examiner to exercise sound judgment during the course of the examination.

The Federal Banking Agencies recently released an interagency examination manual that requires transaction testing to be conducted at every examination where BSA/AML compliance is reviewed. The manual provides that this testing may consist of the examiner validating the tests conducted by an institution's auditor, or testing by undertaking transaction procedures selected from within the core or expanded sections of the examination manual. If an examiner decides to test an auditor's work, the manual requires examiners to select a judgmental sample that includes transactions other than those tested by the independent auditor and determine whether independent testing: is comprehensive, adequate and timely; has reviewed the accuracy of MIS used in the BSA/AML compliance program; has reviewed suspicious activity monitoring systems to include the identification of unusual activity; and has reviewed whether suspicious activity reporting systems include the research and referral of unusual activity.

(7) Additional Guidelines and Reference Tools for Compliance

On June 30th, FFIEC issued the BSA/AML Examination Manual. This manual is the result of a collaborative effort of the Federal Banking Agencies and FinCEN to ensure consistency in the BSA/AML examinations. The manual does not set new standards; instead, it is a compilation of existing regulatory requirements, supervisory expectations, and sound practices in the BSA/AML area. In addition, 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 of the manual and BSA/AML issues.

ANSWERS TO QUESTIONS SUBMITTED FOR THE RECORD

RANDALL JAMES

TEXAS COMMISSIONER OF BANKING

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

before the

FINANCIAL SERVICES SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

UNITED STATES HOUSE OF REPRESENTATIVES

June 9, 2005

Representative Bachus, thank you for the opportunity to comment for the record of the June 9th hearing on financial services regulatory relief concerning the recommended changes in regulations on anti-terrorist, and anti-criminal financial information laws submitted by the American Bankers Association (ABA) and the Independent Community Bankers Association (ICBA).

The Conference of State Bank Supervisors (CSBS) represents the 54 state banking departments throughout the U.S. and its territories. State banking departments are the primary regulator for the vast majority of community banks and CSBS believe that the burdens imposed by the Bank Secrecy Act and the filing of SARs and CTRs fall disproportionately upon those small banks that can not spread the costs of compliance across a large deposit base. We strongly urge Congress, FinCEN, state and federal regulators and enforcement agencies to work together to fully evaluate current threshold requirements for BSA filings based on industry costs versus the benefit received in analysis of that data. These are important and difficult issues. Howver, it is vital to find the proper balance between collecting information to help in the battle against terrorism and financial crimes and the burdens imposed by that effort.

CSBS and representatives from various state banking departments have worked diligently with FinCEN and the Federal Financial Institution Examination Council (FFIEC) to develop clear, risk based BSA examination procedures. We believe these new procedures will alleviate much of the financial industry's concerns in this area. We applaud FinCEN for working with CSBS and the FFIEC in striving to minimize regulatory burdens while still accomplishing its mission of helping to deter terrorism and financial crimes. FinCEN has participated with the federal banking regulators and CSBS on some of the regulatory relief outreach sessions across the nation. Accordingly, CSBS and the federal agencies have been apprised of the banking trade associations' concerns in this regard. These concerns were considered when drafting the new examination manual. Now that the new BSA examination procedures are public, the next important step in this process is conducting thorough examiner training and banker education on the new procedures. Federal and state regulators must ensure that examiners and bankers have similar understandings and expectations of the new examination procedures. CSBS will continue to work closely with FinCEN and the FFIEC on the outreach session planned around the country in the next few months.

Regarding the specific issues raised by the ABA and ICBA, we believe that FinCEN has the expertise and knowledge to respond to most of these requests and we commend them for their outreach efforts to the state regulatory agencies and the industry for input. As indicated previously, CSBS and representatives from various state banking departments will continue to participate in discussions at both the FFIEC and FinCEN's Bank Secrecy Act Advisory Group (BSAAG), both of which are currently reviewing similar issues to those raised by the ABA and ICBA. Thank you again for the opportunity to comment on these important issues.

NATIONAL CREDIT UNION ADMINISTRATION

PROMPT CORRECTIVE ACTION PROPOSAL FOR REFORM

March 2005

TABLE OF CONTENTS **Page**

updated 3/17/05

1. PREFACE

I am very pleased to unveil NCUA's proposed reforms for prompt corrective action (PCA) for credit unions. This reform proposal is consistent with NCUA's steadfast support of PCA as good public policy. Meaningful capital standards are important in protecting the federal insurance funds, taxpayers, and the stability of America's financial system. NCUA also recognizes the importance for institutions in managing capital levels to ensure the efficient use of capital in the economy, to optimize the performance of an institution with appropriate leveraging, and to achieve strategic objectives in providing low-cost services and meeting the service needs of members.

This report is the culmination of several years' worth of experience working with our current PCA system, the feedback we have received from credit unions, and over a year's worth of extensive work analyzing options for a more fully risk-based PCA system for federally insured credit unions. I believe our efforts have resulted in a balanced and credible approach to making credit unions' PCA system aptly robust, yet not unduly burdensome or constraining.

This proposal provides recommended statutory changes needed to make PCA reform possible, as well as an initial framework of how we envision designing through regulation the risk-based net worth requirement. There are several key elements of this proposal I would like to highlight:

- The reform proposal recognizes the inherent limitations in any risk-based capital system. Therefore, we advocate a system involving complementary leverage and risk-based standards working in tandem.

- The proposed changes are designed to achieve comparability with the capital standards for FDIC-insured institutions, as there should not be unwarranted differences in the standards for different types of financial institutions.

- For the leverage requirement, achieving comparability requires we factor in the NCUSIF's deposit-based funding mechanism. *However, the NCUSIF deposit's treatment 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. NCUA remains committed to preserving this accounting treatment.*

- As an initial framework for the risk-based requirement, the 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. Consistent with BASEL II and the FDIC's PCA system, the risk-based requirement addresses credit and operational risk. As there are other forms of risk, such as interest rate risk, NCUA's reform proposal includes recommendations to address these through 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.

The direction of our approach and the timing of this proposal are consistent with the federal banking regulators' recent announcement to issue proposed rules this year incorporating BASEL II into their capital standards. Going forward NCUA remains committed to making adjustments through the regulatory review process to maintain the comparability of capital standards.

As one of my major priorities as Chairman, I look forward to making continued progress working in concert with Congress, the Department of the Treasury, and the credit union community on producing meaningful reforms to the PCA system for credit unions.

JoAnn M. Johnson

Chairman JoAnn M. Johnson

2. INTRODUCTION

NCUA believes the statutory mandate to take prompt corrective action to resolve problems at the least long-term cost to the National Credit Union Share Insurance Fund (NCUSIF) is sound public policy. Further, this policy is consistent with NCUA's fiduciary responsibility to the NCUSIF. Appropriate PCA standards serve as a restraint on growth that outpaces a credit union's ability to generate commensurate earnings, especially aggressive growth strategies that have a high correlation to problems in financial institutions. The framework of PCA also needs to provide institutions with recognition for low-risk, prudent portfolio management strategies.

However, PCA for credit unions does not adequately distinguish between low-risk and higher risk activities. The current PCA system's high leverage requirement (ratio of net worth to total assets) coupled with the natural tendency for credit unions to manage to capital levels well above the PCA requirements essentially creates a "one-size fits all" system. This penalizes institutions with conservative risk profiles. While providing adequate protection for the insurance fund, a well designed risk-based system with a lower leverage requirement would more closely relate required capital levels with the risk profile of the institution and allow for better utilization of capital.

The current high leverage ratio imposes an excessive capital requirement on low-risk credit unions. With a lower leverage requirement working in tandem with a well-designed risk-based requirement, credit unions would have greater ability to serve members and manage their compliance with PCA. By managing the composition of the balance sheet, credit unions could shift as needed to lower risk assets resulting in the need to hold less capital.

A PCA system comparable to that employed in the banking system will provide sufficient protection for the insurance fund. Such a system for credit unions would also remove charter bias and level the playing field by eliminating differing capital standards unrelated to risk. While credit unions are not able to raise capital as quickly in some cases as other financial institutions,[1] the majority of credit unions have a relatively conservative risk profile (driven by the restrictions of powers relative to other institutions and their cooperative, member-owned structure) and a comparatively low loss history. Thus, credit unions should not be required to hold excessive levels of capital.

[1] Stock-owned financial institutions are constrained by the market (and regulatory restrictions on Tier II capital) when raising capital from other sources than retained earnings once the institution's capital level has declined markedly or is otherwise encountering difficulty.

3. TIMELINE OF CAPITAL STANDARDS

Date	Event
1988	Basel I accord.
1991	Congress enacts a system of Prompt Corrective Action for FDIC-insured institutions.
1991	GAO report entitled "Credit Unions Reforms for Ensuring Future Soundness" recommends minimum capital standards and Prompt Corrective Action for credit unions. "*Nevertheless, we believe that credit unions should be required to achieve and maintain some minimum level of GAAP capital (regular reserves plus retained earnings) in order to demonstrate and help ensure that they are economically viable and that their members' money, and ultimately the insurance fund, is as safe as possible.*" p65
1997	Treasury Study recommends Prompt Corrective Action for credit unions. "*Prompt corrective action helps counteract the perverse incentives [e.g., moral hazard, regulatory forbearance, etc.] created by deposit insurance … Prompt corrective action better aligns the incentives of depository institutions' owners, managers, and regulators with the interests of the deposit insurance fund.*" p74
1998	Congress enacts a system of Prompt Corrective Action for NCUA-insured institutions. "*The purpose of this section is to resolve the problems of insured credit unions at the least possible long-term loss to the Fund.*" - § 1790d(a)(1)
2000	NCUA implements prompt corrective action regulations.
2004	Basel II accord. "*It should be stressed that the revised Framework is designed to establish minimum levels of capital …More generally, under the second pillar [supervisory review process], supervisors should expect banks to operate above minimum regulatory capital levels …It is critical that the minimum capital requirements of the first pillar be accompanied by a robust implementation of the second.*" p3
2004	GAO report entitled "Credit Unions Available Information Indicates No Compelling Need for Secondary Capital." "*In addition, GAO believes that any move to a more risk-based system should provide for both risk-based and meaningful leverage capital requirements to work in tandem.*" p6

4. EXECUTIVE SUMMARY

The purpose of prompt corrective action for credit unions is to protect the share insurance fund. It is not to regulate what constitutes sound capital management relative to the business needs of an institution. It is also not designed to encompass all of the possible risks, nor factor in all relevant variables (both qualitative and quantitative), to be able to stand on its own. As the BASEL II[2] report stresses, the capital standards are designed to establish *minimum* levels of capital that work in tandem, not isolation, with a supervisory review process (i.e., an examination and supervision program). Financial institutions will be expected to operate above minimum regulatory capital levels based on their institution specific business needs and holistic assessment of all relevant risks. It is within this context that we offer the following recommendations for PCA reform for credit unions.

A. Tandem Net Worth (Leverage) and Risk-Based Net Worth Requirements

We propose adoption of the following thresholds for PCA net worth categories for credit unions. The net worth ratio thresholds are comparable to those used by the FDIC for the leverage requirement, and the risk-based net worth ratio thresholds are based on the comparable FDIC total risk-based capital requirements and the BASEL II 8% standard.

Proposed PCA Thresholds for Credit Unions[3]

Net Worth Categories*	Net Worth Ratio	Risk-Based Net Worth Ratio
Well Capitalized	5% or greater	8% or greater[4]
Adequately Capitalized	4% to < 5%	8% or greater
Undercapitalized	3% to < 4%	6% to < 8%
Significantly Undercapitalized	2% to < 3%	< 6%
Critically Undercapitalized	< 2%	NA

* The lowest category a credit union falls into governs.

[2] International Convergence of Capital Measurement and Capital Standards, A Revised Framework, June 2004, Basel Committee on Banking Supervision, Bank for International Settlements, is commonly known as Basel II.
[3] This proposal does not apply to credit unions the statute defines as new. Also, we intend to maintain the total asset calculation options for the net worth (leverage) ratio available in the current regulation.
[4] The FDIC PCA system does not impose any requirements on banks unless they fall below adequately capitalized. However, PCA for credit unions imposes an earnings retention requirement on less than well capitalized credit unions, but only for the standard net worth requirement (i.e., leverage ratio) as the risk-based net worth requirement by statute is based only on the adequately capitalized level. In contrast, adequately capitalized banks are not subject to a requirement to increase the leverage ratio beyond adequately capitalized. Further, the FDIC's Tier 1 capital to risk assets threshold for well capitalized is only 6%. Thus, the proposed risk-based thresholds do not distinguish (i.e., are the same) between well and adequately capitalized for credit unions with risk-based net worth ratios of 8 percent or greater. This is also consistent with the 8% target established under BASEL.

Bank PCA Thresholds for Comparison (FDIC-Insured)

Capital Categories*	Tier 1 Capital to Total Assets	Tier 1 Capital to Risk Assets	Total Capital to Risk Assets
Well Capitalized	5% or greater	6% or greater	10% or greater
Adequately Capitalized	4% to < 5%	4% to < 5%	8% to < 10%
Under Capitalized	3% to < 4% or < 3% for CAMEL 1	3% to < 4%	6% to < 8%
Significantly Under Capitalized	2% to < 3%	< 3%	< 6%
Critically Under Capitalized	< 2% (tangible equity)	NA	NA

* The lowest category governs.

B. BASEL II – Standard Approach to Credit and Operational Risk

The proposed initial framework for the regulatory design of the risk-based net worth requirement is based on the BASEL II Standard Approach for credit risk and the basic indicator approach for operational risk. The intention through the ongoing regulatory process is to maintain comparability with FDIC-insured institutions and applicability to the operations of credit unions. This proposal incorporates the risk portfolios and risk weights as specified in BASEL II as applicable to credit unions, with no noteworthy variation. The portfolios and risk weights are as follows (see Appendix 1 for a discussion of each risk portfolio):

Risk Weight	Risk Portfolios
0%	- Cash on Hand - Government Issued or Guaranteed
20%	- Claims on Financial Institutions
20% to 150% (100% unrated)	- Claims on Corporations (per rating)
35%	- Claims Secured by Residential Property
75%	- Regulatory Retail Loans
100%	- Membership Interests and Bank Equity Instruments - All Other Loans - Past Due Loans Secured by Residential Property - All Other Assets
150%	- Past Due Loans All Other
Based on Underlying Obligation	- Commitments - Recourse Obligations and Direct Credit Substitutes
Deduction from Net Worth	- NCUSIF Deposit - Significant Minority Interests or Reciprocal holdings of equity instruments
Special	- ALLL (add to Net Worth and deduct from assets) - Operational Risk (add to risk assets)

C. Interest Rate Risk

We recommend adjusting the statute so the risk-based net worth requirement for credit unions takes account of the comparable risks addressed by the FDIC's risk-based capital requirements. The current statutory language "to take account of any material risks" in relation to the risk-based net worth requirement (§1790d(d)(2)) obligates NCUA to incorporate interest rate risk into the risk-asset weights. However, BASEL (I and II) and the FDIC's risk-based capital system only address credit and operational risk (and market risk in limited situations not relevant to credit unions). They have taken this approach because a balance sheet wide assessment of interest rate risk is costly to incorporate into a regulatory capital scheme and fraught with error as the assumptions related to non-maturity deposits are of necessity "blunt and judgmental."[5] As such, the BASEL and FDIC system deal with interest rate risk under the second pillar, a robust supervisory review process.

Thus, NCUA recommends a comparable approach for credit unions. This is also consistent in principle with the internal ratings based approach for credit risk used in BASEL II in that complex, judgmental areas warrant institution specific modeling. To complement this approach and bolster the supervisory review process in relation to interest rate risk, we are recommending adding more flexibility for reclassification authority to lower net worth categories for concerns involving inadequate net worth levels relative to interest rate risk based on institution specific model results. Further, we will explore adding an "S" component[6] to CAMEL to specifically rate interest rate risk, and tying procedures for reclassification to a lower net worth category institutions with other than acceptable "S" ratings.

[5] Basel Committee on Banking Supervision (2001). The New Basel Capital Accord, Principles for the Management and Supervision of Interest Rate Risk, http://www.bis.org/publ/bcbsca.htm, Annex 3, paragraph 8.

[6] The "S" in CAMELS refers to Sensitivity to Market Risk. The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates.

5. STATUTORY CHANGES RECOMMENDED

A. NET WORTH CATEGORIES - § 1790d(c)(1)

Change
(A) **Well capitalized.** - An insured credit union is 'well capitalized' if - (i) it has a net worth ratio of not less than *5 percent*; and (ii) *it has a risk-based net worth ratio of not less than 8 percent.*
B) **Adequately capitalized.** - An insured credit union is 'adequately capitalized' if - (i) it has a net worth ratio of not less than *4 percent*; and (ii) *it has a risk-based net worth ratio of not less than 8 percent.*
C) **Undercapitalized.** - An insured credit union is 'undercapitalized' if - (i) it has a net worth ratio of less than *4 percent*; or (ii) *it has a risk-based net worth ratio of less than 8 percent.*
D) **Significantly undercapitalized.** - An insured credit union is 'significantly undercapitalized' if - (i) it has a net worth ratio of less than *3 percent*; or (ii) *it has a risk-based net worth ratio of less than 6 percent; or* (iii) it has a net worth ratio of less than *4 percent* and (aa) it fails to submit an acceptable net worth restoration plan within the time allowed under subsection (f); or (bb) materially fails to implement a net worth restoration plan accepted by the Board.
E) **Critically undercapitalized.** - An insured credit union is 'critically undercapitalized' if it has a net worth ratio of less than 2 percent (or such higher net worth ratio, not to exceed 3 percent, as the Board may specify by regulation).

These changes (additions in italics, strikethrough for deletions) reset the benchmarks for the net worth categories, beginning with the well capitalized level at 5%, down from 7%. This is equivalent to the leverage ratio for FDIC-insured institutions.

The changes also set a statutory threshold for the risk-based net worth ratio comparable to that used for the total risk-based capital requirement of FDIC-insured institutions, as well as that adopted under BASEL II (8%).

B. RISK-BASED NET WORTH REQUIREMENT - § 1790d(d)

Change	Comment
(1) **In general.** - The regulations required under subsection (b)(1) shall include a risk-based net worth requirement for insured credit unions ~~that are complex~~, ~~as defined by the Board~~ based on the portfolios of assets and liabilities of credit unions *as defined by the Board.*	As the risk-based net worth requirement applies to all insured credit unions based on the portfolios of risk assets they hold, there is no need to limit this to "complex" credit unions. Further, this maintains the Board's ability to design almost all aspects of the risk-based requirement via regulation.
(2) **Standard.** - The Board shall design the risk-based net worth requirement *in relation to risk assets, as defined by the Board,* to take account of any material risks *that the comparable standards for institutions insured by the Federal Deposit Insurance Corporation take into account, that are applicable to credit unions* ~~against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection~~.	This change incorporates reference to risk assets as defined by the NCUA board. The reference to adequately capitalized is no longer necessary given the change to the net worth category definitions. In addition, we recommend removing the requirement to address all risks and tying the requirement to address the risks addressed under BASEL and the FDIC system. BASEL and the FDIC capital system only address credit and operational risk.[7] A balance sheet wide assessment of interest rate risk is costly to incorporate into a regulatory capital scheme and fraught with error as the assumptions related to non-maturity deposits are of necessity "blunt and judgmental."[8] As such, the BASEL and FDIC system deal with interest rate risk under the second pillar, a robust supervisory review process. NCUA recommends a comparable approach for credit unions. This is also consistent in principle with the internal ratings based approach for credit risk used in BASEL II in that complex and judgmental areas warrant institution specific modeling. (See recommendation below related to more stringent treatment based on other supervisory criteria.)

[7] The BASEL and FDIC system also includes market risk for institutions with large trading portfolios (over 10% of assets or $1B). This has negligible application to credit unions.
[8] Basel Committee on Banking Supervision (2001). The New Basel Capital Accord, Principles for the Management and Supervision of Interest Rate Risk, http://www.bis.org/publ/bcbsca.htm, Annex 3, para. 8.

C. MORE STRINGENT TREATMENT BASED ON OTHER SUPERVISORY CRITERIA. - § 1790d(h)

Change	Comment
(2) *Except to reclassify an insured credit union into the next lower net worth category,* the Board may not delegate its authority to reclassify an insured credit union into a lower net worth category or to treat an insured credit union as if it were in a lower net worth category.	This change supports the recommendation to exclude interest rate risk from the risk-based net worth requirement in favor of addressing this risk, as well as any other material risks not incorporated into the proposed risk portfolios and weights, on an institution specific basis through the supervisory review process. It limits the extent to which the Board may delegate its reclassification authority to only the next lower category. Any delegation of this authority by the board would also include procedures regarding the Regional Directors' use of this authority, such as requiring concurrence from the appropriate central office(s). Any such delegation by the board would remain subject to appeal to respective review committees and ultimately the NCUA Board. NCUA will also explore incorporating an "S" component into CAMEL and developing procedures for reclassifying to a lower category institutions with other than acceptable "S" ratings.

D. DEFINITIONS. - § 1790d(o)

Change	Comment
(2) **Net worth.**—The term 'net worth'—(A) with respect to any insured credit union, means the retained earnings balance of the credit union, as determined under generally accepted accounting principles, *together with any amounts that were previously retained earnings of any credit union with which it has combined*; and	This revised definition addresses the problem related to mergers of credit unions. Based on new GAAP standards (purchase versus pooling method), the retained earnings of the acquired institution would not be considered retained earnings of the continuing institution. This would make mergers of healthy credit unions virtually impossible. The change makes it clear that for regulatory purposes, net worth of any continuing credit union involved in a merger includes retained earnings acquired from other credit unions by a merger.

(2) **Net worth.**—The term 'net worth'— (B) with respect to a low-income credit union includes secondary capital accounts, *except as provided in subparagraph (C) below,* that are – (i) uninsured; and (ii) subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the Fund. *(C) With respect to secondary capital accounts, the Board may set –* *(i) limitations on the initial maturity of such accounts;* *(ii) limitations on the net worth valuation of such accounts according to remaining maturity; and,* *(iii) other limitations on such accounts of credit unions not defined by the Board as small.*	For safety and soundness purposes, this revision clarifies that the Board may through regulation provide limitations on the types and characteristics of secondary capital permitted for low-income credit unions, and the extent to which these count as net worth. Comparable hybrid equity instruments in FDIC insured institutions are subject to limitations in terms of how much may be used to meet capital requirements (50% of Tier 1 for subordinated debt and 100% of Tier 1 for all hybrid equity instruments), as well as reducing pro-rata the amount that counts toward capital as they approach maturity (decline below 5 years). The legislative record for this change should reflect that it is not the intent that the Board be able to preclude the safe and sound use of secondary capital by low-income credit unions in meeting net worth standards, and that any such limitations established by the board must be well grounded on safety and soundness concerns.
(3) **Net worth ratio.** - The term 'net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union *minus its deposit in the Fund* to the total assets of the credit union minus its *deposit in the Fund.*	"*If Congress does not require that the 1-percent deposit be expensed, NCUA should require credit unions to exclude the amount from both sides of their balance sheet when assessing capital adequacy.*" – 1991 GAO Report Credit Unions Reforms for Ensuring Future Soundness - page 174. The 1997 Treasury study of credit unions reached a slightly different conclusion. This report suggested the net worth category thresholds be increased by 1% to address the "double-counting" of equity (both credit union net worth and the Fund) within the credit union system. The report admits this would "more than" compensate for the double-counting effect of the insurance fund deposit. In fact, since the deposit is based on insured shares and not total assets, this results in requiring on average an extra 30 to 40 basis points of net worth in relation to assets. Using the recommended approach of deducting the Fund

	deposit from both net worth (numerator) and total assets (denominator) results in an accurate capital charge to each insured credit union and places the equity within the credit union system on a comparable basis to that of FDIC-insured institutions. It is not NCUA's intention to alter the treatment of the NCUSIF deposit as an asset on credit union financial statements. Expensing the deposit would be inconsistent with its statutory treatment and with GAAP, which the FCU Act mandates credit unions follow.[9]
(5) ***Risk-based net worth ratio****. - The term 'risk-based net worth ratio' means, with respect to a credit union, the ratio of the net worth of the credit union plus any loan loss reserves (subject to limit by the Board), less the credit union's deposit in the Fund, to risk assets of the credit union, as defined by the Board.*	This incorporates similar treatment of the insurance fund deposit, as well as allows the Board through regulation to define risk assets. This proposal incorporates the BASEL II limit on inclusion of loan loss reserves of 1.25% of risk-weighted assets.

E. NET WORTH RESTORATION PLAN REQUIRED. - § 1790d(f)

Change	Comment
(1) **In general.**— *Except as determined by the Board in the case of a credit union that remains marginally undercapitalized for a relatively short-term period,* each insured credit union that is undercapitalized shall submit an acceptable net worth restoration plan to the Board within the time allowed under this subsection.	The authority to waive the requirement to submit a NWRP for credit unions that have a temporary, growth-related, marginal drop in their net worth ratio below "adequately capitalized", as determined on a case-by-case basis, would help address the burden of PCA compliance in situations that don't warrant concern. NCUA envisions defining "marginal" as no greater than 50 basis points below the adequately capitalized level, and "a relatively short-term period" as 180 days. In addition, growth-related would be limited to an unsolicited influx of deposits (e.g., a "flight to quality"). Declines in net worth due to unprofitable operations or extraordinary losses would not qualify.

[9] We plan to incorporate into the examination program and the Financial Performance Report a capital ratio based on GAAP equity (which will not deduct the NCUSIF deposit) to reflect that the Net Worth Ratio is used only for PCA purposes. The GAAP equity ratio can be used for all other purposes, including financial analysis, capital adequacy (CAMEL) assessment, RegFlex determinations, etc.

F. OTHER TECHNICAL CORRECTIONS

Change	Comment
§ 1790d(e)(2) **(A) In general.** – The Board may, by order *or by approval of a Net Worth Restoration Plan*, decrease the 0.4 percent requirement in paragraph (1) with respect to a credit union to the extent that the Board determines that the decrease -	This clarifies that approval of a Net Worth Restoration Plan that involves for a period of time the credit union earning below the 0.4 percent requirement serves as such an order of the Board.
§ 1790d(i)(1) **(B)** *order the credit union to* take such other action as the Board *in its discretion* determines would better achieve the purpose of this section, after documenting why the action would better achieve that purpose.	This makes clear that "other corrective action" (OCA) is not action the Board itself undertakes, but action it orders a critically undercapitalized credit union to take. Also, it makes clear that the Board determines the appropriate OCA, not the credit union.
§ 1790d(i)(3) **(A) In general.** – Notwithstanding paragraphs (1) and (2), the Board shall appoint a liquidating agent for an insured credit union if the credit union is critically undercapitalized on average during the ~~calendar quarter~~ *3-month period* beginning 18 months after the date on which the credit union *first* became critically undercapitalized.	This replaces the reference to calendar quarter with 3-month period. The calendar quarter reference delays measurement and subsequent action until a calendar quarter has elapsed. For situations where the 18 months ends a month into a calendar quarter, this adds an additional 2 months to the timeframe upon which measurement and subsequent action occur.
§ 1790d(l)(3)(A) Deciding whether to appoint conservator or liquidating agent. (ii) give that official an opportunity to take the proposed action, *provided that the Board determines that such action by the official will carry out the purpose of this section*;	This clarifies that for PCA based concerns, the Board need only allow a State official to take a conservatorship or liquidation action in lieu of action by the Board if it will carry out the purposes of PCA.

6. IMPACT ANALYSIS

Average - Current NWR = 13.23
Average - Proposed NWR = 12.53%[10]
Average - Proposed RBNWR = 22.50%

A. Leverage Ratio Comparison[11]

Range 6/30/2004 Data	#FICU based on Current Net Worth Ratio	#FICU based on Proposed Net Worth Ratio
< 2%	17	30
2 to 3%	16	8
3 to 4%	7	18
4 to 5%	20	41
5 to 6%	43	102
6 to 7%	127	433
7 to 9%	1,501	1,932
9 to 11%	2,200	2,073
11 to 13%	1,701	1,431
> 13%	3,578	3,142

B. Risk-Based Ratio Comparison

Category 6/30/2004 Data	#FICU based on Current Risk-Based Net Worth Ratio	#FICU[12] based on Proposed New Net Worth Ratio
Adequately Capitalized	9,193	9,083
Undercapitalized	17	75
Significantly Undercapitalized	NA	52
Critically Undercapitalized	NA	NA

[10] The deduction of the NCUSIF deposit results in an average decline in the net worth ratio of 70 basis points.
[11] Statistics include credit unions that are defined as new, though new credit unions will continue to have separate requirements reflecting they their need to build capital over time from inception.
[12] Does not exclude credit unions less than $10M in assets.

C. Tandem Requirements Comparison

Category 6/30/2004 Data	Current System	Proposed System
Well Capitalized (or new[13])	9,018	9,106
Adequately Capitalized	111	10
Undercapitalized	62	64
Significantly Undercapitalized	13	19
Critically Undercapitalized	6	11

[13] New credit unions are identified and excluded from categories below well capitalized, but are counted with the well capitalized category due to the data limitations of this analysis.

7. DEFINITIONS

Capital. Used interchangeably with net worth.

Corporations. Synonymous with the term "corporates" in BASEL II. Corporates has meaning within industry as Corporate Credit Unions.

Direct Credit Substitute. An arrangement in which a credit union assumes, in form or in substance, credit risk directly or indirectly associated with an on or off-balance sheet asset or exposure that was not previously owned by the credit union and the risk assumed by the credit union exceeds the pro rata share of the bank's interest in the third-party asset. If the credit union has no claim on the asset, then the bank's assumption of any credit risk is a direct credit substitute.

Individual Exposure Limit. The level at which loans no longer qualify for inclusion in the regulatory retail loan portfolio. This level is determined by multiplying the potential regulatory retail loans by 0.2%, subject to a floor of $200,000 and a ceiling of $1,000,000.

NRSRO. An entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) as a Nationally Recognized Statistical Rating Organization. Any applicable rating source relied upon for purposes of PCA risk-weighting must be identified at the time of purchase and must be used for risk-weighting purposes as long as the rating is still publicly available. In the event the rating is no longer available, the credit union may choose a rating from another NRSRO and must use the applicable rating from this source as long as it is available.

Potential Regulatory Retail Loans. All loans minus real estate secured loans minus loans to non small businesses minus government guaranteed portion of loans.

Small Business. Any business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.

"Unrated." Any corporation or security that does not receive a rating from an NRSRO.

8. APPENDIX 1 - REGULATORY RISK PORTFOLIOS

A. Summary of Risk Portfolios[14]

Based on the proposed statutory changes, this section represents how NCUA envisions implementing via regulation the risk-based net worth requirement. The following information is an outline of the proposed risk portfolios and weights, as well as some noteworthy detail, but is not a comprehensive list of all of the specific regulatory provisions that will be needed for full implementation. All parties will have ample opportunity to comment and have input into what would ultimately become the final regulation via the standard rulemaking process.

Cash and Investments

Risk Portfolio	Examples	Risk Weight
1. Cash on Hand	Cash	0%
2. Government Issued or Guaranteed	U.S. Treasury Notes, Federal Agency Notes, Local or State Government Notes, SBA Guaranteed Portion of Business Loans. (Excludes non-guaranteed amounts.)	0%
3. Claims on Financial Institutions	Bank & Credit Union Deposits and Notes	20%
4. Claims on Corporations - Investments (includes GSE issued or guaranteed)	GSE Debentures, Corporate Bonds, Mutual Funds, asset backed and mortgage related (MBS & CMOs) securities, and CUSO investments accounted for under the equity or cost methods.	20% to 150%
5. Membership Interests and Bank Equity Instruments	Corporate capital, CLF stock, FHLB stock, and bank stock.	100%

Loans

Risk Portfolio	Examples	Risk Weight
6. Regulatory Retail Loans	Consumer Loans, Loans to Small Businesses	75%

[14] We plan to maintain the provision for credit unions to apply for a risk mitigation credit to account for any institution specific risk reduction factors.

7. Claims Secured by Residential Property (includes business loans secured by residential real estate)	Fixed and Adjustable Rate Residential Real Estate Secured Loans.	35%
8. All Other Loans • Claims Secured by Commercial Real Estate • Large Retail Loans • Claims on Corporations – Loans	- Business loans secured by commercial real estate. - Consumer loans or loans to small businesses in excess of the lesser of $1M or 0.2% of the regulatory retail portfolio, but not less than $200,000. - Business loans to other than small businesses. Includes loans to CUSOs accounted for under the equity or cost methods.	100%
9. Past Due Loans - Secured by Residential Property	Residential property secured loans in non-accrual status or Delinquent 2 or More Months (90 days past due)	100%
10. Past Due Loans - All Other:	All non-residential property secured loans in non-accrual status or Delinquent 2 or More Months (90 days past due)	150%

Other

Risk Portfolio	Examples	Risk Weight
11. NCUSIF Deposit	Share insurance fund deposit.	Deduct
12. ALLL	Allowance for Loan and Lease Losses account.	Add
13. All Other Assets	Fixed assets, other assets net of those captured specifically.	100%

Off-Balance Sheet

Risk Portfolio	Examples	Risk Weight
14. Commitments	Unused portion of guaranteed lines of credit. Net of those with MAC clauses or unconditionally cancelable.	Varies
15. Recourse Obligations and Direct Credit Substitutes	Loans sold with recourse that qualify for true sales accounting (low level exposure rule).	Varies

Operational Risk

Risk Portfolio	Risk Weight
16. Operational Risk	BASEL II basic indicator approach, 15% of average gross income over 3 year period (converted to a risk asset by multiplying by 12.5 – the inverse of 8%)

B. Supporting Details for Risk Weights

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1. CASH ON HAND

Recommended Risk Weight:	0%
Bank weight (current):	0%
Basel II weight (standard):	0%

Rationale
Cash on hand is not subject to credit risk. Apply Basel II standard approach (¶81, footnote 28).

Impact Model
5300 Account Code 730A

Implementation Issues
None

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2. GOVERNMENT ISSUED OR GUARANTEED

Recommended Risk Weight:	0%
Bank weight (current):	0%
Basel II weight (standard):	0%

This portfolio excludes any portion of these assets that are not guaranteed.

Rationale
Government Issued or Guaranteed are not subject to credit risk. For assets partially guaranteed by the government, includes only the guaranteed portion. Apply Basel II standard approach. - (¶53)

Impact Model
Proxy - 5300 Account Codes 741C+742C+(0.8*400F)

Implementation Issues
Will necessitate call report adjustments.

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3. CLAIMS ON FINANCIAL INSTITUTIONS

Recommended Risk Weight:	20%	Comparable to current and BASEL II approaches.
Bank weight (current):	20%	
Basel II weight (standard):	20%	

Rationale
Apply Basel II standard approach (¶61, first option). For credit risk mitigation techniques, implement the simple approach (¶119 and ¶145) as a voluntary supplement to the call report (alternative component). This can result in a 0% weight - e.g. investment repurchase agreements using government securities with qualifying securities using commercially prudent collateral practices.

Impact Model
Proxy - 5300 Account Codes 730B+730C+744C+652C+672C

Implementation Issues
Will necessitate call report changes.

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4. CLAIMS ON CORPORATIONS - INVESTMENTS[15]

Recommended Risk Weights:

NRSRO Rating	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

Bank weight (current):	20%, 50%, 100% or 200%, depending on investment type and NRSRO rating.
Basel II weight (standard):	Same as recommended.[16]

[15] With only a few minor exceptions (like mortgage related securities), federal credit unions are not permitted to invest in instruments with any noteworthy credit risk (mostly government, federal agency, and GSE debt instruments). However, state-chartered credit unions in some states are authorized to invest in corporate debt instruments.

Rationale
Apply Basel II standard approach (¶66). Using the approach of FDIC's current rule (App. A to Part 325, Section II.B.1.), indirect holdings (e.g., mutual funds and common trusts) are assigned an unrated risk weight or, if identifiable, to the risk category for the highest risk-weighted asset the fund is permitted to hold, with a minimum 20% risk weight. For GSEs, senior debt receives an implicit rating of AAA and mortgage-backed securities guaranteed by GSEs rank *pari passu* with the senior debt (QIS 4).

Impact Model
Proxy - 5300 Account Codes 768-730B-730C-744C-769A-769B-652C+743C+655C

Implementation Issues
Will necessitate call report changes.

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5. MEMBERSHIP INTERESTS AND BANK EQUITY[17] INTERESTS

Recommended Risk Weight:	**100%**
Bank weight (current):	100%
Basel II weight (standard):	100%

As per BASEL II (¶36), must be a non-significant minority interest (less than 20%), otherwise deducted from Net Worth and weighted at 0%.

Rationale
Applies Basel II standard approach (¶36). Also consistent with current treatment for instruments that qualify as capital issued by other banks that are not intentional cross-holdings (i.e., reciprocal holdings). Part 704 does not permit corporate credit unions to hold capital instruments of natural person credit unions. Also, this is more stringent than FDIC's current treatment of FHLB stock. [18] See Appendix 3 for a more detailed discussion of the basis for treatment of membership interests.

Impact Model
Proxy - 5300 Account Codes 769A+769B.

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[16] Short-term ratings are associated with risk weights, based on current FDIC rules and Basel II (¶103), as follows: A-1 to 20%, A-2 to 50%, A-3 to 100%, other ratings (including non-prime, B and C) to 150%, and unrated to 100%.
[17] Bank equity instruments are not permissible for federal credit unions. However, state-chartered credit unions in some states are authorized to invest in bank equity instruments.
[18] 0% for Federal Reserve bank stock (App. A to Part 325, Section II.C, Category 1.b), 20% for FHLB stock (App. A to Part 325, Section II.C, Category 2.b), and 100% for bank capital instruments (App. A to Part 325, Section II.C, Category 4(c)).

Implementation Issues
Will necessitate call report changes for CLF and FHLB stock.

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6. REGULATORY RETAIL LOANS

Recommended Risk Weight:	75%
Bank weight (current):	100%
Basel II weight (standard):	75%

As per BASEL II, excludes consumer loans or loans to small businesses in excess of the individual exposure limit (see definitions section).

Rationale
Applies Basel II standard approach (¶69), using the four criteria (¶70): orientation, product, granularity, and low level of individual exposure limit. Under the orientation criterion, we define small business per the SBA. We set the granularity criterion at 0.2% of total potential regulatory retail loans of the credit union, with a de minimus level of \$200,000. We set the low value of individual exposure limit to \$1 million, rather than €1million. The individual exposure limits and the de minimus levels to be indexed to increases in the CPI. In addition to loans exceeding the individual exposure limit, does not include loans secured by residential property, loans secured by commercial real estate, and loans to businesses that do not meet the definition of a small business.

Impact Model
Proxy - 5300 account codes 396+397+385+370+002+698-(400-718)-(041B-(714-771+716-775)-(713-751+715-755))

Implementation Issues
Need to adjust account 698 and exclude loans that don't meet the individual exposure limit.

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7. CLAIMS SECURED BY RESIDENTIAL PROPERTY

Recommended Risk Weight:	35%
Bank weight (current):	50%
Basel II weight (standard):	35%

As per BASEL II, includes business loans secured by residential property.

Rationale
Apply Basel II standard approach (¶72).

Impact Model
Proxy – 5300 account codes 703+386+003-714+771-716+775-713+751-715+755

Implementation Issues
Modify to exclude commercial property.

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8. ALL OTHER LOANS

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

Encompasses three primary categories in BASEL II:
1. Large Retail Loans.
2. Claims Secured by Commercial Real Estate.
3. Claims on Corporations.

Rationale
Large Retail Loans - As per BASEL II, includes consumer Loans or loans to small businesses in excess of the lesser of $1M or 0.2% of the regulatory retail portfolio, but not less than $200,000. Applies the FDIC's current weights for commercial and consumer loans (App. A to Part 325, Section II.C, Category 4.(b)(7)). This same weight applies to claims on unrated corporates under Basel II.

Claims Secured by Commercial Real Estate - Applies Basel II standard approach (¶74). Does not adopt the preferential treatment (50% weight) approach for loans with low loan-to-value ratios (footnote 25).[19]

Claims on Corporations - BASEL II unrated weight is 100%, but ranges from 20% to 150% based on credit rating (see table in Claims on Corporations – Investments). Applies Basel II standard approach (¶66) for unrated claims. Does not adopt the NRSRO rating table since credit union loans to corporations are not likely to have an applicable rating by an NRSRO (¶68). Loans to credit union service organizations fall into this category.

Impact Model
Large Retail - No proxy.
Commercial Real Estate – No proxy.
Claims on Corporations - 5300 Account codes 400-(.8*400F)-ACCT_718

[19] The preferential treatment of footnote 25 may be implemented as a risk mitigation credit available upon request and subject to NCUA approval.

Implementation Issues
Will necessitate call report change.

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9. PAST DUE LOANS - SECURED BY RESIDENTIAL PROPERTY

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

Comparable to BASEL II past due definition of 90 days or more, includes loans 2 or more months delinquent. BASEL II weight is net of specific provisions.

Rationale
Applies Basel II standard approach (¶78). Does not adopt the netting provision for specific provisions since under GAAP credit unions rarely have loans that qualify for specific provisioning.

Impact Model
5300 Account codes 714-771+716-775+713-751+715-755.

Implementation Issues
Call report needs to add non-accrual and separate commercial real estate.

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10. PAST DUE LOANS - ALL OTHER

Recommended Risk Weight:	150%
Bank weight (current):	100%
Basel II weight (standard):	150%

Comparable to BASEL II past due definition of 90 days or more, includes loans 2 or more months delinquent. BASEL II weight is net of specific provisions.

Rationale
Applies Basel II standard approach (¶75). Does not adopt the netting provision for specific provisions since under GAAP credit unions rarely have loans that qualify for specific provisioning.

Impact Model
5300 Account codes 041B-(714-771+716-775)-(713-751+715-755)

Implementation Issues
Call report needs to add non-accrual and separate commercial real estate.

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11. NCUSIF DEPOSIT

Recommended Risk Weight:	0%	Deduct from net worth.
Bank weight (current):	NA	
Basel II weight (standard):	NA	

Rationale
This balance sheet asset is deducted from net worth for PCA purposes only. Because this account is dollar for dollar deducted from net worth, the account is excluded from risk assets. If the system were to incur losses in excess of retained earnings in the fund, the NCUSIF deposit would be reduced, then replenished by charges to credit unions, resulting in credit unions' expensing of the deposit. Results in an average decline in net worth ratio of 70 basis points.

Impact Model
5300 Account Code 794.

Implementation Issues
None.

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12. ALLL

Recommended Risk Weight:	0%	Add general and specific provisions to Net Worth, limited to 1.25% of risk-weighted assets. Also reduced by balance of loans 6 or more months delinquent.
Bank weight (current):	0%[20]	
Basel II weight (standard):	0%[21]	

Rationale
This contra account is an offset to assets. A 0% credit weight therefore removes this contra asset from the balance sheet. Because the ALLL has already been expensed through the income statement, the account represents a cushion against losses and, therefore, is recognized as an additional source of protection for the NCUSIF. Because most credit unions do not qualify under GAAP for specific provisions, there likely is little benefit to be obtained by imposing the administrative burden of requiring specific and

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[20] Add general provision to Tier 2 capital, limited to 1.25% of risk-weighted assets.
[21] Add general provision to Tier 2 capital, limited to 1.25% of risk-weighted assets under the standard approach (¶42), while internal-ratings based (IRB) approach withdraws the deduction for the general provision (¶43).

general provision data to be reported by loan type. However, loans that are delinquent by 6 or more months represent a high probability of charge-off that will reduce the ALLL and increase provisioning. Thus, the balance of these loans are deducted from the amount of the ALLL that may be added back to Net Worth (before the 1.25% limit is applied).

Impact Model
5300 Account Code 719.

Implementation Issues
None.

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13. ALL OTHER ASSETS

Recommended Risk Weight:	100%
Bank weight (current):	100%
Basel II weight (standard):	100%

Rationale
All other assets not captured in other portfolio. (BASEL II ¶ 81)

Impact Model
Proxy – 5300 account codes 798A+007+008+009.

Implementation Issues
Will necessitate call report changes.

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14. COMMITMENTS

Recommended Risk Weight:	Varies
Bank weight (current):	Varies[22]
Basel II weight (standard):	Varies[23]

Same as loan type, converted to a credit equivalent amount using the factors in the table below.

[22] CCF of 0% or 50% for terms up to 1 year and over 1 year, respectively (App. A to Part 325, Section II.D.2.b. and 5.). Credit weights of 50% or 100% or 200% (App. A to Part 325, Section II.C, Category 3.d. and Category 4.(b)(8) and Category 5.(a)).
[23] Same as recommended CCF table.

Commitment Type/Original Maturity	Cancelable	Up to 1 Year	Over 1 Year
Credit Conversion Factor (CCF)	0%	20%	50%

Rationale
Apply Basel II standard approach. Cancelable means unconditionally cancelable at any time by the bank without prior notice, to the full extent allowable under consumer protection legislation, or automatic cancellation due to deterioration in a borrower's creditworthiness (¶83 and footnote 29).

Impact Model
Proxy - 5300 Account Codes 814+814A

Implementation Issues
Need to segregate by loan type and commitment type/original maturity.

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15. RECOURSE OBLIGATIONS AND DIRECT CREDIT SUBSTITUTES

Recommended Risk Weight:	Varies
Bank weight (current):	Varies[24]
Basel II weight (standard):	Same

Same as loan type, converted to a credit equivalent amount using a CCF of 100%; with a low level recourse rule limiting the credit charge to the maximum contractual exposure less any recourse liability established under GAAP.

Rationale
Apply general version of bank credit weight rule. Other activities covered by the bank rule generally are impermissible, not undertaken by credit unions, or will be reflected on the balance sheet given GAAP treatment for securitized lending transactions (subject to low-level exposure rule).

Impact Model
Proxy - 5300 Account Code 819.

Implementation Issues
Will necessitate Call Report changes.

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[24] Same as above, with additional provisions for rated obligations and other activities (App. A to Part 325, Section II.B.5.(b)).

16. OPERATIONAL RISK

Added to risk-assets by converting to a risk-asset equivalent.

Rationale
Adopts basic indicator approach of BASEL II (¶649). Serves as a proxy for operational risk by calculating 15% of the average annual (positive) gross income over the previous 3 years and multiplying by 12.5 (the inverse of the 8% capital standard).

Impact Model
5300 Account Codes 115+117.

Implementation Issues
None.

9. APPENDIX 2 – CREDIT UNION LOSS HISTORY

Unit Averages

All Loans

	All Total Loan Loss Average	All Total loan loss ST DEV	Number	> $10 M Total Loan Loss Average	> $10 M Total loan loss ST DEV	Number
1994	0.51%	1.70%	12,031	0.37%	0.56%	3,997
1995	0.51%	1.65%	11,724	0.38%	0.41%	4,050
1996	0.60%	1.29%	11,428	0.46%	0.48%	4,133
1997	0.68%	1.51%	11,273	0.55%	0.57%	4,237
1998	0.72%	1.73%	10,995	0.55%	0.56%	4,358
1999	0.60%	1.34%	10,630	0.50%	0.53%	4,434
2000	0.61%	1.44%	10,316	0.44%	0.43%	4,452
2001	0.62%	1.18%	9,984	0.48%	0.49%	4,634
2002	0.68%	1.16%	9,688	0.55%	0.54%	4,719
2003	0.77%	1.50%	9,369	0.60%	0.75%	4,792
3-yr avg	0.69%	1.28%		0.54%	0.60%	
5-yr avg	0.66%	1.32%		0.51%	0.55%	
10-yr avg	0.63%	1.45%		**0.49%**	**0.53%**	
10-yr min	0.51%	1.16%		0.37%	0.41%	
10-yr max	0.77%	1.73%		**0.60%**	**0.75%**	

Credit Card Loans

	All CC Loan Loss Average	All CC loan loss ST DEV	Number	> $10 M CC Loan Loss Average	> $10 M CC loan loss ST DEV	Number
1994	N/A	N/A	12,031	N/A	N/A	3,997
1995	N/A	N/A	11,724	N/A	N/A	4,050
1996	N/A	N/A	11,428	N/A	N/A	4,133
1997	N/A	N/A	11,273	N/A	N/A	4,237
1998	0.83%	1.60%	10,995	1.59%	1.63%	4,358
1999	0.78%	1.62%	10,630	1.44%	1.54%	4,434
2000	0.73%	1.38%	10,316	1.32%	1.36%	4,452
2001	0.87%	1.65%	9,984	1.49%	1.67%	4,634
2002	1.03%	2.17%	9,688	1.69%	2.33%	4,719
2003	1.08%	1.85%	9,369	1.74%	1.86%	4,792
3-yr avg	0.99%	1.89%		1.64%	1.95%	
5-yr avg	0.90%	1.73%		1.54%	1.75%	
10-yr avg	0.89%	1.71%		1.55%	1.73%	
10-yr min	0.73%	1.38%		1.32%	1.36%	
10-yr max	1.08%	2.17%		1.74%	2.33%	

Member Business Loans

	All MBL Loan Loss Average	All MBL loan loss ST DEV	Number	> $10 M MBL Loan Loss Average	> $10 M MBL loan loss ST DEV	Number
1994	0.07%	1.44%	12,031	0.14%	2.09%	3,997
1995	0.03%	0.80%	11,724	0.05%	1.11%	4,050
1996	0.04%	1.10%	11,428	0.08%	1.51%	4,133
1997	0.02%	0.53%	11,273	0.03%	0.55%	4,237
1998	0.04%	1.03%	10,995	0.08%	1.49%	4,358
1999	0.02%	0.50%	10,630	0.03%	0.74%	4,434
2000	0.02%	0.92%	10,316	0.04%	1.20%	4,452
2001	0.02%	0.82%	9,984	0.05%	1.20%	4,634
2002	0.03%	0.86%	9,688	0.06%	1.21%	4,719
2003	0.02%	0.81%	9,369	0.03%	1.03%	4,792
3-yr avg	0.03%	0.83%		0.05%	1.15%	
5-yr avg	0.02%	0.78%		0.04%	1.08%	
10-yr avg	0.03%	0.88%		**0.06%**	**1.21%**	
10-yr min	0.02%	0.50%		0.03%	0.55%	
10-yr max	0.07%	1.44%		**0.14%**	**2.09%**	

Real Estate Loans

	All RE Loan Loss Average	All RE loan loss ST DEV	Number	> $10 M RE Loan Loss Average	> $10 M RE loan loss ST DEV	Number
1994	0.08%	0.82%	12,031	0.10%	0.69%	3,997
1995	0.05%	0.70%	11,724	0.08%	0.59%	4,050
1996	0.06%	0.89%	11,428	0.07%	0.58%	4,133
1997	0.04%	0.51%	11,273	0.06%	0.40%	4,237
1998	0.02%	0.31%	10,995	0.04%	0.28%	4,358
1999	0.03%	0.42%	10,630	0.05%	0.44%	4,434
2000	0.02%	0.38%	10,316	0.03%	0.32%	4,452
2001	0.02%	0.33%	9,984	0.04%	0.34%	4,634
2002	0.03%	0.38%	9,688	0.05%	0.42%	4,719
2003	0.04%	0.63%	9,369	0.05%	0.52%	4,792
3-yr avg	0.03%	0.45%		0.04%	0.42%	
5-yr avg	0.03%	0.43%		0.04%	0.41%	
10-yr avg	0.04%	0.54%		**0.05%**	**0.46%**	
10-yr min	0.02%	0.31%		0.03%	0.28%	
10-yr max	0.08%	0.89%		**0.10%**	**0.69%**	

All Loans Less Real Estate, Member Business Loans, and Credit Card Loans

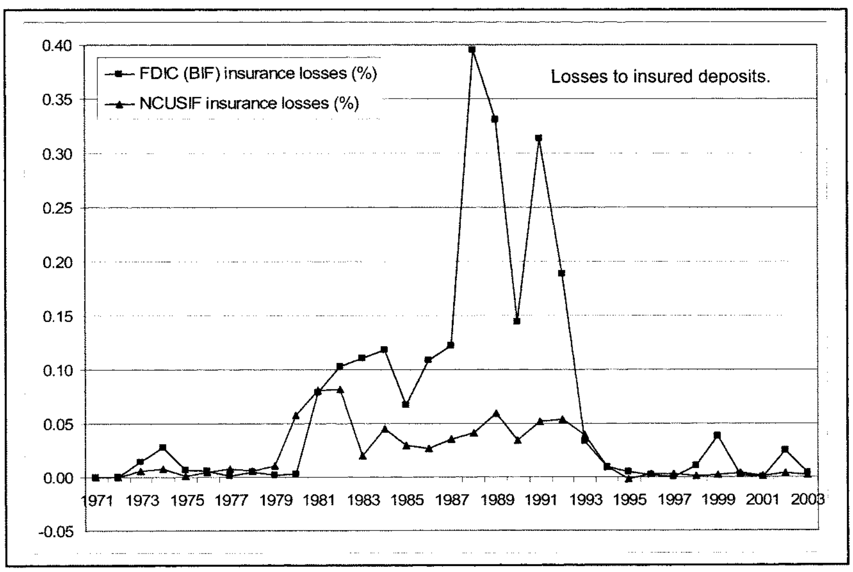
	All	All		> $10 M	> $10 M	
	Non CC RE MBL Loan Loss Average	**Non CC RE MBL loan loss ST DEV**	**Number**	**Non CC RE MBL Loan Loss Average**	**Non CC RE MBL loan loss ST DEV**	**Number**
1994	0.57%	1.60%	12,031	0.53%	0.94%	3,997
1995	0.60%	1.45%	11,724	0.56%	0.66%	4,050
1996	0.72%	1.64%	11,428	0.68%	0.78%	4,133
1997	0.84%	1.64%	11,273	0.85%	0.93%	4,237
1998	0.77%	1.85%	10,995	0.64%	0.75%	4,358
1999	0.67%	1.51%	10,630	0.58%	0.73%	4,434
2000	0.66%	1.54%	10,316	0.52%	0.58%	4,452
2001	0.71%	1.50%	9,984	0.58%	0.66%	4,634
2002	0.78%	1.47%	9,688	0.67%	0.74%	4,719
2003	0.90%	1.66%	9,369	0.77%	0.96%	4,792
3-yr avg	0.79%	1.54%		0.68%	0.79%	
5-yr avg	0.74%	1.53%		0.63%	0.74%	
10-yr avg	0.72%	1.58%		**0.64%**	**0.77%**	
10-yr min	0.57%	1.45%		0.52%	0.58%	
10-yr max	0.90%	1.85%		**0.85%**	**0.96%**	

Aggregate Averages

All CUs	**Total Loan Loss Average**	**CC Loan Loss Average**	**RE Loan Loss Average**	**MBL Loan Loss Average**	**Non CC RE MBL Loan Loss Average**
1994	0.39%	N/A	0.10%	0.67%	0.59%
1995	0.40%	N/A	0.07%	0.36%	0.63%
1996	0.50%	N/A	0.07%	0.24%	0.80%
1997	0.59%	N/A	0.05%	0.19%	0.99%
1998	0.59%	2.16%	0.04%	0.08%	0.73%
1999	0.49%	1.89%	0.03%	0.13%	0.61%
2000	0.42%	1.63%	0.02%	0.06%	0.55%
2001	0.46%	1.77%	0.02%	0.10%	0.62%
2002	0.51%	1.97%	0.02%	0.10%	0.74%
2003	0.56%	2.15%	0.03%	0.10%	0.84%
3-yr avg	0.51%	1.96%	0.02%	0.10%	0.73%
5-yr avg	0.49%	1.88%	0.03%	0.10%	0.67%
10-yr avg	**0.49%**	**1.93%**	**0.04%**	**0.20%**	**0.71%**
10-yr min	0.39%	1.63%	0.02%	0.06%	0.55%
10-yr max	**0.59%**	**2.16%**	**0.10%**	**0.67%**	**0.99%**

CUs > $10M	Total Loan Loss Average	CC Loan Loss Average	RE Loan Loss Average	MBL Loan Loss Average	Non CC RE MBL Loan Loss Average
1994	0.38%	N/A	0.09%	0.66%	0.60%
1995	0.40%	N/A	0.07%	0.34%	0.65%
1996	0.49%	N/A	0.07%	0.23%	0.82%
1997	0.59%	N/A	0.05%	0.18%	1.02%
1998	0.59%	2.18%	0.04%	0.08%	0.73%
1999	0.48%	1.90%	0.03%	0.13%	0.61%
2000	0.42%	1.63%	0.02%	0.05%	0.55%
2001	0.45%	1.77%	0.02%	0.10%	0.62%
2002	0.51%	1.97%	0.02%	0.09%	0.74%
2003	0.55%	2.15%	0.03%	0.09%	0.84%
3-yr avg	0.50%	1.96%	0.02%	0.09%	0.73%
5-yr avg	0.48%	1.88%	0.03%	0.09%	0.67%
10-yr avg	**0.49%**	**1.93%**	**0.04%**	**0.20%**	**0.72%**
10-yr max	0.59%	2.18%	0.09%	0.66%	1.02%
10-yr min	**0.38%**	**1.63%**	**0.02%**	**0.05%**	**0.55%**

FDIC vs. NCUSIF Insurance Loss Comparison



 updated 3/17/05

10. APPENDIX 3 – MEMBERSHIP INTERESTS

The risk portfolio of "Membership Interests and Bank Equity Interests" includes corporate credit union membership capital, Central Liquidity Facility (CLF) stock, Federal Home Loan Bank (FHLB) stock, and bank stock. The recommended credit risk weight for holdings in this risk portfolio is 100% for a non-significant minority interest (less than 20% of the other entity's equity). Significant interests and reciprocal holdings are deducted from net worth and weighted at 0%. Since credit unions have limited holdings in bank equity interests, most of this risk portfolio is comprised of membership interests in corporate credit unions. The proposed treatment of corporate membership (capital) instruments is grounded on:

1. Basel II Standard Approach

The risk weight is based on paragraphs 28, 29, and 81 of the Basel II standard approach. We deduct the entire amount of significant interests from net worth. We use generally accepted accounting practices (GAAP) as our national accounting standards to determine whether an investment is significant.[25]

2. FDIC's Treatment of Bank Equity Instruments

The FDIC's current credit risk weight is 100% for a number of capital instruments, including stock in other insured banks, provided they are not reciprocal holdings.[26] If they are not otherwise deducted from capital, investments in unconsolidated companies, joint ventures, associated companies, and instruments that qualify as capital issued by other banks are risk weighted 100%. 12 CFR 325, App. A, Section II.C, Category 4.(b)(5), (b)(12), and (c).[27]

Note that corporate membership capital is not issued at a premium to book value. Corporate membership capital is in the form of a term certificate or an adjusted balance account. 12 CFR 704.3. Thus, corporate membership capital, unlike bank stock purchased in the market place, is not subject to market risk (stock price fluctuations), only the minimal credit risk from potential failure.

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[25] Even if corporate credit union membership interests were treated under Basel II as if they were investments in commercial entities (based on paragraphs 35 and 36); the risk weight for the investment would be 100% and only the individual significant investments in equity interests exceeding 15% of a credit union's capital would be deducted from capital. This would be consistent with FDIC's current materiality threshold of 15% of capital for such non-financial equity holdings.

[26] FDIC deducts reciprocal holdings of capital instruments of banks from total capital. Reciprocal holdings means intentional cross-holdings of capital instruments by banks. 12 CFR 325, App. A, Section I.B.(4).

[27] No single credit union owns corporate membership instruments of more than 50% of outstanding voting stock, which is FDIC's definition of an investment in unconsolidated banking and finance subsidiaries that is deducted from capital. 12 CFR 325, App. A, Section I.B.(2). No single credit union owns corporate membership interests of 20 percent or more of the outstanding voting stock, which is the threshold FDIC applies on a case-by-case basis for deducting investments in associated companies or joint ventures from capital.

3. Low Systemic Risk

Corporate credit unions are operated for the purpose of serving natural person credit unions. Corporate credit unions actually reduce risk to the credit union system and provide added protection and benefits due to the following:

Corporate credit unions are subject to extensive regulation.
The scope of activities of corporate credit unions is limited by NCUA Rules and Regulations Part 704. For example, corporate credit union investment authority is essentially limited to investment grade securities.[28] State chartered natural person credit unions in several states have similar investments powers. Thus, the insurance fund is not exposed to higher risk activities. Further, federal credit unions may not purchase shares or deposits in a corporate credit union if the NCUA Board has provided notice that a corporate credit union is not operating in compliance with its regulations. 12 CFR 703.14(b).

Corporate credit unions are subject to extensive supervision.
NCUA annually examines all corporate credit unions and has a program of continuing supervision, including review of monthly financial and management information. Our Office of Corporate Credit Unions is composed of highly trained, skilled, and experienced staff who focus exclusively on examining corporate credit unions.

Corporate credit unions provide expertise and economies of scale.
By aggregating investment funds from natural person credit unions, corporate credit unions are able to provide expertise and economies of scale that would not otherwise be applied to these assets and activities in individual natural person credit unions. This results in a reduction of systemic risk and enables NCUA to efficiently examine these investment assets and operating activities (e.g., item processing).

Corporate credit unions add additional capital to the credit union system.
The retained earnings of corporate credit unions are not reflected in the net worth of member natural person credit unions.[29] Assets of corporate credit unions are funded almost entirely by the deposits of member credit unions.[30] Thus, they provide an additional layer of capital for the underlying assets and activities in natural person credit unions.

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[28] Corporate credit unions do have limited holdings of participation loans, investments in credit union service organizations, and fixed assets
[29] Retained earnings of the corporate system totaled $2.5 billion as of Dec. 31, 2004. By way of comparison, member natural person credit unions held $3.3 billion in corporate membership interests.
[30] Corporate credit unions generally have limited leverage. Borrowings of corporate credit unions aggregated only $9.7 billion as of Dec. 2004, versus total assets of $109.9 billion.

4. Low Specific Risk

The risk of failure of an individual corporate credit union is low. Investment securities are investment grade. Principal operating activities of corporate credit unions are the provision of services to member credit unions. Leverage is low. Most other assets are either fully secured or reflect ACH payment services for members.

The assets of corporate credit unions are similar to an indirect holding of a pool of assets (e.g., a mutual fund).[31] When risk of holding corporate instruments is assessed in light of the investment grade quality of a corporate credit union's assets (with the majority of holdings AAA rated), a credit risk weight of 20% would be assigned. This is consistent with the risk weighting of Basel II for claims on financial institutions.

A risk weight for corporate capital instruments needs to cover the limited remaining risks of the corporate: operational risks; the risks arising from the limited leveraging; and assets of corporates that are not investment grade (such as limited holdings of participation loans, investments in credit union service organizations, and fixed assets). A 100% risk weight is more than adequate given:

- Operational risks of the corporate credit union are examined annually by NCUA. Operational risks are adequately covered by the retained earnings of the corporate credit union. In addition, the member credit union is assessed an operational risk charge to further protect the insurance fund. In the absence of a corporate credit union, the member credit union would still need to conduct the service activities.

- Corporate credit unions generally have limited leverage. Borrowings of corporate credit unions aggregated only $9.7 billion as of Dec. 2004, versus total assets of $109.9 billion and total investments of $99.9 billion.

- Corporate assets as of Dec. 2004 other than investments total only $10 billion, including: $4.3 billion in loans to member credit unions (fully secured); $3.6 billion in future dated ACH transactions; $0.9 billion in cash and balances due; $0.5 billion in fixed assets; and $0.4 billion in other loans.

[31] Under the FDIC's rules, an investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. 12 CFR 325, App. A, Section II.B.1.

National Credit Union Administration

Office of the Chairman

June 16, 2005

The Honorable Spencer Bachus
Chairman, Subcommittee on Financial
Institutions and Consumer Credit
Committee on Financial Services
2129 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Bachus and Members of the Subcommittee:

Thank you again for the opportunity to appear before the Subcommittee on June 9, 2005. I appreciated the opportunity to discuss the benefits of Congressional action on both the Credit Union Regulatory Improvement Act and the Financial Institutions Regulatory Relief Act.

The following addresses the questions raised relating to the Community Reinvestment Act (CRA) and its relevance for credit unions.

Loan portfolios in 89% of all credit unions have more than one half of their portfolios in closed-end unsecured loans (average loan of $2,400) providing substantial support of people of modest means.

Credit unions were originally formed to provide people of modest means credit and capital to start and maintain small businesses. Even though currently (since 1998) there are restrictions imposed on member business lending, credit unions continue to meet this need for their members who then invest in their communities. Many of these members have no alternative, as these modest loans are not offered by other financial institutions.

Credit unions continue to pursue those means open to them in providing affordable services to their members. Many times this is in response to pay day lenders and check cashers who pass on higher costs to the consumer.

With the statutory restrictions on serving underserved areas eased (since 1999), credit unions have the opportunity to expand their field of membership into areas defined as underserved while allowing the credit unions to continue their original field of membership. The result: 635 federal credit unions have been approved for underserved expansions, taking in 1,348 communities. In addition, the NCUA has designated 882 federal credit unions as low-income which qualifies them for community development technical assistance and loans, and allows them to accept non-member deposits to assist in furthering their growth.

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300

While NCUA and credit unions have successfully worked together to extend credit to underserved areas and persons of modest means, these efforts are sometimes misconstrued or misinterpreted. For example, the 2003 Home Mortgage Disclosure Act (HMDA) data captures mortgage statistics from 1,920 credit unions, **but it excludes 528 credit unions with assets over $32 million that serve rural communities, which are not designated as MSAs.** While HMDA data shows credit unions continue to have the lowest denial rate for minority applications, this is only part of the picture. As discussed above, credit unions remain focused on small balance consumer lending.

I look forward to continuing our dialogue on the not-for-profit cooperative financial service credit unions continue to provide.

Sincerely,

JoAnn Johnson

JoAnn Johnson
Chairman, NCUA

cc: Chairman Oxley
Ranking Member Frank

National Credit Union Administration

Office of the Chairman

July 7, 2005

The Honorable Spencer Bachus
Chairman, Subcommittee on
Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is provided to answer the question submitted by Representative Brad Sherman requesting my views on the written statement of John Reich, Vice Chairman of the Federal Deposit Insurance Corporation (FDIC) submitted to the Committee on Financial Services at the June 9, 2005 hearing on regulatory reform.

Vice Chairman Reich stated:

> In the past ten 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.

I am pleased to respond to this point of view and provide facts that will reassure the Committee that federal credit unions are operating as authorized, and limited, by the Federal Credit Union Act (FCUA). NCUA carries out its responsibilities under the terms of the FCUA as written by the U.S. Congress through regulation, supervision and examination of federal credit unions.

The Honorable Spencer Bachus
Page 2
July 7, 2005

Federal credit unions are safely and soundly operating with fields of membership that are well within limits established by Congress. While some are growing within their field of membership to asset levels above $1 billion, the total number of federal credit unions has decreased significantly over the last decade.

The industry is still predominantly made up of institutions under $10 million in assets and, as this hearing revealed, all small financial institutions face growing challenges. Additionally, consumers should benefit from different choices in the financial marketplace and credit unions remain very distinct from commercial banks in many ways discussed below. Tax policy rightfully belongs to Congress and the Department of the Treasury, but NCUA can affirm that federal credit unions can only be organized in ways that are consistent with the original reasons the tax exemption was granted in the first place. This has been reaffirmed by a recent Treasury report to Congress. Market share data presented here does not reveal any significant gains by federally insured credit unions over the last decade.

Attached is detailed information on the various issues Vice Chairman Reich expressed in his testimony. I hope these additional facts may serve to provide the Congress with a broader perspective to assess the competitive advantages or disadvantages of federal credit union and bank charters, as well as the marketplace and consumer implications.

Today's not-for-profit financial cooperative system plays a vital role in America's financial services sector. Thank you for the opportunity to address these issues. If you have any questions or need additional information, please contact me.

Sincerely,

JoAnn Johnson

JoAnn M. Johnson
Chairman

Credit Union Growth Trends

It is true that over the last ten years the number of federal and state chartered natural person credit unions with over $1 billion in assets has increased. As of December 31, 2004, there were 50 federal and 48 state chartered credit unions with assets over $1 billion. However, the total number of federal credit unions has fallen by 2000 over the ten year period he cites, from 7643 in 1994 to 5626 in 2004. And due to the challenges of starting a cooperative financial institution in the current financial environment, we have only chartered 208 new federal credit unions since 1985; 1,992 less than the 2,400 new bank charters Vice Chairman Reich cited in his testimony. Only 114 of those 208 newly formed credit unions remain today. Both the decline in the overall number of credit unions and the growth in assets, many through mergers, make the point of the hearing for credit unions, banks, and thrifts – that regulatory burdens are one factor making it increasingly difficult for small institutions to exist. Larger institutions, through efficiency of scale, can absorb the costs (financial, time, and personnel) of compliance more easily. Reducing regulatory burdens for smaller institutions might mitigate this trend.

However, the large majority of credit unions are of modest asset size, especially in comparison to the banks and thrifts. Almost 87 percent of federally-insured credit unions are less than $100 million in assets, with more than 46 percent being less than $10 million.

Field of Membership Limitations Honored

Vice Chairman Reich's statement about "ever-expanding fields of membership" may reflect an opinion about federal credit unions operating with a community charter or multi-employee field of membership. Both types of federal credit union charters are specifically authorized by the Federal Credit Union Act. In fact, community charters have been a traditional option for federal credit unions since the original enactment of the FCUA in 1934. There are three types of charters that federal credit unions can elect; single common bond of occupation or association, multiple-common bond of more than one group, and community common bond. Federal credit unions cannot serve the general public. The "field of membership" acts to limit who is authorized to become a member. This limitation continues to apply to all federal credit unions; it does not apply to commercial banks that can offer services to everyone, anywhere, domestically or internationally. Thus, this traditional difference between federal credit unions and commercial banks remains in place.

In 1998, the U.S. Congress limited community field of memberships to a "well-defined local community, neighborhood, or rural district." The 1998 law also authorized multiple-group common bond credit unions.[1] That type of field of membership option is consistent with the FCUA and helps reduce the vulnerability of existing credit unions to the sometimes overwhelming statutory and regulatory demands that were the subject of the hearing, business combinations, plant closings, or other changes to the sponsoring business or organization the federal credit union serves. Congress specifically authorized that type of charter for federal credit unions in its 1998 amendment to the FCUA and NCUA regulations implementing the law have been upheld in court. Even with the changes made by Congress to the field of membership requirements, almost 26 percent of federal credit unions remain with a single common bond and less than 19 percent currently have community fields of membership.

It is our hope that these facts provide ample justification that these types of fields of memberships are within the legal framework for federal credit unions. Therefore, federal credit unions are not going beyond their legal boundaries by choosing to operate and serve people that qualify for membership under those types of charters authorized by law.

Competition benefits consumers. Every credit union member is free to become a customer of any, and every bank, thrift or other financial provider in the country, but the reverse is not true because of the field of membership rules. With that policy in place it is hard to see how it can be asserted that this is one of the "conditions under which this competition exists enable credit unions to operate with a number of advantages over banks and thrifts" enunciated by Vice Chairman Reich.

[1] NCUA had authorized multiple group Federal credit union's pursuant to policy under the earlier provision in the FCUA; this amendment confirmed such policy by specifically adding it to the FCUA.

Credit unions also compete with credit unions and many overlapping fields of membership exist. NCUA does not, as a policy, seek to protect credit unions from overlapping field of memberships, or from other financial providers, knowing that competition serves a public purpose.

Legislative History of the Credit Union Tax Exemption

Another subject mentioned by Chairman Reich was the credit union tax exemption, which might be refined to the exemption from federal income taxes not distributed to members as interest and dividends.

As you know, the U.S. Congress establishes tax policy at the federal level, so that subject is beyond the purview of this agency. According to a 2001 U.S. Treasury study, the legislative history of the income tax exemption for federal credit unions is based on two points:

> ...(1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on credit unions" because credit union shares function as deposits; and (2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members..."[2]

Federal credit unions continue to maintain this distinction from for-profit commercial banks because they are organized and operated only as cooperatives and they do not issue stock. The asset size of a credit union is not a determining factor.

The Federal Credit Union Act defines a federal credit union as a cooperative association (12 USC 1752(1)). Federal credit unions are organized and governed as member-owned cooperatives operated for the benefit of their members, and are not-for-profit. The Federal Credit Union Act and NCUA regulations implementing the chartering provisions of the FCUA remain consistent with the reasons cited above as to why the U.S. Congress granted federal credit unions tax-exempt status.

Many financial service providers have some unique federal tax feature specific to that type of financial service provider or product. The earnings of federal and state chartered credit unions not distributed to members as interest or dividends are exempt from federal income taxes; there are now over 2000 community commercial banks that have elected to be organized as Subchapter S corporations. Consequently, they benefit from a reduction of federal income taxes at the corporate level, a benefit that is not available to other commercial banks; some farm credit banks are tax-exempt; Federal Home Loan Banks are exempt from federal income taxes; money market mutual funds avoid taxes at the corporate level if 90% of the income is distributed to account holders; some small thrifts and banks qualify for a favorable bad debt reserve method; some insurance companies and products enjoy favorable federal tax benefits. Banks

[2] Comparing Credit Unions with Other Depository Institutions, U.S. Department of the Treasury, January 2001.

and federal credit unions compete with all of these providers, regardless of the federal tax treatment of their earnings.

As you can see, there is no one federal tax regime that uniformly applies to the diverse field of financial service providers. These different features serve a public purpose, subject to review by Congressional policymakers. Singling out only one competitor, federal credit unions, as the statement from Vice Chairman Reich does, ignores this broader picture.

The U.S. Department of the Treasury study cited above was a comprehensive study, completed at the direction of the U.S. Congress. That report stated:

> Although they provide many of the same products and services as banks and thrifts, credit unions have certain distinguishing characteristics. They are member-owned cooperatives, with each member having one vote regardless of the member's deposits. Moreover, they do not issue capital stock; rather, they are non-profit entities that build capital by retaining earnings. Finally, credit unions may serve only an identifiable group of customers with a common bond.
>
> At this time, we do not believe these differences raise any particular safety or soundness or competitive equity concerns. Therefore, we offer no administrative or legislative recommendations.

"Uneven Playing Field"

In addition to these findings from the U.S. Department of the Treasury, there are a number of other distinctions that demonstrate the continuing differences between the more limited activities of federal credit unions and the more expansive authorities provided to commercial banks and thrift institutions:

- Federal credit unions have a federal statutory usury limit of 15%, inclusive of all fees. The Federal Credit Union Act permits a higher rate if the NCUA Board adopts a regulation, but the NCUA Board must reconsider the regulation every 18 months. The current usury ceiling is 18%.
- Other limits on federal credit union lending authority exist, including a limit on loan maturity and a prohibition on prepayment penalties.
- Federal credit unions have more limited investment authority. Federal credit unions are generally limited to investing in government issued or guaranteed securities; they cannot invest in the diverse range of higher yielding products, including commercial paper and corporate debt securities.
- 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 insurance companies.
- Federal credit unions do not have general trust powers.
- Federal credit unions' borrowing is limited to 50% of paid-in and unimpaired capital and surplus.
- Federal credit unions have very limited broker-dealer authority; essentially they can only enter into a third-party networking arrangement with a broker to provide services to their members.
- Federal credit unions can only compensate one member of the board of directors for service as a director; other directors, committee members, and so forth must serve as volunteers.
- Federally insured credit unions' member business loans are limited to the lesser of 1.75 times net worth or 12.25% of total assets.
- Federally insured credit unions must have 2% more in capital than banks to be considered "well capitalized" under federal "prompt corrective action" laws.

The cumulative impact of all these limitations on federal credit unions should reveal to all objective observers that these member-owned cooperatives continue to operate under much more limited authority than do commercial banks. It is hard to understand how Vice Chairman Reich can assert unfair credit union competition by stating "These advantages make for an uneven playing field, a condition that Congress should reexamine and seek to resolve."

Serving People of Modest Means

Vice Chairman Reich also mentioned the Community Reinvestment Act. When Congress last considered credit unions and applying the Community Reinvestment Act to them, the proposal was defeated in large part because credit unions have a field of membership focus and limitation, they historically have not had a "redlining" problem to be fixed and because they address the underserved in other ways.

Loan portfolios in 87% of all credit unions have more than one half of their portfolios in closed-end and unsecured loans (average loan of $2,400) providing substantial support of people of modest means.

Credit unions have acted to fill the void in some of the most difficult economic areas by adopting underserved areas. To date 635 credit unions have been approved to adopt 1,348 underserved communities and as part of the approval process all have submitted plans that reveal how they intend to reach the people most in need of financial services in these areas.

NCUA has also designated 882 federal credit unions as "low-income" credit unions, those where a majority of the membership make less than 80% of the average for all wage earners, or family household income falls at or below 80% of the median household income. These credit unions are qualified to seek NCUA loans and grants to assist them with their mission to serve this membership.

Market Share Unchanged

Market share data also does not seem to support arguments about competitive advantages favoring federally insured credit unions. Federally insured credit unions, while similar in number to FDIC insured institutions, equal only a fraction of the assets of the FDIC insured institutions. Over the past ten years the percent of federally insured credit union assets to FDIC assets has ranged between 5.78 percent and 6.72 percent, with the current level equaling 6.44 percent.

Large FDIC insured institutions, defined as those over $1 billion in assets, currently comprise a larger percent of the banking industry (6.7% of all institutions) than large federally insured credit unions do (1.2% of all institutions).

In addition, the 103 large federally insured credit unions only equal 2.5% of the assets of the 596 large FDIC insured institutions, a much smaller level than the total industry comparison. The comparisons are demonstrated below:

	All Institutions as of March 31, 2005	**All Institutions > $1 billion as of March 31, 2005**
Number of FICU	8,939	103
Number FDIC Insured Institutions	8,942	596
FICU Assets	$662,381,627,906	$224,117,030,306
FDIC Insured Institution Assets	$10,292,505,170,000	$8,872,761,705,000
Percent - number FICU to number FDIC	**99.9%**	**17.3%**
Percent - FICU Assets to FDIC Assets	**6.44%**	**2.53%**

NASCUS

National Association of State Credit Union Supervisors
NASCUS Credit Union Advisory Council
National Institute for State Credit Union Examination

Thomas G. Duncan
General Counsel
United States House of Representatives
Committee on Financial Services
2129 Rayburn
Washington, D.C. 20515

Dear Mr. Duncan:

Chairman Bachus, thank you for your letter requesting comments about the American Bankers Association and Independent Community Bankers Associations' (ICBA) testimony as it relates to regulatory relief concerns, specifically antiterrorist and anti-money laundering laws and regulations. NASCUS[1] appreciates the opportunity to provide comments.

NASCUS believes that it is the state credit union regulators' responsibility to encourage state-chartered credit unions to comply with all applicable laws and regulations. FinCEN, Treasury and Homeland Security should recommend to Congress the appropriate provisions for legislation to protect national security. These federal agencies are best positioned to determine the usefulness and level of information required for Suspicious Activities Reports (SARs) to enforce BSA and anti-money laundering activities.

NASCUS is pleased to have worked with both FinCEN and the Federal Financial Institution Examination Council (FFIEC) to form clear, risk-based Bank Secrecy Act (BSA) and anti-money laundering examination procedures. This process was important because it allowed state regulators the opportunity to provide input into procedures that encourage compliance with BSA.

NASCUS recognizes the importance of state regulators working with federal agencies to enforce BSA anti-money laundering regulations. We welcome future opportunities and look forward to continued cooperation with Congress and federal agencies tasked with BSA compliance.

Sincerely,

George Latham
Past Regulator Board Chairman
National Association of State Credit Union Supervisors

[1] NASCUS is the professional association of the 48 state and territorial credit union regulatory agencies that charter and supervise the nation's 3,800 state-chartered credit unions.

2004 SAR Filings Rose by One-Third, Treasury Unit Says in Latest Report

BNA

June 9, 2005

Depository institutions filed almost one-third more suspicious activity reports (SARs) in 2004 compared to 2003, the Treasury Department's Financial Crime Enforcement Network said June 8.

According to FinCEN's latest SAR Activity Review, SAR filings by deposit-taking financial institutions totaled 381,671 in 2004, marking a 32 percent increase over the 288,343 SARs submitted the year before.

Other sectors also reported increased SAR filings. According to FinCEN, money service businesses--which include currency exchanges, check-cashing firms, and others--filed 296,284 SARs in 2004, which amounts to a 41 percent boost from the 209,512 filings in 2003.

Among other findings, FinCEN said filings related to mortgage loan fraud shot up 93 percent since 2003. Ronald R. Glancz, a partner with the Venable firm in Washington, D.C., said the numbers confirm the growing importance of mortgage-related fraud, but said the increase also reflects a hot market for home mortgages.

"The volume of lending transactions has increased, so you would expect more fraud as well," Glancz said.

The increase in SAR filings is well known among bankers and regulators. FinCEN complains that financial institutions are filing SARs even in somewhat doubtful circumstances to avoid criticism or enforcement action by the government.

So-called defensive filings are clogging government databases and making the anti-money laundering effort more difficult, regulators say. But bankers say they have little choice, and maintain that defensive filings will probably continue until regulators offer a "safe harbor" or similar relief.

The FinCEN report may be found on the agency's Web site at: http://www.fincen.gov/sarreviewmay2005.pdf.

By R. Christian Bruce

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