Testimony of

America's Community Bankers

on

Cutting Through the Red Tape: Regulatory Relief for America's Community-Based Banks

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

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Mr. Chairman and Members of the Subcommittee, I am Mark Macomber, President and CEO of Litchfield Bancorp in Litchfield, Connecticut. Litchfield Bancorp is a $162 million state chartered community bank, part of a two bank mutual holding company.

I am here this morning representing America's Community Bankers (ACB). I serve on ACB's Board of Directors and Executive Committee and am Chairman of the Mutual Institutions Committee. ACB is pleased to have this opportunity to discuss with the subcommittee recommendations to further reduce the regulatory burden and red tape on community banks. And in turn, community banks will be able to better serve consumers and small businesses in their local markets. ACB has a long-standing position on reduction of regulatory burden. Community banks today operate under a regulatory scheme that becomes more and more burdensome every year.

In addition to the regulations imposed on community banks to ensure safe and sound operation of the bank and to protect the deposit insurance fund, we must comply with an array of consumer compliance regulations. These regulations serve a useful purpose but in many cases the regulatory burden of compliance and preparation and delivery of disclosures outweighs the benefits. In the past ten years, a number of very burdensome regulations have been layered on to an already heavy burden. In just the past three years, significant burden has been added by the enactment of the USA Patriot Act and the Sarbanes Oxley Act. As a community banker, I understand the importance of tracking and eliminating terrorist financing mechanisms and also of having a strong corporate governance system in place. As a community banker, I see how much it costs, both financially and in numbers of staff hours for my small mutual community bank to comply with just these two laws. As a community banker, I see projects that will not get funded, products not offered and consumers not served because I have had to make a large resource commitment to comply with the same regulations with which banks thousands of times larger must comply.

This hearing and this topic are important and timely. Ten years ago there were 12,000 banks in the US. Today, there are almost 9,000 of us left. ACB is concerned that community banks are unable to compete with financial services conglomerates and unregulated companies because of the cost of regulation. Community banks are at the heart of cities and towns everywhere and to lose that segment of the industry because of over regulation would be a shame.

I have several recommendations to relieve regulatory burden and red tape, but I would be remiss Chairman Bachus, if I first did not thank you and the members of the House Financial Services Committee, as well as the full Chamber for passing H.R. 1375, the Financial Services Regulatory Relief Act of 2004. We appreciate your hard work in this area. In passing H.R. 1375, the House moved to reduce regulation on community banks in dozens of ways, three of which are particularly important: First, you removed unnecessary restrictions on branching in Section 401, allowing community banks to have flexible branching authority. Second, you provided parity for savings associations in Section 201, permitting them to engage in trust activities in the same manner as banks. And third, the bill provided savings associations full small business lending authority, as well as an increase in their lending limit on other business loans from 10 to 20 percent of assets. A very good start! We have urged the Senate to take up H.R. 1375 and make the first round of reg relief a reality this year.

Now let me turn to the subject of today's hearing.

ACB and its members strongly believe that there is more to being a community bank than just banking. For example, Litchfield Bancorp participates in, and contributes to, financial literacy programs, performing arts initiatives, local sports programs, and numerous charitable organizations. In fact, ACB did a poll of its members last year and found that half of our community bank presidents and CEOs volunteer 11 hours or more per month to non-profits and other local organizations. And 90 percent of our Members support 10 or more nonprofit groups each year. So there is more to community banking than just the business of banking. We provide critical resources, financial and personal, to making our communities better places to live.

ACB has several recommendations to further reduce regulations on community banks that will help make doing business easier and less costly, further enabling community banks to help their communities prosper and create jobs.

H.R. 3952 (the Promoting Community Investment Act)

First, ACB strongly supports passage of H.R. 3952, the Promoting Community Investment Act, sponsored by Congressman Jeb Hensarling. Mr. Hensarling's bill will allow community banks with less than $1 billion dollars in assets to participate in the Community Reinvestment Act (CRA) small institution examination. According to a report by the Congressional Research Service, a community bank participating in the streamlined CRA exam can save 40 percent in compliance costs! By passing H.R. 3952, you will free up capital and other resources for almost 1,700 community banks across our nation that are in the $250 million to $1 billion asset-size range, allowing them to invest even more into their local communities.

In addition to allowing banks with up to $1 billion in assets to use the streamlined CRA exam, ACB welcomes a review of the current examination procedures and guidance as a means to critically assess the issues that are highlighted in a debate of Internet banking, nationwide operations, assessment area, expanded service offerings and other developments. The reviews should cover the following areas:

- Incentives for both large and small institutions to achieve higher ratings;
- Reduction of burdensome recordkeeping requirements for all institutions;
- Acknowledgment of the use of alternative delivery systems by all institutions and a further acknowledgement of the role of technology in the fulfillment of CRA;
- Expansion of the degree of favorable consideration received by institutions for out-of-assessment-area provision of lending and other financial services; and
- Provisions for banks facing difficulty obtaining necessary CRA credit as a result of abnormal competition for CRA credits in their assessment areas.

We believe that raising the threshold for the definition of small bank will reduce the regulatory burden for those institutions between $250 million in assets and $1 billion in assets without diminishing the activities of community banks or their CRA obligations. The goals of the

Community Reinvestment Act are laudable and I take them seriously but as a community banker I would not be in business if I did not meet the credit needs of all aspects of my community. I do not need costly record keeping or a lengthy examination to tell me if I am doing the job.

Subchapter S reforms

Secondly, ACB supports passage of legislation to reform Subchapter S of the Internal Revenue Code.

Although not within the jurisdiction of this committee, we urge you to convey support to the leadership of the House Ways and Means Committee. The legislation should include several provisions: 1) increase the number of shareholders of community banks who are eligible to form a Subchapter S corporation from 75 to 200; 2) permit IRA's to be eligible shareholders; 3) clarify that interest on investments maintained by a bank to enhance safety and soundness is not disqualifying passive income; and 4) permit bad debts to be charged off at the corporate level.

Congress made Subchapter S status available to insured depositories for the first time in 1996, but many existing institutions have been unable to make the election because a corporation is not eligible if it has more than 75 shareholders.

Subchapter S of the Internal Revenue Code was first enacted in 1958 to eliminate the double taxation on the profits of small corporations. In effect, small corporations became subject to a method of taxation similar to that imposed on partnerships.

Because of recent false rhetoric, I hasten to add that the shareholders of Subchapter S banks are fully taxed on corporate profits.

Taxes

And speaking of taxes, I have to mention that a primary burden for many community banks is that they pay taxes but compete against a new breed of credit unions that operate as full service banks that do not pay taxes to support federal, state or local governments. ACB recognizes that this is not a tax-writing committee but you hold the other shoe by controlling the expansion of credit union authorities that implicitly expands their tax advantage, and by overseeing the regulators that also are expanding authorities and the scope of the tax exemption.

The third way you can help community banks is to support Ways and Means Chairman Bill Thomas, who has proposed undertaking a review of the roles of tax-exempt institutions, and the appropriateness of maintaining tax-exempt status when they compete for profit against tax-paying companies.

In my own state, Charter Oak Federal Credit Union is a $425 million institution that offers every service my bank can provide. Their earnings last year were $4.6 million, none of it taxed. They are more than two and half times my bank's size, provide virtually identical services in a geographic area larger than that served by my own bank. By simply calling themselves a credit union and requiring a $5.00 share purchase for "members" they avoid over $1.5 million in

income taxes. They are not the mom and pop institution run by volunteers people erroneously associate with the credit union label. They are an aggressive financial services competitor subsidized by my own institution's taxes and, for that matter, by my personal taxes, and yours.

Congress must eliminate the tax-exempt status and special regulatory treatment of the new breed of complex, bank-like credit unions. Community banks pay taxes, and therefore contribute to the tax base in their local communities; providing important funds that are used for police officers and firefighters, for fixing roads, and improving our children's schools. In addition to paying taxes, bank-like credit unions should also be required to meet the same CRA requirements as banks in their markets.

Until such credit unions pay taxes and comply with CRA, the National Credit Union Administration (NCUA) should stop liberalizing its field of membership rules and should prohibit further expansion into commercial banking services. Congress should also reject proposals to give such credit unions additional powers.

Congress chartered credit unions in 1934 to serve persons of modest means. In return, credit unions were exempted from taxation. However, an October 2003 General Accounting Office (GAO) report indicates "that credit unions served a slightly lower proportion of low-and moderate-income households than banks." So in fact, community banks do a better job in serving the very consumers credit unions claim as the basis for their tax-exempt preference.

Because my bank is a mutual community bank, the taxation argument is especially significant. Mutual savings banks like mine operate in a manner very similar to credit unions. We have no stockholders, but lost our tax subsidy in 1952, and have been paying our fair share of taxes ever since. At that time, mutual institutions were deemed to be mature members of the financial services marketplace. The powers of credit unions today far exceed the powers of the mutual savings institution industry in 1952.

Over the years, two distinct credit union industries have emerged. The first group consists of credit unions that adhere to their original statutory mission. The other has expanded fields of membership, maintains extensive branch networks, and offers products virtually identical to community banks and much larger institutions. Yet, they are still exempt from taxes and the CRA. Correcting that inequity, either by taxing bank-like credit unions or giving community banks tax relief, and ensuring appropriate safety and soundness practices in bank-like credit unions, should be a high priority for Congress.

A final point that I would like to raise with regard to credit unions is one of safety and soundness. Credit unions have begun to offer products to their members and to engage in activities that are new to the institutions and are also new to the supervisors. The financial services industry has seen what a rapid expansion of products and services can mean to an industry that is not prepared for the risks. Credit unions that operate like banks should be treated like banks in every respect including taxation and supervision.

Basel II

ACB's fourth recommendation is for Congress to make sure that Basel II and its attendant capital requirements do not put community banks at a competitive disadvantage with large, international institutions. This is probably one of the most important issues facing community banks today.

ACB believes that legislators, regulators and the industry should examine and evaluate, prior to implementation, the cost and complexity of the proposed Basel II capital accord, its competitive impact on banking institutions of different sizes, and the ability of regulators to properly supervise and examine the proposed new minimum capital requirements. Any new capital accord should treat similar risks comparably from institution to institution to avoid creating competitive inequities. Regulators should consider a more simplified approach to the proposed new capital requirements so that the benefits and incentives of more risk-sensitive capital requirements are made available to all financial institutions operating in the United States. If Basel II is implemented for a portion of the banking industry, alternatives must be provided at the same time for banks operating under the Basel I structure to maintain similar capital requirements for similar risks.

The U.S. banking regulators have begun the implementation process of the Accord in the United States. The most important aspect of implementation would be that the Accord might apply only to the 10 to12 largest U.S. banking organizations that have total assets of $250 billion or more or total on-balance-sheet foreign exposure of $10 billion or more. Other institutions can opt-in to the Accord if they can meet very strict and burdensome eligibility standards. The cost and complexity of opting in does not make this a viable option for most community banks.

As a result of the planned implementation in the United States, for the first time there would be a bifurcated regulatory capital framework. This has raised concerns that the Accord will create competitive inequities between large and small banks because of, among other things, the more favorable capital treatment of mortgage and other retail lending under the Accord.

Congress must make sure community banks across the country are not adversely affected by Basel II.

Accounting Issues

There are a number of accounting issues that are currently in play, including the recently resolved accounting for loan loss reserve issue, the treatment of loan participations, and the impact of accounting changes on the capital treatment given to trust preferred securities issuances. These are just a few examples of the many issues that have arisen the past few years. In these and in other examples, ACB and community bankers are concerned that the confusion that results from the differing information received from the federal banking agencies and the accounting community, including FASB, the SEC, and the accountants themselves, results in a significant burden.

We urge Congress to work with the accounting community to recognize the significant business impact that accounting changes have on the bottom-line of community banks. The federal bank

agencies, the FASB, the SEC and others must work together to understand that disagreement among these groups only adds to the regulatory burden on community banks. They will not be able to make loans or to raise capital.

If community banks are unable to enter into participation agreements because of adverse accounting consequences or the additional added expenses of establishing special purpose entities, loans will not be made in communities by those institutions that are most likely to make them. Loans are often too large or too risky for just one community bank to make and a participation arrangement is the only solution. Many community banks have been able to raise needed capital by issuing trust preferred securities in a pooled arrangement. The uncertain capital treatment created by accounting changes is a burden and forces community banks to look elsewhere to raise capital.

Examination and Supervision

Another area that I would like to highlight is that of uncertainty in the examination and supervision area. When the Washington main offices of the federal bank agencies develop a policy or change a regulatory requirement, ACB notes that regulatory burden on community banks can be reduced if a consistent message is given to the examiners in the field and then it is transmitted to the community banks in a timely way. We hear anecdotally that examiners frequently do not have the same message that Washington has and that uncertainty is adding to the burden of community bank compliance. Further, the vast number of regulatory issuances should be reviewed. Continuous release of information that must be absorbed by the small staffs of community banks is another example of regulatory burden. ACB does not mean to suggest that regulations and policies necessary for safety and soundness should not be issued, but the message should be consistent and easily understandable.

Finally, ACB believes that the fees charged for examinations should be rational and based on work done. In addition, we continue to believe that state non-member banks should not be required to pay examination fees to the FDIC. The imposition of these additional fees reduces the amount of resources available to the community.

Unnecessary and redundant privacy notices

And lastly, ACB urges you to review the rules that require community banks to send multiple privacy notices. We suggest that required annual privacy notices for banks that do not share information with nonaffiliated third parties should be eliminated. Banks with limited information sharing practices should be allowed to provide customers with an initial notice, and provide subsequent notices only when terms are modified.

I am sure you are all inundated by privacy statements each fall. I am equally confident that most or all of them remain unread. At my bank we send out thousands of such notices each year at significant cost, in both dollars and staff time, even though our policies and procedures have remained consistent over many years. Redundancy in this case does not enhance consumer protection, rather it serves to numb our customers with volume.

I will tell you, community banks guard their depositors' information like Fort Knox and have built their reputations on the trust of their customers that their bank will actually do so. Most community banks do not share information in any way whatsoever. Others share information only under very controlled circumstances when certain operational functions are outsourced to a vendor. The requirement to send notices should be amended when circumstances have not changed or when we are only reiterating that no customer information is ever shared. We do agree a notice should be sent, but it becomes an expensive burden to send it multiple times when once will more than suffice.

Conclusion

I wish to again express ACB's appreciation for your invitation to testify on the importance of cutting red tape for community banks. We strongly support the Committee's efforts in providing regulatory relief, and look forward to working with you and your staff in crafting legislation to further accomplish this goal.