Texas Department of Banking
Testimony

Testimony provided to the Senate Business and Commerce Committee regarding HB 2007

Date: April 24, 2007

The Honorable Troy Fraser
Texas Senate
Chairman, Senate Business and Commerce
P.O. Box 12068
Austin, Texas 78711

Re: House Bill 2007

Chairman Fraser and Members of the Committee:

House Bill 2007 is the result of various banking industry attorneys, bankers, and Banking Department staff working with you to seek areas of appropriate improvements and modernization in portions of the Finance Code that affect state banks in Texas.

H.B. 2007 provides for modernization of the regulation of banking in this state. The bill:

- Requires the Department of Banking to encourage and assist banks in providing financial literacy programs for their local communities;
- Adds flexibility to examination scheduling requirements by permitting standards to be established by rules that can be more readily adapted to changes in federal law;
- Revises the calculation base for legal limits on loans, investments, and fixed assets to more closely conform to similar federal standards and ease regulatory burden for banks;
- Revises the classification of nonworking mineral or royalty interests to personal property instead of real property for bank regulatory purposes;
- Modernizes state law regarding deposits eligible for asset pledging to retain parity with competing financial institutions; and
- Enhances regulatory authority to flexibly and effectively respond to industry needs and cooperate with other bank regulatory agencies during a disaster or other emergency.

Encouraging bank-provided financial literacy programs in local communities *(SECTION 1)*

Even though it is widely recognized that financially educated people make better bank customers, the Department of Banking does not have a clear mandate to further this goal. The Department of Banking seeks statutory support to encourage and assist banks in providing financial literacy programs for their local communities. Texas began addressing the subject in 2005 by passing laws to add financial education components to the curriculum for high school

and for job training programs. However, available statistics paint an alarming picture of how Texas ranks among the states:

- Lowest average credit score of any state in the nation at 651 (national average is 678). *Source: April 2006 Experian Report*
- One of five states to rate an "F" in assets and opportunities for families; and a "D" in financial security. *Source: The Corporation for Enterprise Development, 1999*
- Ranked 48th among states for average household net worth, and nearly one out of five Texans has no net worth. *Source: July 2005, Ft. Worth Star-Telegram*
- Spent the least in the nation on adult literacy at $5.05 per capita (national average is $46.65). *Source: U.S. Department of Education, 2004*
- Received 4th highest number of identity theft complaints filed with the Federal Trade Commission. *Source: December 2004, Office of Consumer Credit Legislative Report: Reviewing Identity Theft and Senate Bill 473*
- Largest number of properties in foreclosure in the nation at 16,965, with 12,377 homes already lost to foreclosure as of August 2006. *Source: July 2006 RealtyTrac U.S. Foreclosure Market Report*

SECTION 1 of the bill adds new Section 12.1085 to the Finance Code, requiring the Department of Banking to seek to improve the financial literacy and education of Texas residents, and to encourage access to mainstream financial products and services by persons who have not previously participated in the conventional finance system. In cooperation with other agencies and nonprofit foundations, the Department of Banking is directed to encourage and assist banks in developing programs for their local communities. The bill authorizes the Department of Banking to seek and accept gifts, grants, and donations for this purpose.

Adding flexibility to examination scheduling requirements ***(SECTION 2)***

Section 31.105, Finance Code, regarding examination frequency, was amended in 2001, in response to changes in federal law, to incorporate the precise, federal examination schedule in 12 U.S.C. §1820(d). Federal law has recently changed again in this regard, but the Department of Banking lacks the explicit flexibility in Section 31.105 to readily adapt.

Specifically, under previous federal requirements, well-capitalized commercial banks with total assets less than $250 million and rated under the Uniform Financial Institutions Rating System as a composite 1 or 2, could be examined under an extended 18 month examination cycle, with provisions that allowed the federal supervisory authorities the discretion of conducting an examination more frequently if deemed necessary. The Financial Services Regulatory Relief Act of 2006 increased the total asset threshold to $500 million from $250 million, effectively allowing more banks to qualify for the extended 18 month examination cycle.

Modern financial regulatory practices rely on flexibility to establish a periodic examination schedule by rule that can vary depending on the condition of the subject bank. Less frequent examinations were originally established by federal law, a practice the state was required to adopt to preserve the competitive equality of state banks with federally chartered institutions.

SECTION 2 of the bill amends Section 31.105, Finance Code, to allow modification by rule of the statutory requirement for an annual examination of every state bank. Adopted rules would closely approximate the federal examination frequency guidelines for reasons of competitive equality.

Revising calculation of legal loan and investment limits ***(SECTIONS 3, 5-10, 13, and 14)***

A concept in state law since at least 1943, "certified surplus" is that portion of the bank's surplus designated as "certified" by the board of directors of a bank for use in the specified measurement base ("capital and certified surplus") for calculations of certain loan and investment limits under state law. The amount of certified surplus must be recorded in the directors' minutes where it is readily available to examiners. Under current law, a state bank can elect to certify part or all of its surplus without restriction.

The board action required under the "certified surplus" process is sometimes inadvertently omitted or forgotten, creating a potential regulatory "trap" for bankers and examiners. Because officers and directors incur personal liability for any loss resulting from a loan that exceeds the legal lending limit, the "trap" has teeth. Revising the calculation base for legal limits on loans, investments, and fixed assets to create uniformity with federal standards will simplify the process for banks and reduce the regulatory burden created by equally applicable yet conflicting state and federal law.

The bill brings state law more in line with federal law regarding legal loan and investment limits by eliminating the concept of "certified surplus" as a measurement tool in favor of the federal tiered capital approach. SECTION 14 of the bill repeals the definition of "certified surplus" in Section 31.002(a)(10) and the board action requirement in Section 33.105(b), Finance Code. SECTIONS 3, 5-10, and 13 changes each mention of a variant of "capital and certified surplus" to an equivalent variant of "unimpaired capital and surplus," the same language used in federal law, *see, e.g.*, 12 U.S.C. §84. Under existing rulemaking authority, the Finance Commission can apply standards similar to those in federal regulations (generally, Tier 1 capital) to state banks.

The bill has the effect of increasing legal lending and investment limits by an incremental amount beyond what a state bank could set for itself under current law. In general, 25% of unimpaired capital and surplus will exceed 25% of capital and "certified" surplus for many state banks, although state banks that have continually increased certified surplus through periodic certification of positive earnings will not experience a significant change in their legal loan limit. The Department of Banking believes the safety and soundness implications of a slightly increased legal loan and investment limit are marginal and can be easily managed. Other states with equal or greater limits have not experienced unusual difficulties from the higher limits. Specifically, fifteen other states and the U.S. Territory of Guam have lending limits for state banks that equal or exceed the proposed legal lending limit for Texas state banks. Theses states are California, Colorado, Delaware, Georgia, Illinois, Kansas, Kentucky, Louisiana, Missouri, Nebraska, New Mexico, New York, North Dakota, Oklahoma, and Tennessee.

Classifying nonworking mineral or royalty interests as personal property ***(SECTION 4)***

The authority of banks to invest in real estate is severely limited, as is appropriate for safety and soundness of a depository institution. Other than investment in bank facilities, banks generally acquire other real estate only through foreclosure in instances where the real estate was pledged to secure a loan subsequently in default or, in the statutory language of Section 34.003(a), only "as necessary to avoid or minimize a loss on a loan or investment previously made in good faith." Such acquired real estate must be disposed of promptly, subject to certain exceptions, but generally no later than 10 years after its acquisition. These restrictions exist because the risks of real estate ownership create serious safety and soundness concerns.

Subsurface rights are generally classified by law throughout the United States as real property interests and, as such, are subject to the "other real estate owned" limitations. However, foreclosed property in the form of "nonworking" mineral or royalty interests presents unique issues. A nonworking mineral or royalty interest offers the benefit of shared production or mining revenue without exposure to expenses of exploration, development, production, operation, maintenance, abandonment, or other expense associated with extracting and marketing the minerals. However, if the minerals are not being produced, or if the revenues generated are merely nominal and sporadic, the subsurface rights have little or no value. Often such an interest cannot be sold because there are no willing buyers in the market, or if it can be sold, the price is seldom more than a nominal amount. A number of banks in Texas continue to hold nonworking mineral or royalty interests originally acquired through foreclosure several decades ago. In such an instance, repeated regulatory disapprovals and the continual demands for divestiture required by Section 34.003 and applicable federal law constitute technical violations rather than substantive concerns.

SECTION 4 of the bill adds new Section 34.004, Finance Code, to classify nonworking mineral or royalty interests as personal property instead of real property for bank regulatory purposes, thereby permitting banks to hold such interests, but only if the interests were acquired for debts previously contracted and are of nominal value on the financial statements. Further, the banking commissioner must make a prior determination that the possession of such rights and interests is not inconsistent with the safety and soundness of the state bank, and the banking commissioner may at any time order a state bank to divest such interests based on a determination that continued ownership of such interests is detrimental to the state bank.

Modernizing state law regarding deposits eligible for asset pledging *(SECTION 11)*

Section 34.304(b), Finance Code, currently permits a state bank to pledge collateral to secure a deposit made by "this state, an agency or political subdivision of this state, the United States, or an instrumentality of the United States." Otherwise, deposits may only be secured or guaranteed by deposit insurance. National banks have broader pledging authority, and state savings banks in Texas acquired even greater rights in the 79th Legislature.

SECTION 11 of the bill amends Section 34.304(b), Finance Code, to empower a state bank to pledge collateral to secure a deposit made by:

- any state or an agency, political subdivision, or instrumentality of any state;
- the United States or an agency or instrumentality of the United States;

- any federally recognized Indian tribe; or
- another entity to the same extent and subject to the same limitations as may be authorized by the law of this state or of the United States for any other depository institution doing business in this state.

The Texas Department of Banking does not consider the expanded authority as proposed to create material safety and soundness concerns.

Enhancing regulatory authority to facilitate disaster recovery *(SECTION 12)*

The unprecedented magnitude and duration of the effects of Hurricanes Katrina and Rita in 2005 caused major disruptions in disaster recovery efforts by financial institutions. Many institutions had to adjust plans and improvise responses to successfully address unexpected complications. Overall, financial institutions overcame difficult circumstances through advance planning and preparation and by working together, and were able to assist customers and communities in their time of greatest need.

Hurricanes Katrina and Rita also exposed deficiencies in the banking emergency provisions of Chapter 37, Finance Code. The chapter does not contemplate an ability to deal with damaged facilities and disrupted operations, to meet the banking needs of evacuees, or to effectively cooperate with other state and federal bank regulatory agencies — in short, the ability to do what needs to be done to ensure continuation of safe and effective access to financial services in the event of a serious natural disaster or other emergency. Multiple facilities were destroyed outright or sustained significant damage, and some branches and ATMs were underwater for weeks. Chapter 37 authorizes temporary closing of branches and little else, but is silent with respect to alternate bank facilities. Federal and state bank regulatory agencies creatively expedited or waived many legal restrictions and application procedures to permit use of temporary bank facilities and processes during the recovery effort, notwithstanding the lack of clear statutory authority. Finally, Chapter 37 does not contemplate the kind of coordinated, interstate effort among bank regulatory agencies and the banking industry that was required in the aftermath of this disaster. Chapter 37 should be amended to create an adequate, flexible and suitable statutory foundation that enables the Department of Banking to use its banking regulatory expertise to facilitate prompt restoration of public access to banking services, yet does not require the Department of Banking to assume an unfamiliar role beyond its traditional responsibilities and expertise.

SECTION 12 of the bill adds new Sections 37.007 and 37.008 to the Finance Code, relating to recovery from a natural disaster or other emergency.

Section 37.007 authorizes the banking commissioner to approve temporary branch offices or other facilities, including interstate facilities, as required for prompt restoration of public access to banking services.

Section 37.008 authorizes the banking commissioner to enter into cooperative, coordinating, or information sharing agreements with other state and federal agencies and with affected banks and banking trade associations, and to temporarily waive legal restrictions and expedite or

suspend application procedures in the Finance Code. The bill also requires the banking commissioner to coordinate and cooperate with and assist the office of the governor in the performance of the larger duties of that office under other state or federal law, as required by Section 421.071, Government Code.

Respectfully submitted,

Randall S. James
Banking Commissioner