Texas Department of Banking
Testimony

Testimony of Randall James, Texas Commissioner of Banking On behalf of the Conference of State Bank Supervisors before the Subcommittee on Financial Institutions and Consumer Credit Committee on Financial Services, United States House of Representatives

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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 6,251 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. This testimony will review and update several issues that we have previously discussed in this forum, and before the Senate Banking Committee.

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 many of the nation's 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. Community banks represent a shrinking percentage of the assets of our nation's banking system, and we believe that compliance costs are a major factor 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.

My colleagues and I are especially pleased to see provisions in the current bill that recognize this growing disparity in our financial services industry, and the impact this bifurcation has on our economy. Targeted relief for community banks is an essential component of any regulatory reform bill, and we strongly endorse several new provisions of H.R. 3505 that provide this relief.

The streamlining of reports of condition, including short-form reporting for certain community banks; the expansion of healthy community banks' eligibility for an 18-month examination cycle; and the new exemptions in Gramm-Leach-Bliley's annual privacy notice requirement will all reduce burden on these institutions without creating new risks to safety and soundness.

The Conference of State Bank Supervisors endorses approaches that recognize and encourage the benefits of diversity within our banking system. Our dual banking system exists because one size is not appropriate for every customer, and one system is not appropriate for every institution.
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. 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, this regulatory scheme will also impose new requirements on state-chartered banks operating in the majority of states that do not 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 expressed particular concern about Bank Secrecy Act requirements, Currency Transaction Reports and Suspicious Activity Reports. We are especially pleased to see that H.R. 3505 seeks to address these concerns by reducing collection requirements and making them more consistent. We also want to acknowledge the efforts of FinCEN and the federal banking agencies, with whom we have worked to develop clear, risk-based BSA examination procedures. We hope these procedures will improve the effectiveness of BSA compliance procedures, while reducing unnecessary burden on the institutions we supervise. We welcome the additional study on these issues that H.R. 3505 calls for.

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.

We applaud this committee's willingness to revisit and amend legislation to ensure that our laws fulfill Congressional intent. One example of this in the current bill are the 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.

Section 401 of H.R. 3505 helps restore competitive equity by allowing de novo interstate branching for most federally-insured depository institutions.

Recommendations for Additional Changes

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 further 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.

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.

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.

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.

Challenges to Regulatory Burden Relief

The current trend toward greater, more sweeping federal preemption of state banking laws threatens all of the regulatory burden relief issues described above.

Federal preemption can be appropriate, even necessary, when genuinely required for consumer protection and competitive opportunity. The extension of the Fair Credit Reporting Act amendments met this high standard.

We appreciate that the largest financial services providers want more coordinated regulation that helps them create a nationwide financial marketplace. We share these goals, but not at the expense of distorting our marketplace, denying our citizens the protection of state law and the opportunity to seek redress close to home, or eliminating the diversity that makes our financial system great. The Comptroller's regulations may reduce burden for our largest, federally-chartered institutions, 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 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 and we urge you to move this bill through the House of Representative this session of Congress. We thank you for this opportunity to testify, and look forward to any questions that you and the members of the subcommittee might have.