Testimony of Elizabeth A. Duke
On Behalf of the American Bankers Association
Before the
Subcommittee on Financial Institutions and Consumer Credit
Of the
Financial Institutions Committee
United States House of Representatives

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Mr. Chairman and members of the Subcommittee, my name is Elizabeth A. Duke, Sr. Vice President, Government Relations, SouthTrust Corporation (a $48 billion bank holding company headquartered in Birmingham, Alabama). I am a member of the Board of Directors of the American Bankers Association (ABA) and I chair ABA's Government Relations Council. The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

I want to express our appreciation to you, Mr. Chairman, for your leadership in reducing unnecessary regulatory costs and for providing this forum to thoroughly discuss these issues. I would also like to acknowledge Congresswoman Roukema for her commitment to regulatory relief over the last several congresses and Congressman Bereuter, who was instrumental in developing and passing legislation to reduce the regulatory burden in previous Congresses.

I am glad to be here today to present the views of ABA's members on the need to reduce the burden of red tape and paperwork. This is an important issue for ***all*** businesses, including banking. The bi-partisan accomplishments forged in previous Congresses have clearly helped to restore balance in the bank regulatory process. In addition to the statutory changes, Congressional initiatives to roll back unnecessary regulation have created an environment within the bank regulatory community that has encouraged review, streamlining and even elimination of some unnecessary regulations. The result is a more efficient regulatory system and lower costs.

The process of reviewing regulations and their impact on our businesses and communities is an ongoing process, as the marketplace continues to change rapidly. Outdated laws and regulations only serve to squander scarce resources of banks that could otherwise be used to provide financial services demanded by our customers. Today, I would like to talk about the need to reduce unnecessary government regulation and discuss some of the key provisions in H.R. 3951, The Financial Services Regulatory Relief Act of 2002. The bill contains many important improvements that genuinely reduce unnecessary regulatory burdens. It also contains many provisions that should make the regulatory agencies more efficient and will have an ***indirect*** impact on banks. Unfortunately, the bill also contains provisions that are not directed as reducing red tape, but in effect are designed to enhance the competitive position of one financial services industry – credit unions – over taxpaying financial services providers.

I. The Need for Reducing Unnecessary Government Regulation

Mr. Chairman, the cost of regulation is not just a minor nuisance for bankers – it has a significant impact on bank customers and local economies. Compliance costs are a significant drain on bank resources and result in more expensive bank products and lower economic growth – often with very little customer benefit.

Over the past 25 years, the compliance burden has grown so large and is so pervasive throughout all levels of bank management that it is extremely difficult to measure. Research done by the ABA and the Federal Reserve[1] in the 1990s indicates that the total cost of compliance <u>today</u> for banks would range from $25 billion to $33 billion per year. And these costs do not include the cost related to preparing and sending 2.5 billion privacy notices under the Gramm-Leach-Bliley Act, which last year was estimated to be in excess of $1 billion.

Regulatory costs are significant for banks of all sizes, but pound for pound, small banks carry the heaviest regulatory load. In 1996, Congress found that "small businesses bear a disproportionate share of regulatory costs and burdens."[2] For the typical small bank, about one out of every four dollars of operating expense goes to pay the costs of government regulation.[3] For large banks as a group, total compliance costs run into the billions of dollars annually.

Certainly, some of this cost is appropriate for safety and soundness reasons. But consider the direct impact on bank lending and economic growth if this burden could be reduced by 20 percent and redirected to bank capital. It would support additional bank lending of approximately $40 billion to $50 billion. This would clearly have a big impact on our economies. In fact, it represents nearly 10 percent of all consumer loans or 30 percent of all small business and farm loans.

Cost is not the only problem – compliance also puts a big strain on manpower, especially at small banks. SouthTrust Corporation is a large banking firm with $48 billion in assets. We have ***64 full-time employees*** devoted to compliance. Small banks do not have this luxury. I know this intimately as I spent 10 years as CEO of a community bank, Bank of Tidewater, Virginia. My own experience, confirmed by studies done in the 1990s, was that I spent on average about one full day per week on compliance issues. For the industry as a whole, this amounts to 4 million CEO hours per year.

My experience was not unusual. In fact, there are more than ***3,800 banks and thrifts with fewer than 25 employees; almost 1,000 banks and thrifts have fewer than 10 employees***. These banks simply do not have the human resources to run the bank *and* to read, understand and implement the thousands of pages of new and revised regulations, policy statements, directives, and

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[1] "Survey of Regulatory Burden", American Bankers Association, June 1992;
Elliehausen, "The Cost of Banking Regulation: A Review of the Evidence," Staff Study, Board of Governors of the Federal Reserve System, April 1998.
[2] Small Business Regulatory Enforcement Fairness Act of 1996.
[3] According to the Small Business Administration's Office of Advocacy, the total cost of regulation is 60 percent higher per employee for firms with fewer than 20 employees compared to firms with more than 500 employees due to the fixed costs associated with regulations. (Crain and Hopkins, "Impact of Regulatory Costs for Small Firms," Small Business Administration, Office of Advocacy, 2001)

reporting modifications they receive every year. I'm sure I speak for all bankers when I say that I would much rather be spending my time talking with our customers about their financial needs and how my bank will fulfill them than poring over piles of government regulations.

The bottom line is that too much time and too many resources are consumed by compliance paperwork, leaving too little time and resources for providing actual banking services. The losers in this scenario are bank customers and the communities banks serve.

II. Key Provisions in H.R. 3951

There are several provisions that I would like to highlight today that take a step forward in reducing the regulatory burden. As I will discuss below, there are several provisions that unfortunately are aimed at changing the competitive structure between credit unions and taxpaying banks, and, we believe, should ***not*** be included as part of this regulatory relief legislation.
While I will focus my comments on these areas, there are many other provisions included in H.R. 3951 that, while directed at changes within the regulatory agencies, are sure to make the agencies more efficient and would have some positive indirect impact on banking institutions.

Thrift Parity for Trust Activities

Section 201 would exempt savings associations from both broker-dealer and investment adviser registration under the federal securities laws. The ABA strongly and enthusiastically endorses Section 201. Commercial banks and trust companies have long been exempt from investment adviser registration under the Investment Advisers Act of 1940.[4] This exemption is grounded upon the notion that bank trust departments that provide investment advice to personal trust accounts, charitable foundations, employee benefit plans, and the like are subject to federal and state fiduciary laws and are appropriately regulated and supervised by state and federal banking regulators.

In 1980, the Congress gave savings associations the authority to engage in trust and fiduciary activities on the same basis as national banks. However, no commensurate revisions were made to the Investment Advisers Act of 1940, thereby forcing trust and fiduciary activities engaged in by savings associations to be subject to both regulation and examination by state and federal thrift examiners and the Securities and Exchange Commission ("SEC").

Section 201 would remedy this situation by exempting savings associations from investment adviser registration to the same extent as commercial banks and trust companies. Savings associations, like their commercial bank brethren, are subject to a multitude of state and federal fiduciary laws, including ERISA, rules and regulations issued by their primary regulator, state fiduciary law, and decisional law and are subject to extensive examination and oversight by their

[4] While it is true that the Gramm-Leach-Bliley Act narrowed the bank exemption from investment adviser registration to exclude those banks and trust companies that provide investment advisory services to registered mutual funds, Section 201 makes clear that these same limitations applicable to banks would be equally applicable to savings associations.

federal regulators. ***No need exists for yet another layer of costly and duplicative regulatory oversight.***

With respect to broker-dealer registration, Section 201 also would accomplish what the SEC has endeavored to accomplish through rulemaking. Specifically, the SEC has stated in its interim final rules addressing the bank exemptions to broker-dealer registration under Title II of the Gramm-Leach-Bliley Act of 1999, that extending the broker-dealer exemptions beyond banks and trust companies to savings associations was reasonable, in the public interest and consistent with the protection of investors. We strongly supported the SEC's statement in this regard and applaud the Committee's efforts to provide certainty and to create a level playing field under the federal securities laws between commercial banks and savings associations.

Cross Marketing

H.R. 3951 (Section 501) makes two important changes applicable to the new merchant banking powers authorized under the Gramm-Leach-Bliley Act. The first change is important in that it would allow ***all*** financial holding companies ("FHCs") engaged in merchant banking activities to cross-market products and services offered by both the bank and the portfolio company in which the investment is made so long as the financial holding company has a non-controlling investment stake in the portfolio company. The second change would permit all FHCs, whether or not their investment in the portfolio company was controlling, a limited ability to cross-market bank and portfolio company products and services. This latter change is necessary to ensure that FHCs affiliated with securities underwriting firms are not unfairly disadvantaged vis-à-vis those FHCs affiliated with insurance underwriting firms.

Under the Gramm-Leach-Bliley Act, an FHC is permitted to engage in merchant banking equity investment activities if, among other things, it is affiliated with either a securities firm or an insurance underwriting firm. The theory behind these requirements is that affiliation with either of these firms evidences some degree of sophistication with the financial markets.

The Gramm-Leach-Bliley Act generally imposes cross-marketing restrictions on FHC's engaged in merchant banking activities. The Act prohibits a depository institution controlled by an FHC from marketing any product or service of a company in which the FHC has made a merchant banking investment. The reverse is also true: the company in which the FHC has invested may not market the products and services of the FHC's affiliated depository institution to its customers.

A carve-out from this prohibition is provided, however, for merchant banking investments made by insurance companies owned by an FHC. Thus, insurance underwriting firms that affiliate with depository institutions are able to cross-market, through Internet websites or through statement stuffers, depository institution products to or through the company in which they have made a merchant banking investment. Products and services offered by the company in which the insurance underwriting firm has invested also may be marketed through Internet websites or statement stuffers via the depository institution that is affiliated with the insurance underwriting firm.

The ABA's affiliate, the ABA Securities Association (ABASA), has consistently championed the ability of FHCs affiliated with securities firms to engage in website/statement stuffer cross-marketing. Nearly all of ABASA's members are FHCs that may make merchant banking investments because of their affiliation with securities firms, while very few own insurance companies that could engage in the type of insurance company merchant banking permitted by Gramm-Leach-Bliley. As a result, our FHC members could not take advantage of the website/statement stuffer exception, while other FHCs with insurance company merchant banking operations would be permitted to do so. The ability to cross-market through Internet websites is important to banks. Current business practices often require an FHC to invest in an Internet firm in order for its banks' products to be posted on or linked to that firm's website.

Taken together, the amendments would allow banks to cross-market bank products and services to customers of a portfolio company and vice versa, so long as the FHCs investment stake was non-controlling, which is defined as owning or controlling 25 percent or more of the total equity or any class of voting securities. No distinction would be made between those FHCs authorized to engage in merchant banking by virtue of their insurance underwriting affiliates versus those that are authorized on the basis of their securities firms. In addition, even where a control situation existed, limited cross-marketing through websites and statement stuffers would be permitted for all FHCs.

Mr. Chairman, these amendments are very, very positive. They have the strong support of both the industry and the Federal Reserve Board. The amendments will not only put ABASA's members on an equal footing with those insurance underwriting firms that engage in merchant banking, they will also allow all FHCs to engage in cross-marketing so long as their merchant banking stake is non-controlling. This latter provision is very important to level the playing field between FHCs and other non-FHC financial firms not similarly constrained by the Gramm-Leach-Bliley Act's bar on cross-marketing.

Control of Shares by Trusts

Section 502 would give the Federal Reserve Board the discretion to grant exceptions to Section 2(g)(2) of the Bank Holding Company Act. Bank holding companies are generally prohibited from owning more than 5 percent of the voting shares of any company. Section 2(g)(2) provides that shares held in trust for the benefit of employees and certain others shall be deemed to be controlled by or attributed to the bank holding company. Consequently, shares held in trust that are attributable to the bank holding company by operation of Section 2(g)(2) must not, ***when aggregated with all other shares held***, cause the bank holding company to own more than 5 percent of the voting shares of any one company.

This attribution provision has raised significant questions among ABA's membership about the continued ability of bank holding companies to offer benefit plans, such as 401(k) plans, to their employees. As the Committee is aware, the ability to offer a retirement plan as part of a benefits package is often the key to hiring and keeping qualified employees. While the ABA would prefer that the bill contain a specific carve-out from Section 2(g)(2) for employee benefit plans in addition to the general exemptive authority provided in H.R. 3951, we are confident that the Board will properly exercise its authority to exempt these plans from the attribution rule.

Exam Cycle

Section 601 provides discretion for Federal regulators to adjust the exam cycle of insured depository institutions. The ABA believes that this provision helps to more effectively allocate examination and supervisory staff. Moreover, under current law, an 18-month, rather than the normal 12-month, examination cycle is required for institutions with assets under $250 million. Many community banks have experienced considerable growth over the last five years, pushing them out of the small bank examination cycle. Yet, their core simplicity in structure has not changed. Thus, greater flexibility to adjust examination schedules to meet the evolving industry – both in size and complexity – is appropriate.

Subchapter S

ABA supports the provision in H.R. 3951, Section 101, allowing the use of a debt instrument to satisfy the qualifying shares ownership requirement by directors of national banks. Passage of this provision would help national banks who find it difficult to elect subchapter S tax status because of the difficulties associated with the director qualifying shares requirements contained in the banking laws.[5] There are many other subchapter S changes that would be helpful to banks interested in making a subchapter S election, including, but not limited to, raising the shareholder limit from 75 to 150, providing passive income relief to banks and allowing IRA shareholders. Many of these changes can be found in the Subchapter S Modernization Act of 2001 (H.R. 2576; S. 1201). While we realize that these provisions are not under the jurisdiction of this subcommittee, we thought it would be appropriate to raise these suggestions as we appreciate the subcommittee's interest in making subchapter S more widely available to community banks.[6]

Expanded Community Development Investment Authority for Thrifts

Section 202 would make the community development investment authority of thrifts parallel to that of banks. Thrifts are currently more restricted than banks in the types of investments they can make. We believe that allowing thrifts the same range of investment opportunities as banks would be beneficial to communities.

We also suggest increasing the investment limit for banks to that of thrifts. Increasing the investment limit would significantly increase the potential resources available for community development, and we urge the Subcommittee to consider such an expansion.

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[5] Subchapter S is a method of taxation whereby shareholders are taxed in a manner that is similar to the taxation of a partnership. Corporations that meet the strict eligibility standards under subchapter S of the Internal Revenue Code benefit from lower taxes, as the shareholders are taxed directly, rather than the corporation. The Small Business Job Protection Act of 1996 (H.R. 3488) permitted eligible banks, for the first time, to elect subchapter S status beginning in January 1997.

[6] Note that the granting of these changes, while helpful to community banks, would still not put them on a par with tax-exempt credit unions. Significantly, earnings of subchapter S banks are taxed in all instances, whether these earnings are passed on to owners of the bank or not. The same is not true for credit unions, which may retain their earnings tax free. This provides greater growth potential for credit unions vis-à-vis subchapter S or other taxpaying institutions, and further expands the credit union tax subsidy.

Additionally, we propose allowing bank-affiliated Community Development Corporations (CDCs) to become members of the Federal Home Loan Bank System. Often, insured depository institutions, which otherwise might not be members of the Home Loan Bank System, will set up a community development corporation to house their community and economic development efforts. Allowing these bank-affiliated CDCs to join the Home Loan Bank System poses no increased risk to the System because they are supervised by the bank regulators. It does provide these institutions with another source of funds to further their community development activities. This, like increasing the investment authority of thrift institutions, will be beneficial to communities.

Interstate Branching

Section 401 would remove the prohibition on national and state banks from expanding through *de novo* interstate branching. Currently, this may occur only if a state's law expressly permits interstate branching. The current constraint was developed as a compromise when the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 was enacted. Not surprisingly, removing this provision remains controversial even though the market has evolved since that time. The ABA is still discussing this issue with our members and with state bankers' associations.

III. Credit Union Provisions

The ABA has major concerns with provisions in H.R. 3951 that would expand credit union powers, membership, and business lending authority, while also promoting the further consolidation of an already rapidly consolidating tax-exempt credit union industry. These provisions are designed to enhance the competitive position of credit unions vis-à-vis taxpaying financial institutions and should not be a part of any regulatory burden legislation. The distinction between these credit union-related provisions and the provisions previously mentioned rests with the tax-exempt status of credit unions and the limitations on their powers that result from their tax status. Each of the provisions discussed below have the real effect of expanding the credit union charter and its powers – and would likewise expand the credit union tax subsidy and competitive advantages over taxed financial competitors. The same cannot be said about other provisions in this bill.

However, there are two provisions related to credit unions that could reasonably be considered to eliminate burdens without expanding their powers or enhancing their competitive positions. The first provision authorizes a fifteen-year maturity limit for loans and grants rulemaking authority for the National Credit Union Administration (NCUA) to establish longer maturity limits. Under current law, there is a twelve-year maturity limit for loans (with certain exceptions such as mortgage for primary residence). ABA does not oppose this provision as long as it is consistent with safe and sound practices. Second, the bill would provide NCUA with the authority to approve by regulation additional investment authority for credit unions. Current law limits credit unions investment authority to loans, government securities and certain other limited investments; with the diminishing size of the Treasury market, this limitation has become a real issue for credit unions. These two legislative changes have the effect of eliminating a practical barrier in activities already authorized. They do not, like the provisions discussed below and opposed by the ABA, expand the competitive benefits of tax-subsidization already granted to credit unions.

Expansion of Credit Union Powers

Section 305 greatly expands the authority of credit unions to invest in credit union service organizations (CUSOs), thus allowing such entities – which can engage in a wide variety of powers beyond those authorized for credit unions themselves – to vastly broaden their market reach. The provision would triple the amount that credit unions can invest in service organizations, which are not regulated by NCUA. This represents a significant increase in risk, where half of an adequately capitalized credit union's net worth would be at risk. ABA steadfastly opposes this initiative.

Since the beginning of 1999, almost all CUSOs have been formed as limited liability corporations which ***allows the earnings of the CUSO to be taxed at the credit union's marginal tax rate of zero percent***. Thus, any expansion in a credit union's authority to invest in a CUSO would represent a further expansion of the credit union tax subsidy. This expansion of the subsidy would widen the competitive disadvantage between taxpaying banks and tax-exempt credit unions. This provision would expand the tax subsidy provided to credit unions well beyond the current ten-year ***$16 billion*** cost estimated by the U.S. Treasury Department.

Moreover, the ability of CUSOs to provide services to non-credit union members represents a further erosion of the common bond. Thus, this provision is an attempt to circumvent the mission of the credit union charter and an unnecessary expansion of the tax subsidy provided to these institutions.

Expanded Membership

Section 308 would permit credit unions that seek to convert their charters, e.g., from a occupation-based institution to a community charter serving a wide geographic area and/or large population base, to gain the new charter's expanded field of membership while maintaining its prior membership categories. For example, if Lockheed FCU was to add Orange County, it could continue to serve A&H Machine in Oklahoma or Access Graphics in Colorado, or Metrix Group in New Jersey. Moreover, Lockheed FCU has branch locations in New Hampshire and Texas along with California.

Such a provision violates the "reasonable proximity" requirement established by Congress for credit unions just a few years ago. Congress made it quite clear in the Credit Union Membership Access Act of 1998 that if a multiple group credit union was to add a new group to its field of membership, the credit union needed to be "within reasonable proximity to the location of the group."[7] This provision was meant to continue the credit unions' focus on the uniquely "local" aspect of their business operations. The provision in H.R. 3951 would undermine the unique nature of credit unions as volunteer-run, democratic organizations. If members are not within physical proximity of the credit union, they are less likely to participate in the governance of the credit union and to volunteer. If credit unions desire to be full-service financial institutions, they should be required to play by the same rules.

[7] 12 USC 1759(f)(1)(B).

Voluntary Mergers of Credit Unions

Another, perhaps less obvious, aspect of the bill would greatly encourage further consolidation in the credit union industry beyond what is already occurring. During the last decade, the number of credit unions has fallen 19 percent from 12,860 credit unions as of year-end 1990 to 10,365 as of June 2001. Since the beginning of 1991, credit union mergers have averaged 306 per year. Importantly, much of the consolidation has been a result of large credit unions aggressively absorbing small credit unions. ***In 1998, Congress sought to promote small credit unions by maintaining limitations on the ability of larger credit unions to voluntarily merge together.*** It did so by specifically directing the NCUA to promote the creation of independent credit unions and limiting the merger of credit unions with over 3000 members to situations involving a troubled credit union.

The new proposal would permit such mergers any time credit unions want to merge. The effect of this provision would be to eliminate any restriction on the merger of healthy credit unions, leading to even more rapid consolidation of credit unions into ever-larger tax-exempt institutions. We think small, traditional credit unions would share our concerns in this area. Regardless, such an eventuality would further destroy the "myth" that credit unions represent small, niche players in the financial services marketplace. The very consideration of this change in policy should raise the significant question to policymakers as to why such credit unions are deserving of federal and state tax subsidies.

Credit Union Business Lending Expansion

H.R. 3951, Section 306, would also expand the business lending powers of credit unions and represents another attempt to emasculate the business lending restrictions enacted by Congress in the 1998 credit union legislation. That law, which prohibited credit unions from lending amounts greater than 12.25 percent of their capital to businesses, contains limited exemptions which result in loans that are not counted toward the cap. In general, under existing law, the types of loans which are excluded from the definition are those which are secured, guaranteed, insured or in an amount of less that $50,000. ***This proposal to exclude business loans to nonprofit religious organizations would add a significant new unsecured, non-guaranteed, non-insured*** category of loans to the exemptions.

Simply put, these expansions are an attempt to circumvent the restrictions created by Congress and do so in a way that may add significantly to the riskiness of the credit unions' portfolio. We understand the intent of the provision's author. However, consequent to the broad nature of the provision, very large religious-affiliated organizations or even businesspersons remotely affiliated with religious organizations could be construed to qualify. Many religious organizations operate significant business enterprises, such as television networks, bookstores, universities, production houses, web sites, retirement homes, and the like. Therefore, a credit union would be able to make unlimited business loans so long as the borrower was determined to be a nonprofit religious organization. We do not believe that the government should extend its subsidies to support these types of loans.

Our nation's banks provide a wide range of financial assistance to a multitude of religious organizations, facilitating the building of churches and synagogues, the provision of literacy programs, the creation of job training assistance efforts, and the development of a panoply of community development activities. We applaud efforts of all those in the financial community, including credit unions, who engage in such activity. However, the ***ABA does not believe that the government should subsidize such activities for one segment of financial institutions and not others.*** Such would be the case if Congress adopted this provision.

IV. Conclusion

Mr. Chairman, the cost of unnecessary paperwork and red tape is a serious long-term problem that will continue to erode the ability of banks to serve our customers and support the economic growth of our communities. We thank you for continuing to look for ways to reduce the regulatory burden on banks and thrifts, and to restore balance to the regulatory process. Mr. Chairman, the ABA is committed to working with you and the members of this subcommittee to achieve this goal.