CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

July 14, 2003

H.R. 1375
Financial Services Regulatory Relief Act of 2003

As ordered reported by the House Committee on the Judiciary on July 9, 2003

SUMMARY

H.R. 1375 would affect the operations of financial institutions and the agencies that regulate them. Some provisions would address specific sectors: national banks could more easily operate as S corporations or adopt other alternative organizational structures; thrift institutions would be given some of the same investment, lending, and ownership options available to banks; credit unions would have new options for investments, lending, mergers, and leasing federal property; and certain privately insured credit unions could become members of the Federal Home Loan Bank system. The bill would provide the Federal Deposit Insurance Corporation (FDIC) with new enforcement authorities and modify regulatory procedures governing certain types of transactions, such as the establishment of de novo branches and interstate mergers. It would also give agencies more flexibility in sharing data, retaining records, and scheduling examinations, and would limit the legal defenses that the United States could use against certain claims for monetary damages.

CBO estimates that enacting this bill would reduce federal revenues by $37 million over the next five years and by a total of $117 million over the 2004-2013 period. In addition, we estimate that direct spending would increase by $17 million over the next five years and by a total of $22 million over the 2004-2013 period.

H.R. 1375 contains intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA), but CBO estimates that the cost of complying with those requirements would not exceed the intergovernmental threshold established in UMRA ($59 million in 2003, adjusted annually for inflation).

H.R. 1375 contains several private-sector mandates. Those mandates would affect certain depository institutions, nondepository institutions that control depository institutions, uninsured banks, bank holding companies and their subsidiaries, savings and loan association holding companies and their subsidiaries, and Federal Home Loan banks. At the same time, the bill would relax some restrictions on the operations of certain financial institutions. CBO

estimates that the aggregate direct cost of complying with the private-sector mandates in the bill would not exceed the annual threshold established in UMRA ($117 million in 2003, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 1375 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By Fiscal Year, in Millions of Dollars									
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
CHANGES IN REVENUES										
Estimated Revenues										
S Corporation Status	-2	-5	-8	-9	-11	-13	-14	-12	-12	-13
Business Organization Flexibility	*	*	*	*	-1	-2	-2	-3	-4	-5
Total[a]	-2	-5	-8	-10	-12	-15	-17	-14	-16	-18
CHANGES IN DIRECT SPENDING[b]										
Estimated Budget Authority	1	1	1	7	7	1	1	1	1	1
Estimated Outlays	1	1	1	7	7	1	1	1	1	1

NOTE: * = Revenue loss of less than $500,000.

a. Negative revenues indicate a reduction in revenue collections.

b. CBO estimates that implementing H.R. 1375 could affect spending subject to appropriation, but we estimate that any such effect would be insignificant.

BASIS OF ESTIMATE

Most of the budgetary impacts of this legislation would result from three provisions: section 101, which would make it easier for national banks to convert to S corporation status or alternative organization forms; section 214, which would limit the government's legal defenses against certain claims for monetary damages; and section 302, which would allow certain federal credit unions to lease federal land at no charge. For this estimate, CBO assumes that H.R. 1375 will be enacted in the fall of 2003.

H.R. 1375 also would affect the workload at agencies that regulate financial institutions. We estimate that the net change in agency spending would not be significant. Based on information from each of the agencies, CBO estimates that the change in administrative expenses—both costs and potential savings—would average less than $500,000 a year over the next several years. Expenditures of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the FDIC are classified as direct spending and would be covered by fees or insurance premiums paid by the institutions they regulate. Any change in spending by the Federal Reserve would affect net revenues, while adjustments in the budget of the Securities and Exchange Commission (SEC) and Federal Trade Commission (FTC) would be subject to appropriation.

Revenues

CBO estimates that enacting H.R. 1375 would reduce federal tax revenues collected from national and state-chartered banks and would have an insignificant effect on civil and criminal penalties collected for violations of the bill's provisions.

S Corporation Status. Under this bill, some national banks would find it easier to convert from C corporation status to S corporation status. Section 101 would allow directors of national banks to be issued subordinated debt to satisfy the requirement that directors of a bank own qualifying shares in the bank. This provision would effectively reduce the number of shareholders of a bank by removing directors from shareholder status, making it easier for banks to comply with the 75-shareholder limit that defines eligibility for subchapter S election.

Income earned by banks taxed as C corporations is subject to the corporate income tax, and post-tax income distributed to shareholders is taxed again at individual income tax rates. Income earned by banks operating as S corporations is taxed only at the personal income tax rates of the banks' shareholders and is not subject to the corporate income tax. The average effective tax rate on S corporation income is lower than the average effective tax rate on C corporation income. CBO estimates that enacting this provision would reduce revenues by a total of $36 million over the next five years and by $100 million over the 2004-2013 period.

Based on information from the Federal Reserve Board, the OCC, and private trade associations, CBO expects that most of the banks that would be affected are small, although banks and bank holding companies with assets over $500 million would also be affected. In addition, states are likely to amend the rules for state-chartered banks to match those for national banks. CBO expects that most conversions to Subchapter S status would occur between 2004 and 2006 and that national banks would convert earlier than state-chartered banks.

Business Organization Flexibility. Under section 110 of this bill, the Comptroller of the Currency could allow national banks to organize in noncorporate form, for example as Limited Liability Corporations (LLCs) as defined by state law. LLCs generally choose to be taxed as partnerships. Only a few states currently allow banks to organize as LLCs, however, and the Internal Revenue Service (IRS) currently taxes state-chartered bank-LLCs as C corporations. LLCs have more organizational flexibility than S corporations while retaining the corporate characteristic of limited liability.

Income earned by banks taxed as C corporations is subject to the corporate income tax, and post-tax income distributed to shareholders is taxed again at individual income tax rates. Income earned by partnerships—like that earned by S corporations—is taxed only at the personal income tax rates of the partners and is not subject to the corporate income tax. The average effective tax rate on partnerships is lower than the average effective tax rate on C corporation income but is similar to the average effective tax rate on S corporation income.

Based on information from the OCC, the FDIC, and private trade associations, CBO believes that it is quite possible that the OCC would alter its regulations to allow national banks to organize in noncorporate form. We expect that, over the next decade, most states that do not currently allow banks to organize as LLCs will begin allowing them to do so in order to be competitive. Under H.R.1375, future IRS tax treatment of bank-LLCs is uncertain. CBO assumes that the IRS may allow bank-LLCs to be taxed as partnerships at some point in the next decade. The estimated revenue effects of section 110 reflect CBO's estimate of the likelihood of such IRS actions. CBO anticipates that banks forming as LLCs would most likely be newly chartered institutions and that, over the next decade, only a very limited number of banks would convert from C corporation or S corporation status to LLCs taxed as partnerships.

CBO estimates that enacting this provision would reduce federal revenues by a total of $1 million over the next five years and by $17 million over the 2004-2013 period.

Civil and Criminal Penalties. H.R. 1375 would make all depository institutions—not just insured institutions—subject to certain civil and criminal fines for violating rules regarding breach of trust, dishonesty, and certain other crimes. It also would authorize the FDIC to take enforcement action or impose civil penalties of up to $1 million a day on any individual, corporation, or other entity that falsely implies that deposits or other funds are insured by the agency. Based on information from the FDIC, CBO expects that enforcement actions would likely deter most individuals or institutions from violating rules regarding breach of trust, dishonesty, or certain other crimes. As a result, we estimate that any additional penalty collections under those provisions would not be significant.

Direct Spending

CBO estimates that enacting H.R. 1375 would increase direct spending by a total of about $15 million over the 2004-2013 period to pay for increased litigation costs and larger payments for "goodwill" claims against the government. The bill also would reduce offsetting receipts collected from credit unions that lease federal facilities, and it could affect the cost of deposit insurance.

Monetary Damages in Goodwill Cases. Section 214 would preclude the use of certain legal defenses in claims for damages against the United States arising out of the implementation of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). CBO estimates that enacting this provision would increase the cost of litigating and resolving such claims by a total of $15 million over the next five years.

Background on Goodwill Cases. Under section 214, courts could not dismiss a claim arising out of the implementation of FIRREA on the basis of res judicata, collateral estoppel, or similar defenses if the defense was based on a decision, opinion, or order of judgment entered by any court prior to July 1, 1996. On that date, the Supreme Court decided *United States v. Winstar Corp.*, 518 U.S. 839 (1996), holding that the government became liable for damages in breach of contract when the accounting treatment of "supervisory goodwill" that it had previously approved was prevented by enactment of FIRREA. About 100 "goodwill" cases against the government are still pending before the courts, with claims totaling about $20 billion. CBO estimates that, under current law, such claims will cost the government about $1.5 billion over the 2004-2013 period. Judgments, settlements, and litigation expenses for such claims are paid from the FSLIC Resolution Fund, and such payments do not require appropriation action.

By eliminating some defenses currently available to the United States in such cases, section 214 would increase the likelihood that some claims would reach a hearing on the merits, thereby allowing cases to proceed further in the judicial process than may otherwise be likely. According to the Department of Justice (DOJ) and the FDIC, this provision would affect only a few of the goodwill cases; claims in the affected cases could total about $200 million. (This provision also could affect cases in which the FDIC is the plaintiff as the receiver of a failed thrift, but any monetary awards to the FDIC would be intragovernmental payments and would have no net effect on the federal budget.)

Estimated Cost of This Provision. CBO expects that enacting section 214 would increase the cost of litigation and potential settlements or judgments against the United States. Whether those costs are large or small would depend on the role those defenses would otherwise play in the outcome of each case. For example, the cost could be significant if the loss of those defenses resulted in a judgment for plaintiffs on the merits but could be negligible if the judgment were against the plaintiffs.

For this estimate, CBO assumes that defenses of res judicata and collateral estoppel would be just two of several possible defenses and other factors affecting awards of monetary damages and that barring them would therefore have a small effect on the potential costs of such claims. We estimate that enacting this provision would increase expected payments for such claims by about $10 million—or 5 percent of the roughly $200 million in claims that might be affected by this provision. Given the pace of such litigation, we expect that those added costs would occur in 2007 and 2008. In addition, CBO estimates that DOJ's administrative costs would increase by an average of about $1 million a year as a result of the added time and workload associated with those cases. This estimate is based on historical trends in the cost of litigating such claims.

Nongoodwill Cases. Because section 214 would not limit the affected claims to goodwill cases, this provision also could affect other types of claims for monetary damages arising out of the implementation of FIRREA that meet the criteria in the bill. This provision could encourage the filing of such claims that were resolved prior to July 1, 1996; however, DOJ is currently unaware of any such claims.

Offsetting Receipts From Federal Leases. Section 302 would allow federal agencies to lease land to federal credit unions without charge under certain conditions. Under existing law, agencies may allocate space in federal buildings without charge if at least 95 percent of the credit union's members are or were federal employees. Some credit unions, primarily those serving military bases, have leased federal land to build a facility. Prior to 1991, leases awarded by the Department of Defense (DoD) were free of charge and for terms of up to 25 years; a statutory change enacted that year limited the term of such leases to five years and required the lessee to pay a fair market value for the property. According to DoD, about 35 credit unions have leased land since 1991 and are paying a total of about $525,000 a year to lease federal property. Those proceeds are recorded as offsetting receipts, and any spending of those payments is subject to appropriation.

CBO expects that enacting this provision would result in a loss of offsetting receipts from all credit union leases. Those lessees currently paying a fee would stop making those payments after they renew their current leases, all of which should expire within the next five years. In addition, credit unions that have long-term, no-cost leases would be able to renew them without becoming subject to the fees they otherwise would pay under current law.

CBO estimates that enacting this provision would cost a total of about $2 million over the next five years and an average of about $700,000 annually after 2008.

Deposit Insurance. Several provisions in the bill could affect the cost of federal deposit insurance. For example, the bill would streamline the approval process for mergers, branching, and affiliations, which could give eligible institutions the opportunity to diversify and compete more effectively with other financial businesses. In some cases, such efficiencies could reduce the risk of insolvency. It is also possible, however, that some of the new lending and investment options could increase the risk of losses to the deposit insurance funds.

CBO has no clear basis for predicting the direction or the amount of any change in spending for insurance that could result from the new investment, lending, and operational arrangements authorized by this bill. The net budgetary impact of such changes would be negligible over time, however, because any increase or decrease in costs would be offset by adjustments in the insurance premiums paid by banks, thrifts, or credit unions.

Spending Subject to Appropriation

Section 201 provides thrift institutions with exemptions from broker-dealer and investment-advisor registration requirements similar to those accorded banks. Section 313 provides similar exemptions for federally insured credit unions. Based on information from the SEC, CBO estimates that the budgetary effects of those exemptions would not be significant.

Section 312 would exempt federally insured credit unions from filing certain acquisition or merger notices with the FTC. Under current law, the FTC charges filing fees ranging from $45,000 to $280,000, depending on the value of the transaction. The collection of such fees is contingent on appropriation action. Based on information from the FTC, CBO estimates that this exemption would have no significant effect on the amounts collected from such fees.

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 1375 would preempt certain state laws and place new requirements on certain state agencies that regulate financial institutions. Both the preemptions and the new requirements would be mandates as defined in UMRA. CBO estimates that the cost of those mandates taken together would not exceed the threshold established in UMRA ($59 million in 2003, adjusted annually for inflation).

Section 209 would preempt certain state securities laws by prohibiting states from requiring agents representing a federal savings association to register as brokers or dealers if they sell deposit products (CDs) issued by the savings association. Such a preemption would impose costs (in the form of lost revenues) on those states that currently require such registration. Based on information from representatives of the securities industry and securities regulators, CBO estimates that losses to states as a result of this prohibition would total less than $1 million a year.

Section 301 would authorize certain privately insured credit unions to apply for membership in a Federal Home Loan Bank (FHLB). Part of the application process would require state regulators of credit unions to determine whether an applicant is eligible for federal deposit insurance. This requirement would be a mandate, but because the regulators already make that determination under state law, the additional cost to comply with the requirement would be minimal.

Upon becoming members, those credit unions would be eligible for loans from the FHLB. To preserve the value of those loans, section 301 would preempt certain state contract laws that otherwise would allow defaulting credit unions to avoid certain contractual obligations. Because those credit unions are not currently eligible for membership in a federal home loan bank, and accordingly, have no contracts for credit, this preemption, while a mandate, would impose no costs on state, local, or tribal governments.

Section 302 would require state regulators of credit unions to provide certain information when requested by the NCUA. Because this provision would not require states to prepare any additional reports, merely to provide them to NCUA upon request, CBO estimates that the cost to states would be minimal.

Section 401 would expand an existing preemption of state laws related to mergers between insured depository institutions chartered in different states. Current law preempts state laws that restrict mergers between insured banks with different home states. This section would expand that preemption to cover mergers between insured banks and other insured depository institutions or trust companies with different home states. This expansion of a preemption would be a mandate under UMRA but would impose little or no cost on states.

Section 401 also would preempt state laws that regulate certain fiduciary activities performed by insured banks and other depository institutions. The bill would allow banks and trusts of a state (the home state) to locate a branch in another state (the host state) as long as the services provided by the branch are not in contravention of home state or host state law. Further, if the host state allows other types of entities to offer the same services as the branch bank or trust seeking to locate in the host state, home state approval of the branch would not be in contravention of host state law. This provision could preempt laws of the host state but would impose no costs on them.

Section 619 provides that, except where expressly provided in a cooperative agreement, only the bank supervisor of the home state of an insured state bank may impose supervisory fees on the bank. To the extent that state laws permit such charges, this provision would preempt state authority. However, based on information from the Conference of State Bank Supervisors, under current practice, host states rarely if ever charge such fees, and therefore, we estimate that enacting this provision would have no significant effect on state revenues.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

H.R. 1375 contains several private-sector mandates as defined by UMRA. At the same time, the bill would relax some restrictions on the operations of certain financial institutions. CBO estimates that the aggregate direct costs of mandates in the bill would not exceed the annual threshold established in UMRA ($117 million in 2003, adjusted annually for inflation).

Mandates

The bill would impose mandates on depository institutions controlled by companies other than depository institution holding companies; nondepository institutions that control insured depository institutions; uninsured banks; bank holding companies and their subsidiaries; savings and loan association holding companies and their subsidiaries; and Federal Home Loan Banks. Mandates in the bill include an expansion of the authority of the FDIC over certain insured depositories and companies that control insured depositories, a prohibition on participation in the affairs of financial institutions of people convicted of certain crimes, and additional reporting requirements for FHLBs.

Expansion of the FDIC's Authorities. The Gramm-Leach-Bliley Act allowed new forms of affiliations among depositories and other financial services firms. Consequently, insured depository institutions may now be controlled by a company other than a depository institution holding company (DIHC). H.R. 1375 would amend current law to give the FDIC certain authorities concerning troubled or failing depository institutions held by those new forms of holding companies.

Under current law, if the FDIC suffers a loss from liquidating or selling a failed depository institution, the FDIC has the authority to obtain reimbursement from any insured depository institution within the same DIHC. Section 407 would expand the scope of the FDIC's reimbursement power to include all insured depository institutions controlled by the same company, not just those controlled by the same DIHC.

The cost of this mandate would depend, among other things, on the probability of failure of the additional institutions subject to this authority and the probability that the FDIC would incur a loss as a result of those failures. The new authority would apply only to a handful of depository institutions. Based on information from the FDIC, CBO estimates that the cost of this mandate would not be substantial.

In addition, section 408 would allow the FDIC to prohibit or limit any company that controls an insured depository from making "golden parachute" payments or indemnification payments to institution-affiliated parties of troubled or failing insured depositories. (Institution-affiliated parties include directors, officers, employees, and controlling shareholders. Institution-affiliated parties also include independent contractors such as accountants or lawyers who participate in violations of the law or undertake unsound business practices that may cause a financial loss to, or adverse effect on, the insured depository institution.)

Based on information from the FDIC, CBO expects that only a few institutions would be covered by the new authority. In the event that the FDIC exercises this authority, CBO expects that the cost to institutions of withholding such payments would be administrative in nature and minimal, if any.

Prohibitions on Convicted Individuals. Current law prohibits a person convicted of a crime involving dishonesty, a breach of trust, or money laundering from participating in the affairs of an insured depository institution without FDIC approval. The bill would extend that prohibition so that uninsured banks, bank holding companies and their subsidiaries, and savings and loan holding companies and their subsidiaries could not allow such persons to participate in their affairs without the prior written consent of their designated federal banking regulator.

Assuming that those institutions already screen potential directors, officers, and employees for criminal offenses, the incremental cost of complying with this mandate would be small.

Reporting Requirements for Federal Home Loan Banks. Section 616 would require the Federal Home Loan Banks to report the compensation and expenses paid to directors in their annual reports. CBO expects that the cost of complying with this mandate would be minimal.

PREVIOUS CBO ESTIMATE

On June 11, 2003, CBO transmitted a cost estimate for H.R. 1375 as ordered reported by the House Committee on Financial Services on May 21, 2003. H.R. 1375 as approved by the House Committee on the Judiciary is identical to the version of the bill reported by the House Committee on Financial Services.

ESTIMATE PREPARED BY:

Federal Costs: Kathy Gramp and Jenny Lin
Federal Revenues: Pam Greene
Impact on State, Local, and Tribal Governments: Victoria Heid Hall
Impact on the Private Sector: Judith Ruud

ESTIMATE APPROVED BY:

Robert A. Sunshine
Assistant Director for Budget Analysis

G. Thomas Woodward
Assistant Director for Tax Analysis