STATEMENT OF THE CONFERENCE OF STATE BANK SUPERVISORS

On

"PROPOSED REGULATIONS TO REQUIRE REPORTING OF NONRESIDENT ALIEN DEPOSIT INTEREST INCOME"

Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
Thursday, October 27, 2011, 9:30 a.m.
Room 2128 Rayburn House Office Building

INTRODUCTION

The Conference of State Bank Supervisors[1] ("CSBS") appreciates the opportunity to submit this statement for the record of the Subcommittee's hearing on the Internal Revenue Service's ("IRS") rule requiring the reporting of interest paid to nonresident alien depositors.

State regulators play a central role in ensuring the safety and soundness of the entities we supervise and spurring economic growth in our local communities. To that end, CSBS supports H.R. 2568 to prevent the Treasury from expanding bank reporting requirements with respect to interest on deposits paid to nonresident aliens. If enacted as drafted, this rule could have a significant negative impact upon the community banks operating in several areas around the nation. These institutions are vital to the stability and strength of the U.S. financial system and economic growth. As such, it would be a mistake to enact such a proposal without an analysis of the impact on community banks.

This statement first provides background on the importance of the community banking system. Against this context, the statement then discusses state banking regulators' concerns with the proposed rule by the IRS to require reporting for interest on deposits maintained at banks and paid to nonresident aliens and the negative consequences the proposal could have upon financial institutions, particularly community banks.

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[1] The Conference of State Bank Supervisors is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. State banking regulators supervise approximately 5,500 state-chartered financial institutions. Further, the majority of state banking departments also regulates a variety of non-bank financial services providers, including mortgage lenders. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to state banking and financial regulators and represents its members before Congress and the federal financial regulatory agencies.

WHY COMMUNITY BANKING STILL MATTERS

Over the past several months, state regulators have heard the very loud concerns of community bankers regarding their future. These concerns come from the feared trickle-down effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act and other regulatory actions deemed necessary to address identified weaknesses in the banking system. In addition, community banks are facing an uncertain future as the structure and role of larger financial institutions in the economy is evolving and the future of mortgage finance is being debated. This proposed rule will undoubtedly exacerbate the already challenging business and regulatory environment facing the industry.

These concerns are very real and are worthy of our collective attention. This should be a serious, national concern. CSBS and its members believe that the viability of the community bank model has significant systemic consequences, which if left unaddressed will cause irreparable harm to local economies and erode critical underpinnings of the broader economy.

The challenges the community banking system is facing are already having an impact upon local economic development, as some local economies remain stalled or even eroded by more limited credit availability. As Members of Congress meet with bankers in your offices and in your districts, it is informative to ask about the loans that are not being made. While some banks are not positioned to lend due to their financial condition, many banks are not making residential real estate loans due to the increased compliance burden. In addition, commercial real estate (CRE) loans are not being made due to the stigma of an entire asset class. We cannot accept this as collateral damage in the interest of consistency and national policy.

A strong community banking system is absolutely critical to the well-being of the United States economy. A diverse financial system characterized by strong community banks ensures local economic development and job creation, provides necessary capital for small businesses, and provides stability and continued access to credit during times of crisis. Therefore, it is critical that policies and decisions made in Washington, D.C. carefully consider the impact on smaller banks and the communities they serve. Put simply, how community banks are impacted by regulatory measures, such as the extended reporting requirements proposed by the IRS, is too important not to understand.

CONCERNS WITH IRS PROPOSED RULEMAKING

In January 2011, the IRS published a notice of proposed rulemaking ("NPR") to "provide guidance on the reporting requirements for interest on deposits maintained at U.S. offices of certain financial institutions and paid to nonresident alien individuals."[2] Rules currently in effect require reporting of U.S. bank deposit interest only if the interest is paid to a U.S. person or a nonresident alien individual who is a resident of Canada. The proposed rule, however, would extend the information reporting requirement to include bank deposit interest paid to nonresident alien individuals who are residents of *any* foreign country.

[2] *Federal Register*, Vol. 76, No. 5, Friday, January 7, 2011, Notice of Proposed Rulemaking 146097-09, Pages 1105-1108.

In the *Federal Register* notice, the IRS specifically solicits information regarding the economic impact of the rule upon small commercial banks, savings institutions, credit unions, and small securities brokerages. The NPR's request for this information highlights the key challenge with the proposed rule's broad mandate. State regulators fully understand the importance of developing and maintaining cooperative information exchanges with other nations, but the proposed rule's unintended consequences could adversely affect local banking sectors and local economies in Florida and across the United States.

Many nonresident aliens deposit funds in American banks to protect their assets from political instability and the volatility associated with other currencies. U.S. law provides depositors with assurances that such assets will not be nationalized or used against them in a punitive manner—a significant concern for foreign nationals from countries where political and legal conditions lead to concerns over personal safety. Additionally, the U.S. dollar provides a historically unparalleled store of value. While many countries can provide financial safety, the U.S. banking system offers nonresident aliens the stability of denominating their assets in U.S. dollars.

Under the proposed rule, nonresident alien depositors would be informed that their interest income "may be" reported to their resident country. Requiring banks to report nonresident alien interest income to the IRS without definitively explaining how the information will be used could cause foreign nationals to doubt the benefits of holding deposits in U.S. banks. Without clear understanding, this uncertainty may lead to deposit withdrawals, removing a source of stable deposits, and potentially causing liquidity concerns for institutions with significant nonresident alien deposits.

The NPR states that the rule will not have a significant impact on a substantial number of small entities because "[t]he depository accounts … tend to be with larger financial institutions operating in the United States, and therefore the number of small entities that will be required to undertake this collection of information is expected to be limited." This statement reflects the IRS's failure to understand fully the consequences of the rule. Though the regulatory burden associated with reporting may be small, the potential financial impact resulting from reallocated deposits could disproportionally affect community banks in areas with large nonresident alien populations, such as the state of Florida and the border region in Texas. Community banks are already operating in a challenging business environment as the repercussions of the recent financial crisis continue to be felt. Nonresident alien deposits serve as a stable source of funds for community-based institutions in certain areas, giving banks and their customers the liquidity needed to support local economies and contribute to job growth.

Before moving forward with this proposal, more analysis needs to be conducted to better understand the consequences of such a broad reporting requirement, especially one that lacks specificity regarding the possible uses of the information obtained. CSBS believes that the IRS, in consultation with relevant state and federal banking regulators, should perform an analysis of the expected reduction in deposits held in U.S. banks as a result of implementing this rule, including worst-case, expected-case, and best-case scenarios.

It is for these reasons that CSBS supports H.R. 2568, Congressman Posey's bill which would prohibit the proposed rule from taking effect, and its companion measure in the Senate, S. 1506, authored by Senator Rubio. If enacted, these bills would wisely prevent the Secretary of the Treasury from expanding the current reporting requirements as proposed by the IRS.

CONCLUSION

As regulators, state banking regulators understand and appreciate the importance of government-to-government information sharing to accomplish policy goals. CSBS and its members also recognize that recent international tax issues clearly indicate the need for strong information agreements that encourage reciprocity and usability. However, these arrangements should be established only where there is a clear understanding of the financial and economic consequences and in such a manner that provides affected individuals with certainty about the full ramifications. Without addressing these prerequisites, there is a greater chance that the reporting of interest paid to nonresident aliens could deprive community banks of a source for stable deposit funds, especially for community banks in areas with large nonresident alien populations.

It is for these reasons that CSBS believes it crucial that the IRS perform further analysis to better understand the possible consequences their NPR could have upon financial institutions operating in an already challenging economic and regulatory environment. As President Obama directed in Executive Order 13,563 on January 18, 2011, the IRS should "use the best available techniques to quantify anticipated present and future benefits and costs as accurate as possible."

Thank you for the opportunity to submit this statement. CSBS looks forward to working with the Subcommittee on this issue.