ICBA TESTIMONY

Good morning Chairman Bachus, Ranking Member Waters, and members of the Committee. My name is Pierce Stone, and I am chairman, president and CEO of Virginia Community Bank, a community bank with $140 million in assets, located in Louisa, Virginia. I also serve as Chairman of the Independent Community Bankers of America on whose behalf I appear before you today. I want to thank you for giving me the opportunity to testify today on H.R. 3951, the Financial Services Regulatory Relief Act of 2002.

We applaud your efforts to reduce many of the unnecessary regulatory and paperwork burdens imposed on community banks without jeopardizing the safety and soundness of our financial system. During the current economic climate, it is especially important for Congress to eliminate the regulatory obstacles that community banks face so that community banks can commit more of their time and resources to serving the people in their communities.

Mr. Chairman, I would like to take this opportunity to thank you and congratulate you for your ongoing efforts on behalf of community banking. You have been an advocate for many of our causes, including protecting and preserving the deposit insurance fund, increasing insurance coverage levels for individual accounts, retirement accounts and municipal deposits, and for recognizing the unique needs and characteristics of community banks and the communities we serve.

ICBA Supports Tiered System

ICBA supports a bank regulatory structure that fosters the safety and soundness of our nation's banking system, and recognizes the fact that community banks pose a very different risk to the banking system than larger banks.

In recognition of these differences, both Congress and the agencies have instituted welcomed regulatory and supervisory policies that lighten the regulatory and paperwork burden for community banks. These policies include less frequent safety and soundness exams for small, healthy banks; streamlined and risk-focused exam procedures for small, noncomplex banks; less frequent CRA exams for small, well-rated banks; and streamlined CRA exams for small banks. Bank regulators are also considering the development of bifurcated capital adequacy rules with simpler rules and calculations for community banks.

The Federal Reserve has also called for enhanced oversight of "large complex banking organizations" whose failure or disruption could have systemic implications for the entire financial services industry and our economy. Community banks present no such systemic risk. Congress and the agencies have instituted policies that recognize the uniqueness of community banks and their need to operate under a lighter regulatory burden. For example, The Federal Home Loan Bank System Modernization Act of 1999 (part of the Gramm-Leach-Bliley Act) provides community banks with enhanced access to membership in the FHLB System and the ability to use advances for small business and agricultural lending.

ICBA strongly supports these efforts and urges Congress and the agencies to continue to adopt policies to build a tiered regulatory and supervisory system that recognizes the differences between community banks and larger, more complex institutions. A tiered regulatory system allocates the cost of regulatory/paperwork burden relative to the risk of the institution and helps restore equity in regulation, leveling the playing field and enhancing customer service.

Deposit Insurance Reform

Another issue that helps to level the playing field for community banks is deposit insurance reform, a critical issue for community banks. Mr. Chairman, you have been a great leader in advancing this issue in Congress, especially your efforts to increase FDIC insurance coverage levels for retirement accounts, individual accounts and municipal deposits. Core deposits are the single most important source of funding and liquidity community banks rely on to make loans. Attracting and retaining core deposits is critical to a community banks' ability to serve their community's credit needs. We thank you for your support and leadership in moving H.R. 3717, the Federal Deposit Insurance Reform Act of 2002, through this committee.

There are many provisions in H.R. 3951 that address a range of supervisory and enforcement issues among the agencies that are technical in nature, which we generally support. There are also several provisions of the bill, which are more substantive in nature, several of which we also support and several that we have some concern with. In addition, there are also several provisions that ICBA urges this committee to include in H.R. 3951, which I will discuss later in my testimony.

Provisions ICBA Supports

Subchapter S

ICBA supports Section 101 of this bill, which removes a restriction in current law that makes it difficult for community banks to qualify as "Subchapter S" corporations. Expanding Subchapter S eligibility is very important for community banks. In 1958, Congress created S corporations to create an effective alternative business structure for private entrepreneurs. A Subchapter S Corporation can escape punitive double taxation by paying income tax only at the shareholder level. Through the Small Business Job Protection Act of 1996, community banks became eligible to elect S Corporation status for the first time. To be eligible for Subchapter S status, a corporation may have no more than 75 shareholders.

Unfortunately, many small banks are having trouble qualifying for Subchapter S status under the current rules and cannot benefit from Congress's intended tax relief. We would like to see additional changes to the tax code to liberalize eligibility requirements for community banks to convert to Subchapter S status, but we understand that this committee's jurisdiction over this issue is limited.

Section 101 expands Subchapter S eligibility for banks by removing one of the barriers community banks face when trying to convert to Subchapter S status. Under the National Bank Act, all directors of national banks must own shares of the bank having an aggregate value of at least $1000, or an equivalent interest in the bank holding company that controls the bank. This requirement means that all of the directors must be shareholders, thereby making it very difficult and at times impossible for community banks to comply with the 75 Subchapter S shareholder limit. Section 101 removes the director shareholder restriction in the law by delegating authority to the Office of Comptroller of the Currency to permit the directors of banks seeking Subchapter S status to satisfy the shares requirement by holding a debt instrument that is subordinated to depositors. This would avoid having to count a director as a shareholder for purposes of Subchapter S status while still maintaining that directors retain the requisite personal investment in the financial soundness of their bank. Section 101 helps to liberalize the Subchapter S status rules, thereby enabling more community banks to significantly reduce their tax liability.

Management Interlocks

ICBA also supports Section 404, which increases the exemption for the Depository Institutions Management Interlocks Act to $100 million from $20 million in asset size. The Depository Institutions Management Interlocks Act prohibits depository organizations from having interlocking management officials if the depositories are located or have an affiliate in the same metropolitan, primary metropolitan, or consolidated metropolitan statistical, area. Section 404 increases the existing exemption, which helps to ensure that small community banks can obtain qualified and knowledgeable bank directors. Increasing this exemption will expand the pool of talent on which these banks can draw. It also helps community banks with affiliates located in rural areas that may have difficulty obtaining bank directors because of their location.

Reduced Exam Cycles

Another very important aspect of regulatory relief for community banks is reducing the frequency of safety and soundness exams for small healthy banks. Section 601 gives the federal banking agencies the discretion to adjust the exam cycle of insured depository institutions to ensure that examiner resources are used in the most efficient manner. ICBA strongly supports reducing the frequency of examinations on small healthy community banks and supports minimally intrusive examinations.

ICBA Supported Provisions Currently Not Included in H.R. 3951

Extend SIPC Coverage to Banks

ICBA urges the Committee to include a provision in H.R. 3951 that amends the Securities Investor Protection Corporation (SIPC) statute to provide community banks with the same protection afforded other investors and other depository institutions for their brokerage account assets when a broker dealer fails. Under current law, banks that are customers of a broker dealer that subsequently fails are not afforded any protection by the SIPC.

The failure last year of MJK Clearing, a subsidiary of Minneapolis-based Stockwalk Group, Inc., has left more than one hundred banks -- whose brokers used MJK for clearing and safekeeping their customers' securities -- without proper recourse for their loss of investments.

SIPC is a nonprofit corporation formed under the Securities Investor Protection Act of 1970 and serves as the brokerage industry's safety net for customer accounts. SIPC does not provide any guaranty of principal or protection against market risk or fraud. It allows an investor to get back its stock, bonds, and cash held by a broker-dealer in the event of a brokerage firm collapse.

SIPC coverage extends to customers of brokerage firms, but does not insure assets of a bank acting as an investor for its own account. Thrifts and credit unions are not excluded from SIPC coverage. The change we seek to the SIPC statute creates parity for banks. A legislative amendment to the SIPC statute eliminating the exclusion of banks from SIPC coverage would be an effective means to afford banks the protection they need when a broker dealer safekeeping their investment fails.

In the event of a broker dealer collapse, community banks may find their own securities placed in a pool of assets used to satisfy claims of other SIPC-covered accounts. As a result, the community bank's brokerage account may be illiquid for an extended period, and community banks may suffer significant losses when liquidation of the broker dealer is complete. A simple change in the SIPC statute would remedy this inequity.

Powers of State Member Banks

ICBA also urges the Committee to include in H.R. 3951 repeal of the provision in the Federal Reserve Act that places unnecessary limitations on the powers of a state member bank, limiting state member banks to the activities granted to national banks. This is an unfair restriction on state member banks. State-chartered *nonmember* banks enjoy the opportunity to engage in investment activities within the confines of safety and soundness, and state-charter *member* banks should be afforded the same opportunity. The current law unnecessarily treats state-chartered member banks and state-chartered nonmember banks differently by limiting the activities of state-charter member banks. Many provisions in H.R. 3951 create parity among bank and thrift institutions; repealing this restriction would simply do the same for state-chartered banks. We urge the Committee to include a provision in H.R. 3951 that gives the Federal Reserve more flexibility to allow state member banks to engage in investment activities authorized by their chartering state and approved by the FDIC as not posing a significant risk to the deposit insurance fund.

Provisions in H.R. 3951 ICBA Opposes

Cross-Marketing Restrictions

ICBA opposes several provisions in H.R. 3951. One of these is Section 501, which diminishes the cross-marketing restrictions imposed by the Gramm-Leach-Bliley (GLB) Act on the merchant banking investments of financial holding companies. Currently, a depository institution controlled by a financial holding company, and a nonfinancial company owned under the GLB Act's merchant banking authority by the same financial holding company, are prohibited from engaging in cross-marketing activities. H.R. 3951 would allow depository institutions controlled by a financial holding company to engage in cross-marketing activities with companies owned under the merchant banking authority of the GLB Act. We believe that these cross-marketing activities will undermine the separation between the nonfinancial portfolio company and the financial holding company along with its depository institution subsidiaries, therefore breaching the separation between banking and commerce.

As you know Mr. Chairman, during the debate of the GLB Act, Congress imposed strict cross-marketing prohibitions on transactions between depository institutions and merchant banking portfolio companies controlled by the same financial holding company in order to maintain the separation of banking and commerce when banks engage in merchant banking activities. We are concerned that the cross-marketing provisions in H.R. 3951 breach the banking and commerce line.

Congress has spoken clearly on the important separation of banking and commerce. If there was ever any doubt that this was the right policy choice, the events taking place today in Japan should erase those doubts. The kieritzu concept did not work in Japan, and it will not work in the U.S.

De novo Branching Across State Lines

Section 401 of the bill removes the current prohibition on national and state banks to expand through de novo interstate branching. ICBA opposes this provision. Under federal law, national and state banks are allowed to branch de novo into another state only if that state expressly permits de novo interstate branching.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 involved a series of compromises, including specific protections afforded to state authority. We recognize that federal law allows federally-chartered thrifts to branch across state lines without regard to state law. However, we believe that the state legislature is the appropriate forum in which to decide whether national and state banks are permitted to expand into another state through de novo interstate branching.

States have long played a critical role in setting banking policy and overseeing both local and national financial institutions. In establishing bank structure laws, Congress has generally chosen to establish a basic framework of rules, while allowing states to adopt additional rules and higher standards, particularly with regard to bank competition and operation.

Seventeen states have made the decision to enact legislation that expressly permits entry of a bank into their state by de novo branching. Thirty-three states have yet to establish such a law and instead continue to require interstate entry through the acquisition of an existing bank. States should be free to make this decision because they know best what the banking structure in their state should be. We support leaving the decision regarding de novo interstate branching within the discretion of state authority.

Credit Union Provisions

ICBA opposes several credit union related provisions in H.R. 3951, including Section 301, the provision that permits privately insured credit unions to become members of the Federal Home Loan Bank (FHLB). Under current law, only federally insured credit unions may become members of the FHLB. Allowing privately insured credit unions to become members of FHLB could pose a significant risk to the FHLB system, a system that many community banks rely on as an important source of alternative funding.

Privately insured credit unions do not operate under the federal regulatory oversight that current FHLB members do (including state chartered institutions). Members of the FHLB system are federally insured depository institutions. The strong link to federal insurance should not be diluted by opening the door to non-federally insured entities. In addition, when the FHLBs are reviewing institutions for membership (and monitoring their performance) they have easy access to the regulator's exam reports. There is a question as to whether the information available for privately insured credit unions would be of a similar quality.

I would note also that the National Association of Federal Credit Unions (NAFCU), the largest trade group exclusively representing federal credit unions, opposes this provision.

Several other provisions in H.R. 3951 that we oppose attempt to expand the credit union member limitation and create other advantages strictly for credit unions. These include, allowing federal credit unions to provide check cashing services to anyone eligible to become a member; offering credit unions a minimal charge for real estate leases on federal land; providing additional investment authority for credit unions and exclusion of loans to non-profit religious organizations from the member business loan limit.

ICBA also opposes expansion of member limits in voluntary mergers and conversions involving multiple common bond credit unions, Section 308. In voluntary mergers of multiple bond credit unions, the National Credit Union Association has determined that it must consider requiring employee groups over 3,000 in the merging credit union to spin off and form separate credit unions. Section 308 provides that this numerical limitation would not apply in voluntary mergers.

Section 308 also allows a community charter credit union to retain in its membership field all employee groups from the multiple bond credit union that has merged or converted into it. This is merely another attempt by credit unions to expand their membership beyond what is permitted under current law.

Credit unions were created by Congress, and given certain tax and regulatory advantages, for the purpose of serving individuals of modest means. Credit unions and community banks are similar in many ways. They both serve the community and offer many of the same products. But one big difference remains: credit unions do not pay taxes, giving them a major competitive advantage over taxpaying banks and thrifts. Providing credit unions the ability to expand their membership through voluntary mergers and conversions involving multiple common bond credit unions goes against the spirit of the credit union charter as well as the Credit Union Membership Act of 1998 (H.R. 1151).

Conclusion

Mr. Chairman we appreciate the opportunity to testify before you today on H.R. 3951 and provide our views on this important piece of legislation. We look forward to working with you on this legislation and on other legislation that may have an impact on community banks.