

Written Statement of
J. Thomas Cardwell
Former Commissioner of the State of Florida Office of Financial Regulation
on
Proposed Regulations to Require Reporting of
Nonresident Alien Deposit Interest Income
before the
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
October 27, 2011

Madame Chairwoman and Members of the Subcommittee:

I am Tom Cardwell. I served as the Commissioner of Financial Regulation of Florida from August 2009 until August 2011.

I appear before you today as the public official who, for that period, had responsibility for the safety and soundness of financial institutions chartered by the state of Florida.

The Office of Financial Regulation is responsible for chartering and regulation of 170 commercial banks and 38 international offices having deposits exceeding \$70 billion.

The rule proposed by the Internal Revenue Service that will require the automatic reporting of interest on the deposits of non-resident aliens, I believe, creates serious safety and soundness concerns to banks and further will have significant negative economic impacts on the communities served by those banks.

BACKGROUND OF NRA BANK DEPOSITS

The United States has long been a recipient of substantial deposits from foreign residents. These deposits have been beneficial to us and have, as a matter of long standing policy, been encouraged.

Florida, among other states, is home to significant non-resident alien (NRA) deposits. Our bankers tell us that most of these are stable long-term deposits that play a significant role in funding our banks. These accounts have not been associated with money laundering or the conduct of illicit activities.

NRA deposits are often driven here by a distrust of foreign economies and their governments by their own citizens. Experience with inflation, devaluation, nationalization and corruption causes ordinary citizens, quite rationally and appropriately, to wish to put some part of their life savings in a safe place. The United States is such a place.

Florida's geographic location has long made it a hub for business, trade and travel for people from Central and South America. Governments and economies in the area are often unstable. This has resulted in banks located in Florida receiving significant deposits from people in the region who are attracted by the safety of our financial system and by Florida's geographic proximity.

Beyond economic concerns, citizens in some countries rightly distrust their governments. Dictators, demagogues, political partisans, corrupt state and local officials often act outside the law. Extortion, abduction, robbery and embezzlement are facts of life. Providing such governments with a list of assets is felt by their citizens to jeopardize not only their property but also their lives and those of their families and associates.

OFR STUDY AND CONCLUSIONS

As Commissioner of Financial Regulation I felt it important to try to determine the effects of the proposed NRA rule on the state's institutions and on its economy. To do so, we contacted individual institutions, we reviewed the financial data that the Office collects and we applied our experience and expertise regarding the impact the rule could have on financial institutions.

We concluded that (1) there will be a negative impact on the safety and soundness of individual institutions and (2) there will be a negative impact on state and local economies in Florida.

I would add that I think it fair to say that what we found in Florida can be extrapolated to other parts of the country where there are NRA deposits.

A. IMPACT ON THE SAFETY AND SOUNDNESS OF INDIVIDUAL INSTITUTIONS

The Office of Financial Regulation conducted a survey of NRA deposits in South Florida. There are 32 state chartered banks and 22 foreign banks or banking corporations in that area over which OFR has regulatory responsibility. The survey reflects data from 16 of the state chartered banks and 21 of the 22 foreign entities.

As reflected in the tables below, there are \$14.2 billion dollars in NRA deposits in Florida regulated institutions.

With respect to the 16 Florida chartered commercial banks surveyed, 41% of their total deposits were in NRA deposits.

Institu- tion Name	Total NRA Deposits	Total Deposits (including NRA's)	% Total NRA Deposits to Total Deposits
Bank 1	\$734,738	\$802,233	91.59%
Bank 2	\$230,508	\$347,871	66.26%
Bank 3	\$63,467	\$169,694	37.40%
Bank 4	\$46,489	\$476,988	9.75%
Bank 5	\$413,260	\$463,634	89.13%
Bank 6	\$13,933	\$91,591	15.21%
Bank 7	\$100,337	\$219,331	45.75%
Bank 8	\$646,043	\$700,190	92.27%
Bank 9	\$329,253	\$455,750	72.24%
Bank 10	\$1,605,665	\$3,412,205	47.06%
Bank 11	\$26,471	\$79,272	33.39%
Bank 12	\$41,233	\$132,563	31.10%
Bank 13	\$45,185	\$1,352,921	3.34%
Bank 14	\$174,228	\$1,279,015	13.62%
Bank 15	\$67,004	\$140,857	47.57%
Bank 16	\$195,665	\$1,444,091	13.55%
TOTALS	\$4,733,479	\$11,568,206	40.92%

With respect to the 21 Florida regulated foreign institutions surveyed, 90% of their total deposits are NRA deposits.

Institution Name	Total NRA Deposits	Total Deposits (including NRA's)	% Total NRA Deposits to Total Deposits
Bank 1	\$131,855	\$152,753	86.32%
Bank 2	\$2,802,193	\$2,802,193	100.00%
Bank 3	\$297,733	\$294,292	101.17%
Bank 4	\$1,315,665	\$1,440,756	91.32%
Bank 5	\$1,100,000	\$1,097,055	100.27%
Bank 6	\$885	\$11,375	7.78%
Bank 7	\$205,634	\$205,655	99.99%
Bank 8	\$90,747	\$134,615	67.41%
Bank 9	\$598,090	\$598,434	99.94%
Bank 10	\$414,465	\$423,107	97.96%
Bank 11	\$167,333	\$587,599	28.48%
Bank 12	\$385,368	\$391,103	98.53%
Bank 13	\$35,079	\$130,773	26.82%
Bank 14	\$17,774	\$25,661	69.26%
Bank 15	\$30,505	\$97,870	31.17%
Bank 16	\$197,516	\$200,076	98.72%
Bank 17	\$291,946	\$292,363	99.86%

Institution Name	Total NRA Deposits	Total Deposits (including NRA's)	% Total NRA Deposits to Total Deposits
Bank 18	\$514,610	\$514,914	99.94%
Bank 19	\$698,791	\$698,922	99.98%
Bank 20	\$208,785	\$219,045	95.32%
Bank 21	\$6,453	\$6,906	93.44%
TOTALS	\$9,811,427	\$10,325,467	89.91%

It should be noted that these figures do not include NRA deposits in nationally chartered banks, or federally regulated foreign institutions, or in banks chartered in other states that are operating in Florida. While we do not have hard figures, it is probable that NRA funds in these other institutions substantially exceed those in Florida regulated entities.

1. Effect on Liquidity

Banks do not keep their deposits in their vaults. They lend the money to borrowers. A typical loan to deposit ratio is 85%. The loans are illiquid. Borrowers do not have to return the money other than on the stated terms.

Regulators generally recognize a deposit runoff of 15% could place an institution in jeopardy. There would not be cash available to pay off depositors. When this happens, the bank fails.

Eleven (11) of the sixteen (16) surveyed banks in South Florida have over 30% NRA deposits. A loss in a short period of time of even half of those deposits would put those institutions at risk of failure.

LEVEL OF NRA DEPOSITS	NUMBER OF AFFECTED SOUTH FLORIDA BANKS
NRA Deposits Comprise Over 80% of Total Deposits	3
NRA Deposits Comprise Over 47% of Total Deposits	7
NRA Deposits Comprise Over 30% of Total Deposits	11

The 22 foreign entities are less at risk for complete failure. However, given their high percentage of NRA deposits (14 over 90%, 17 over 67%), it is unlikely there would be any reason for them to continue to do business in Florida. There would, thus, be a Florida failure, in the sense the institution would be gone from Florida’s economic landscape.

LEVEL OF NRA DEPOSITS	NUMBER OF FLORIDA REGULATED FOREIGN ENTITIES
NRA Deposits Comprise Over 90% of Total Deposits	14
NRA Deposits Comprise Over 67% of Total Deposits	17
NRA Deposits Comprise Over 27% of Total Deposits	19

2. Other Negative Effects on Bank Conditions

In addition to liquidity issues, loss of deposits will shrink the ability of institutions to make loans and engage in other financial transactions. With less in deposits, there is less to lend. This negatively impacts the income of banks. Banks in Florida have been under significant stress following the financial and real estate crises we have sustained. Over the last two years, Florida has closed over 30 financial institutions. Approximately two-thirds of our banks are on our regulatory watch list. Many have impaired capital levels. Of the banks I regulated, 64% were unprofitable last year. Of all banks headquartered in Florida, both state and national, 66% were unprofitable. Continued losses erode capital and lead to further closures. Withdrawal of deposits will impair earnings and can lead to further failures. At best, the process of returning to fiscal soundness will be delayed and made more tenuous. At worst, some banks will not be able to earn their way out of their current difficulties and will fail.

The existing NRA deposits cannot be quickly replaced with domestic or other NRA deposits. Since NRA deposits are generally a low cost source of funds when a financial institution must replace them with higher cost funds, the net interest margin is squeezed. The result is either greater losses or lesser profits, depending on the condition of the bank. This is a particularly bad time to further reduce community bank earnings.

3. Effect on Lending

The domestic banks the OFR regulates are primarily community banks. These are the backbone of small business lending. The foreign institutions also lend their deposits to Florida borrowers. They also lend those deposits to individuals and businesses in foreign countries to enable them to do business here. Examples are loans to buy property in Florida or to finance trade transactions with U.S. based businesses.

The generally recognized economic rule is that every dollar in deposits generates nine (9) dollars in lending. The table below shows the impact of deposit loss on lending capacity.

EXISTING RELATIONSHIP:

**\$14.2 Billion in NRA Deposits
Support \$127.8 Billion in
Lending**

% Decrease in NRA Deposits	Estimated Decrease in South Florida Lending (Billions)
20%	\$ (25.56)
30%	\$ (38.34)
40%	\$ (51.12)
50%	\$ (63.90)
60%	\$ (76.68)

Reduction in deposits will lead to diminished lending capacity. It should be noted that, if nationally chartered banks and federally regulated foreign deposit entities are considered, as they should be, the lending base diminution will be at least twice the above.

B. IMPACT ON THE STATE AND LOCAL ECONOMY

The banks I regulated were largely community banks. Community banks are the key to small business lending. Withdrawal of deposits diminishes the lending capacity of financial institutions. It is generally agreed that bank deposits have a nine to ten times multiplier effect on lending depending on Federal Reserve reserve requirements. As an example, withdrawal of \$10 billion of deposits could result in reduced lending capacity of \$90 billion or more.

As noted in the survey, if Florida chartered banks lost 20% of their NRA deposits, it would decrease their lending capacity by over \$25 billion.

Florida's economy is fragile. As of the end of 2010, 19.4% of Florida residential mortgages were 90 days or more past due. Forty-seven percent were under water. The current Florida unemployment rate is 10.7%, one of the highest in the nation. Florida lacks the presence of large corporations or manufacturing facilities. It predominantly has a small business economy. The diminution of lending capacity of community banks is particularly harmful to the state's economic recovery.

The largest concentration of banks with NRA deposits is in the southern part of the state. The impact of diminished lending will be exacerbated there as it will fall on a more concentrated area. This is the moment when Florida most needs to prime the lending pump particularly to small businesses. The proposed rule will materially undercut the effort to do so.

Reduction of NRA deposits will have a long-term as well as a short-term negative impact. The

permanent departure of a class of stable deposits reduces the lending base into the foreseeable future.

Current federal policy has expressed a critical need to encourage small business lending, particularly by community banks. To promote this policy, Congress passed the Small Business Jobs Act which included a \$30 billion fund to provide Tier 1 capital for community banks to encourage their lending to small businesses. The implementation of this rule will directly undermine that policy.

It is my opinion that the reduction in NRA deposits that will be caused by this rule will measurably slow down the recovery of the Florida economy and will certainly not be a benefit to the economy as a whole.

THE NEGATIVES OF THE RULE FAR EXCEED THE POSITIVES

1. Since the United States does not tax NRA deposits there is no need to collect account information for the purpose of seeing that domestic taxes are paid. The rule collects the information in blanket fashion even though the IRS argues it will only be given to those countries that can be trusted to use it properly. There is no benefit to collecting information that will not be used where the act of collection drives away depositors.
2. There is nothing in the Background and Explanation of Provisions in the published notice that gives any indication of the extent to which the rule will be of any benefit to the United States.
3. The asserted interests of the United States taxing authorities can be achieved by methods other than the blanket collection of the entire universe of non-resident alien deposit information with the authority to make it available to other governments. The United States has tax treaties with many countries. These treaties could provide for the reciprocal exchange of information on an appropriate case by case basis.
4. There is nothing in the rule to address confidentiality of the information. A general “trust me” statement that the IRS will use its authority wisely will not be sufficient in the minds of depositors who already have a skeptical view of government. The rule creates room for doubt and it is that doubt that will cause deposits to leave.
5. The proposed rule treats a nuanced issue with what some would call a “meat ax” approach. It disregards obvious specific problems in favor of a generalized approach which might be convenient to administer and to advocate with others but causes substantial harm to a broad spectrum of institutions, regulators, individuals, and long established policies.
6. The rule does impose substantial regulatory burdens on financial institutions and particularly on those which are small businesses. The options are to gather the information by hand or to invest in software or software changes. Cost will vary from institution to institution depending on the number of NRA accounts and the ability of existing software to carry out the task. Based on anecdotal information, the cost could be many thousands of dollars for some

institutions. The burden of the costs will be much higher on smaller institutions which have less revenue over which to spread those costs. It is in particular a burden to our many institutions which in the current environment are not profitable.

If there are significant objectives that need to be addressed in the area of tax transparency that call for transmission of non-resident alien account information to the IRS, an effort should be made to create a rule that achieves those objectives and also addresses the harm the current proposal creates.

At a minimum, before proceeding further with the proposal, an appropriate credible study should be undertaken. We need to make sure that we truly understand both the positives and the negatives of what will happen if the rule is implemented. The failure to do so can cause significant and, in some cases, irreversible damage to many of the stakeholders in this issue.

IRS DEFENSE OF THE RULE

The IRS defends the proposed rule on several grounds.

1. There is no requirement that the information be exchanged with other governments. The problem is not that the exchange is mandatory. The problem is the fear of the depositor that it could be exchanged when the IRS, in its discretion, decides to do so. It is the risk of disclosure that will cause depositors to move deposits.
2. The information is not exchanged unless and until several conditions are met, including a review of the protections against the misuse of information. There is, however, no reference to what the conditions are. There is no disclosure of how or by whom the review is conducted. There is no identification of any written rule, policy or procedure by which a decision is made. There is no way that a depositor could assess the risk that his or her information could be disclosed.
3. Information can only be exchanged if there is a tax treaty or Tax Information Exchange Agreement (TIEA). This is of no comfort to the depositor, unless the treaty has protections built into it. The IRS has not advised what provisions are made regarding confidentiality or misuse of the information in any treaty.
4. The United States needs to provide tax information to other countries if it wants to get information in return. Under existing law, if a foreign government requests bank information regarding deposits under a treaty or TIEA, the IRS can request the information from banks and provide it to the foreign government. The IRS has the authority it needs. It would seem far preferable to have foreign governments specify what they want, and from whom, than for the IRS to position itself to “at its discretion respond, exchange spontaneously or automatically [provide information to] a foreign government” as it claims it wishes to do.
5. Deposits will not run off because they did not when deposit information was collected from Canadians. Canada is not Latin America or Central America. Canadian citizens are not, to the best of my knowledge, concerned with a government that does not follow the rule of law.

Banks have asked their customers what effect the rule will have and those customers say they will remove their deposits from the United States.

The IRS has failed to address concerns that individual institutions with concentrations of deposits are at risk, that specific local economies will be disproportionately affected and that the costs of implementation will fall far more heavily on community banks.

THIS PROPOSAL GIVES RULE MAKING A BAD NAME

There has been a great deal of criticism of late of government regulation at all levels. As a regulator, I saw many good rules and some bad ones. I understand the importance of rules in carrying out our laws and policies and supported and promulgated a number of them.

This is a bad rule. First, although it has the lofty intent of stopping U.S. tax cheats, in application it will cause far more damage than benefit. Second, the rule will weaken and, in some cases, may cause the failure of financial institutions. Third, it will harm local economies by reducing loan capacity. Fourth, it will add additional expenses to institutions, many of whom can ill afford it. Fifth, the goal of stopping tax cheats will not be advanced by collecting information from depositors in countries which are not associated with U.S. tax cheating.

It is just this type of rule that has universal application, a disconnect between the end and the means, that is costly, and which causes collateral problems that drive businesses and the public crazy.

CONCLUSION

Let me say that I am not without understanding of the reasons for promulgating this rule. The ability of the United States to prevent tax abuse by its own citizens through the use of foreign accounts is very important.

The formulation of the rule before us, however, presents what I believe to be very clear and substantial risks.

Unfortunately, if I am right, the rule will create irreversible damage. Once accounts are moved away, they will not come back.

Before we act on the rule, there should be a very clear vetting that the benefits to be obtained are greater than the damage it will cause.

I would hope we would have a high degree of comfort that we are not doing more damage than good.

I suspect that the goal of international tax transparency can be achieved either without this rule or by more nuanced approaches that avoid the dangers that I fear are ahead.

I appreciate your time and attention and stand ready to respond to any questions you may have.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: J. Thomas Cardwell	2. Organization or organizations you are representing: Former Florida Bank Regulator
3. Business Address and telephone number: [REDACTED]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
6. If you answered yes to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets. N/A	
7. Signature: 	

Please attach a copy of this form to your written testimony.