TESTIMONY OF

GAVIN GEE

DIRECTOR OF FINANCE

IDAHO DEPARTMENT OF FINANCE

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

before the

BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

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Good morning, Chairman Shelby, Ranking Member Sarbanes and members of the Committee. I am Gavin Gee, Director of Finance for the Idaho Department of Finance, and I am pleased to be here today on behalf of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to be here today to discuss strategies for reducing unnecessary regulatory burden on our nation's financial institutions.

CSBS is the professional association of state officials who charter, regulate and supervise the nation's approximately 6,240 state-chartered commercial banks and savings institutions, and nearly 400 state-licensed foreign banking offices nationwide.

As past chairman of CSBS, I am pleased to represent my colleagues in all 50 states and the U.S. territories.

CSBS gives state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of the state banking system. We especially appreciate this opportunity to discuss our views in our capacity as the chartering authorities and primary regulators of the vast majority of our nation's community banks.

Chairman Shelby and Senator Crapo, we applaud your longstanding commitment to ensuring that regulation serves the public interest without imposing unnecessary or duplicative regulatory burdens on financial institutions. At the state level, we are constantly balancing the need for oversight and consumer

protections with the need to encourage competition and entrepreneurship. We believe that a diverse, healthy financial services system serves the public best.

CSBS and the state banking departments have been working closely with the federal banking agencies, through the Federal Financial Institutions Examination Council, to implement the Economic Growth and Regulatory Paperwork Reduction Act of 1996. While this legislation made necessary and beneficial changes, we see continuing opportunities for Congress to streamline and rationalize regulatory burden, especially for community banks.

Principles for Regulatory Burden Relief

The Conference of State Bank Supervisors has developed a set of principles to guide a comprehensive approach to regulatory burden relief. We ask Congress to consider each proposal carefully against these principles.

First, a bank's most important tool against regulatory burden is its ability to make meaningful choices about its regulatory and operating structures. The state charter has been and continues to be the charter of choice for community-based institutions because the state-level supervisory environment – locally-oriented, relevant, responsive, meaningful, and flexible – matches the way these banks do business.

A bank's ability to choose its charter encourages regulators to operate more efficiently, more effectively, and in a more measured fashion. A monolithic regulatory regime would have no incentive for efficiency. The emergence of a nationwide financial market made it necessary to create a federal regulatory

structure, but the state system remains as a balance to curb potentially excessive federal regulatory measures, and as a means of promoting a wide diversity of financial institutions.

Second, while our current regulatory structure and statutory framework recognize some differences between financial institutions, too often it demands a "one size fits all" approach. Overarching federal requirements designed to cover all institutions are often unduly burdensome on smaller or community-based banks.

Regulatory burden always falls hardest on smaller institutions. Although 48 of the nation's 100 largest banks hold state charters, state charters make up the vast majority of the 6,100 smaller institutions. We see this impact on earnings every day among the institutions we supervise. Community banks represent a shrinking percentage of the assets of our nation's banking system, and we cannot doubt that compliance costs are in part driving mergers. These mergers do not always serve the best interests of our citizens. Even where laws officially exempt small, privately-held banks, as in the case of Sarbanes-Oxley, the principles behind these laws hold all institutions to increasingly more expensive compliance standards.

Congress has an urgent responsibility to review the impact that these federal statutes have had on our nation's economy. My colleagues and I see a financial service industry that is bifurcated, and becoming more so. We see the emergence of a line that divides our country's banking industry into larger and

smaller institutions. This process has wide-ranging implications for the economic health of our entire country.

The nation's community banking industry is the fuel for the economic engine of small business in the United States. Although I speak as a state bank supervisor, I recognize that federally-chartered community banks are equally important to small business.

The Small Business Administration tells us that small business in the United States accounts for 99% of all employers, produces 13 times more patents per employee than large firms, generates 60 to 80% of new jobs, and employs 50% of the private sector. Small businesses must be served, and community banks are the primary source of that service. They are often better-positioned to offer customized products that meet small businesses' unique needs.

Unnecessary regulatory burden shifts community banks' financial and human resources away from these activities to activities whose benefits may not justify their costs. Reducing this burden will allow banks to focus on their core businesses, providing the services that fuel our economy.

We suggest that Congress and the regulatory agencies seek creative ways to tailor regulatory requirements for institutions that focus not only on size, but on a wider range of factors that affect consumer needs and business practices. These factors might include geographic location, structure, management performance and lines of business. The largest banks are pushing, understandably, for a comprehensive, national set of rules for their evolving multistate operations. We

ask you to remember, however, that new universal federal requirements will also cover state-chartered banks operating in states that do not already have similar rules in place, because these states have made individual determinations that they are unnecessary regulatory burdens.

Third, while technology continues to be an invaluable tool of regulatory burden relief, it is not a panacea.

Technology has reduced regulatory burden in countless ways. State banking departments, like their federal counterparts, now collect information from their financial institutions electronically as well as through on-site examinations. Most state banking departments now accept a wide range of forms on-line, and allow institutions to pay their supervisory fees on-line. Many state banking departments allow institutions online access to maintain their own structural information, such as addresses, branch locations and key officer changes.

At least 25 state banking agencies allow banks to file data and/or applications electronically, through secure areas of the agencies' websites. Nearly all of the states have adopted or are in the process of accepting an interagency federal application that allows would-be bankers to apply simultaneously for a state charter and for federal deposit insurance.

Shared technology allows the state and federal banking agencies to work together to improve the examination process, while making the process less intrusive for financial institutions. Technology helps examiners target their

examinations through better analysis, makes their time in financial institutions more effective, and expedites the creation of examination reports.

The fact that technology makes it so much easier to gather information, however, should not keep us from asking whether we *should* be gathering all of this information.

Our Bankers Advisory Board members have expressed particular concern about Bank Secrecy Act (BSA) requirements, Currency Transaction Reports and Suspicious Activity Reports. These collection requirements have become far more extensive in the past three years, representing the new importance of financial information to our national security. Financial institutions recognize that they are in a unique position to gather this type of financial data, and that this information can prove to be invaluable. However, as both state and federal regulators and law enforcement officials become more sophisticated about the types of financial information that is useful, we hope that Congress can review requirements to assure that banks collect only essential information. In particular, we urge Congress, FinCEN and the federal banking regulators to simplify the BSA reporting forms and look carefully at potential changes to threshold levels.

Likewise, CSBS has worked diligently with FinCEN and the federal banking agencies to develop clear, risk-based BSA examination procedures. We hope these procedures will alleviate some of the financial industry's concerns in this area.

Recommendations for Regulatory Burden Relief

Specifically, my colleagues and I recommend that Congress include the following reforms in any regulatory burden relief legislation.

Federal Financial Institutions Examination Council

Improving coordination and communication among regulators is one of the most important regulatory burden relief initiatives. To that end, we recommend that Congress change the state position on the Federal Financial Institutions Examination Council (FFIEC) from one of observer to that of full voting member.

The FFIEC's State Liaison Committee includes state bank, credit union, and savings bank regulators. The chairman of this Committee participates in FFIEC meetings, but is not able to vote on policy or examination procedures that affect the institutions we charter and supervise. State bank supervisors are the primary regulators of approximately 74% of the nation's banks, and thus are vitally concerned with changes in federal regulatory policy and procedures. (Matrix number 72)

Regulatory Flexibility for the Federal Reserve

CSBS also believes that the Federal Reserve should have the flexibility it needs to allow state-chartered member banks to exercise the powers granted by their charters, as long as these activities pose no significant risk to the deposit insurance fund.

Current law limits the activities of state-chartered, Fed member banks to those activities allowed for national banks. This restriction stifles innovation

within the industry, and eliminates a key dynamic of the dual banking system. We endorse an amendment to remove this unnecessary limitation on state member banks, which has no basis in promoting safety and soundness.

A major benefit of our dual banking system has always been the ability of each state to authorize new products, services and activities for its state-chartered banks. Congress has consistently reaffirmed this authority; the Federal Deposit Insurance Corporation Improvement Act (FDICIA), in 1991, allowed states to continue to authorize powers beyond those of national banks. Removing unnecessary restrictions on state member banks would be a welcome relief. (Matrix number 70)

Coordination of State Examination Authority

CSBS and the state banking departments have developed comprehensive protocols to coordinate the supervision of state chartered banks that operate branches in more than one state. Through the CSBS Nationwide State Federal Cooperative Agreements, in place since 1996, a bank's chartering state (the "home state") works closely with either the FDIC or Federal Reserve and bank commissioners in the states where the bank operates branches (the "host state") to provide quality, risk-focused supervision. To bolster these efforts, we strongly recommend that the Senate include language that reinforces these principles and protocols in any regulatory burden relief bill.

CSBS believes that Congress should codify the procedures for examining state-chartered institutions with branches in more than one state. The House

included a provision to make this change in H.R. 1375, the regulatory burden relief bill it passed in the 108th Congress.

This provision, as slightly modified, would recognize the primary authority of the chartering or home state, while requiring all home and host state bank supervisors to abide by any written cooperative agreement relating to coordination of exams and joint participation in exams.

The language adopted by the House also provides that, unless otherwise permitted by a cooperative agreement, only the home state supervisor may charge state supervisory fees on multistate banks.

The host state supervisor could still examine the branch for compliance with host state consumer protection laws, with written notification to the home state supervisor. If the cooperative agreement allows it or if the bank is troubled, the host state supervisor could also participate in the home state's examination of the out-of-state bank, to ascertain that the bank is conducting its branch activities in a safe and sound manner.

If the host state supervisor determines that a branch is violating host state consumer protection laws, the supervisor may undertake enforcement actions, with written notice to the home state supervisor. This provision would not limit the authority of federal banking regulators in anyway, nor would it affect state taxation authority. (Matrix number 60)

Limited Liability Corporations

States have been the traditional source of innovations and new structures within our banking system, and CSBS promotes initiatives that offer new opportunities for banks and their customers without jeopardizing safety and soundness.

In this tradition, CSBS strongly supports an FDIC proposal to make federal deposit insurance available to state-chartered banks that organize as limited liability corporations (LLCs). An LLC is a business entity that combines the limited liability of a corporation with the pass-through tax treatment of a partnership.

The FDIC has determined that state banks organized as LLCs are eligible for federal deposit insurance if they meet established criteria designed to insure safety and soundness and limit risk to the deposit insurance fund.

Only a handful of states now allow banks to organize as LLCs, including Maine, Nevada, Texas, Vermont and, most recently, Utah. More states may consider this option, however, because the structure offers the same tax advantages as Subchapter S corporations but with greater flexibility. Unlike Subchapter S corporations, LLCs are not subject to limits on the number and type of shareholders.

It is not clear, however, that federal law allows pass-through taxation status for state banks organized as LLCs. An Internal Revenue Service regulation currently blocks pass-through tax treatment for state-chartered banks. We ask the

Committee to encourage the IRS to reconsider its interpretation of the tax treatment of state-chartered LLCs. (Matrix number 71)

De Novo Interstate Branching

CSBS seeks changes to federal law that would allow all banks to cross state lines by opening new branches. While the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 intended to leave this decision in the hands of the states, inconsistencies in federal law have created a patchwork of contradictory rules about how financial institutions can branch across state lines.

These contradictions affect state-chartered banks disproportionately. Federally-chartered savings institutions are not subject to *de novo* interstate branching restrictions. Creative interpretations from the Comptroller of the Currency have exempted most national banks, as well.

Therefore, we ask Congress to restore competitive equity by allowing *de novo* interstate branching for all federally-insured depository institutions. (Matrix number 26)

Additionally, the Conference of State Bank Supervisors endorses approaches, such as the Communities First Act (S. 1568, introduced by Senator Brownback of Kansas and co-sponsored by Senator Hagel of Nebraska), that recognize and encourage the benefits of diversity within our banking system. CSBS supports the great majority of regulatory burden reductions proposed in the Communities First Act, believing that they will alleviate the burden on community banks without sacrificing either safety and soundness or community

responsiveness and responsibility. Our dual banking system exists because one size is not appropriate for every customer, and one system is not appropriate for every institution. We ask that Congress include some type of targeted relief for community banks in any regulatory relief legislation.

The Communities First Act (CFA) includes several of the changes CSBS recommends to help reduce regulatory burden without undue risk to safety and soundness. My colleagues and I have developed these recommendations through extensive discussions among ourselves and with state-chartered banks, and we ask that the Committee include these provisions in any legislation it approves.

Extended Examination Cycles for Well-Managed Banks under $1 Billion

We believe that advances in off-site monitoring techniques and technology, combined with the health of the banking industry, make annual on-site examinations unnecessary for the vast majority of healthy financial institutions. Section 107 of the CFA would extend the mandatory federal examination cycle from 12 months to 18 months for healthy, well-managed banks with assets of up to $1 billion, and CSBS endorses this change.

Raising the threshold for eligibility for the 18-month examination cycle from $250 million in assets to $1 billion in assets will allow for more effective allocation of examiner resources, as well as relieving unnecessary burden on well-managed institutions.

Changing the safety-and-soundness examination cycle for these banks would have no effect on the cycles for Community Reinvestment Act (CRA) and compliance examinations, which are scheduled separately. (Matrix number 169)

Privacy Notices

We recommend that, in certain circumstances, banks be exempted from the provisions of the Gramm-Leach-Bliley Act ("GLBA") that require annual privacy notices be sent to all customers. Section 203 of the CFA would create this exemption for banks that do not share customer information except as permitted by GLBA exceptions, do not share information with affiliates under the Fair Credit Reporting Act, and have not changed their privacy policy since they last mailed privacy notices to their customers. (Matrix number 63)

Call Reports

We support CFA's provisions, in Sections 102 and 204, to allow well-capitalized and well-rated banks with assets of $1 billion or less to file a short form Call Report every other quarter. This would reduce the reporting obligations of smaller institutions while still providing the banking agencies with the information we need. In conjunction with this, we believe that streamlining the information currently by Call Reports would reduce burden without endangering safety and soundness. Much of the perceived burden associated with Call Reports is the ever-increasing demand for more information, not all of which seems essential for regulators to do their jobs.

More broadly, we believe that banks would benefit from the type of sunset provisions on federal legislations that many states include in their own banking statutes. Although regulators constantly review regulations for their continued relevance and usefulness, many regulations and supervisory procedures still endure past the time that anyone remembers their original purpose. (Matrix number 109)

Sunset provisions require legislators and regulators to review their laws at regular intervals to determine whether they are still necessary or meaningful. The passage of the Fair Credit Reporting Act amendments showed how valuable this review process can be.

Understanding that we cannot impose a sunset date on the entire federal banking code, we urge Congress to apply this approach to as wide a range of banking statutes as possible.

Challenges to Regulatory Burden Relief

The current trend toward greater, more sweeping federal preemption of state banking laws threatens all of the regulatory burden relief issues described above.

Federal preemption can be appropriate, even necessary, when genuinely required for consumer protection and competitive opportunity. The extension of the Fair Credit Reporting Act amendments met this high standard.

We appreciate that the largest financial services providers, creating a nationwide financial marketplace, want more coordinated regulation. We share

these goals, but not at the expense of distorting our marketplace, denying our citizens the protection of state law and the opportunity to seek redress close to home, or eliminating the diversity that makes our financial system great.

The Comptroller's regulations may reduce burden for our largest, federally-chartered institutions and their minority-owned operating subsidiaries, but they do so at the cost of laying a disproportionate burden on state-chartered institutions and even on smaller national banks.

We ask the Committee and Congress to review the disparity in the application of state laws to state and nationally chartered banks and their subsidiaries. Because expansive interpretations of federal law created this issue, a federal solution is necessary in order to preserve the viability of the state banking system.

Conclusion

Mr. Chairman, members of the Committee, the regulatory environment for our nation's banks has improved significantly over the past ten years, in large part because of your diligence.

As you consider additional measures to reduce burden on our financial institutions, we urge you to remember that the strength of our banking system is its diversity. The American banking system has a sufficient number of financial institutions, of different sizes and with different specialties, to meet the needs of the world's most diverse economy and society. While some federal intervention may be necessary to reduce burden, relief measures should allow for further

innovation and coordination at both the state and federal levels, and among community-based institutions as well as among the largest providers.

Diversity in our financial system is not inevitable. Community banking is not inevitable. This diversity is the product of a consciously developed state-federal system. Any initiative to relieve regulatory burden must recognize this system's value. Vibrant, diverse local economies require a responsive and innovative state banking system that encourages community banking.

History shows that state bank examiners are often the first to identify and address economic problems, including cases of consumer abuse. We are the first responders to almost any problem in the financial system, from downturns in local industry or real estate markets to the emergence of scams that prey on senior citizens and other consumers. We can and do respond to these problems much more quickly than the federal government, often bringing these issues to the attention of our federal counterparts and acting in concert with them.

State supervisors are sensitive to regulatory burden, and constantly look for ways to simplify and streamline compliance. We believe in, and strive for, smart, focused, and reasonable regulation. Your own efforts in this area, Chairman Shelby, have greatly reduced unnecessary regulatory burden on financial institutions regardless of their charter.

The industry's continued high earnings levels suggest that whatever regulatory burdens remain, they are not interfering with larger institutions' ability

to do business profitably. The growing gap between large and small institutions, however, suggests a trend that is not healthy for the industry or for the economy.

The ongoing effort to streamline our regulatory process while preserving the safety and soundness of our nation's financial system is critical to our economic well-being, as well as to the health of our financial institutions. State bank supervisors continue to work with each other, with our legislators and with our federal counterparts to balance the public benefits of regulatory actions against their direct and indirect costs.

We commend you, Mr. Chairman, Senator Crapo, and the members of this Committee for your efforts in this area. We thank you for this opportunity to testify, and look forward to any questions that you and the members of the Committee might have.