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TESTIMONY OF
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Before the
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
of the
COMMITTEE ON FINANCIAL SERVICES
of the
U. S. HOUSE OF REPRESENTATIVES
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Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, I appreciate this opportunity to appear before you again to discuss with you ways in which we can reduce unnecessary regulatory burden on America's banking system, and to express the views of the Office of the Comptroller of the Currency (OCC) on H.R. 1375, the Financial Services Regulatory Relief Act of 2003 (FSRR Act). Let me also thank Congresswoman Capito, for again sponsoring a bill that includes sensible and appropriate regulatory burden relief for national banks and other financial institutions.

Many of the provisions in the FSRR Act were also in H.R. 3951, the financial services regulatory relief legislation which was prepared for Floor action in the House last year after being reported by the Committee on Financial Services. I want to thank the Committee for including almost all of the items suggested by the OCC in these bills. In addition to the provisions that were in H.R. 3951, the FSRR Act also includes some important new amendments that will advance the goal of reducing unnecessary burdens and costs on our nation's banks.

Effective bank supervision demands that regulators achieve a balance between promoting and maintaining the safety and soundness of the banking system and fostering banks' ability to conduct their business profitably and competitively. This is only possible if banks are free from burdensome constraints that are not necessary to further the purposes of the banking laws or to protect safety and soundness. Unnecessary burdens drive up the costs of doing business for banks and their customers and prevent banks from effectively serving the public. Periodic review of the banking statutes and regulations is an essential means of ensuring that banks are not needlessly encumbered by requirements that are no longer appropriate for today's banking environment.

The OCC has a continuing commitment to review its regulations and make changes, consistent with safety and soundness, to enable banks to keep pace with product innovation, new technologies, and changing consumer demand. We constantly reassess the effectiveness and efficiency of our supervisory processes to focus our efforts on the institutions and activities that present the greatest risks, and to reduce unnecessary burdens on demonstrably well-run banks. An exciting new development in this regard is the OCC's new "E-corp" system, which enables national banks to file their corporate applications electronically. Using National BankNet, the OCC's internet-based system for national banks, national banks can now file new branch and branch relocation applications electronically. We will be adding more applications to the system on a rolling basis.

In addition, we also are currently working with the other banking agencies to prepare for the regulatory review required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Section 2222 requires the Federal Financial Institutions Examination Council and each Federal banking agency to conduct a review of all regulations every 10 years to identify outdated, unnecessary regulatory requirements. We and the other Federal banking agencies have identified our teams for this project and our work is already underway.

However, the results that Congress can achieve today by removing or reducing regulatory burden imposed by Federal statutes can be broader and more far-reaching than regulatory changes that we can make under the current law. The FSRR Act contains a number of important provisions that will help banks remain profitable and competitive by eliminating unnecessary burden. My testimony will highlight several of these provisions.¹

The FSRR Act also contains provisions that further our ability to promote and maintain the safety and soundness of the banking system. I will mention a few of these provisions in my testimony. I will also take this opportunity to briefly discuss our suggestions to improve some of the provisions in the FSRR Act and our recommendations for additional changes that you may wish to consider as the legislation advances.

National Bank Provisions

The FSRR Act contains several provisions that would streamline and modernize aspects of the corporate governance and interstate operations of national banks. The OCC strongly supports these provisions.

For example, section 101 of the Act relieves a restriction in current law that impedes the ability of national banks to operate as “Subchapter S” corporations. The National Bank Act currently requires all directors of a national bank to own at least \$1,000 worth of shares of that bank or an equivalent interest in a bank holding company that controls the bank. The requirement means that all directors must be shareholders, making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for treatment as a Subchapter S corporation. These banks are thus ineligible for the benefit of Subchapter S tax treatment, which avoids a double tax on the bank’s earnings. Community banks suffer most from this result.

Section 101 authorizes the Comptroller to permit the directors of banks seeking Subchapter S status to satisfy the qualifying shares requirement by holding a debt instrument that is subordinated to the amounts owed by the bank to its depositors and general creditors. The holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S. The subordinated liability has features resembling an equity interest, however, since the directors could only be repaid if all other claims of depositors and nondeposit general creditors of the bank were first paid in full, including the claims of the FDIC, if any. The new requirement would thus ensure that directors retain the requisite personal stake in the financial soundness of their bank, but yet would allow the bank to take advantage of Subchapter S tax treatment.

Similarly, section 102 of the Act eliminates a requirement in current law that precludes a national bank from prescribing, in its articles of association, the method for election of directors that best suits its business goals and needs. Unlike most other companies and state banks, national banks cannot choose whether or not to permit cumulative voting in the

¹ A detailed section-by-section review of the provisions of Title I, IV, and VI of the FSRR Act that are relevant to the OCC’s responsibilities is attached to this testimony as an appendix.

election of their directors. Instead, current law requires a national bank to permit its shareholders to vote their shares cumulatively. Section 102 provides that a national bank's articles of association may permit cumulative voting. This amendment would conform the National Bank Act to modern corporate codes and provide national banks with the same corporate flexibility available to most corporations and state banks.

An important new provision that was added to FSRR Act is section 110. This provision is strongly supported by the OCC and clarifies that the OCC may permit a national bank to organize in any business form, in addition to a "body corporate." An example of an alternative form of organization would be a limited liability national association, comparable to a limited liability company. The provision also clarifies that the OCC's rules will provide the organizational characteristics of a national bank operating in an alternative form, consistent with safety and soundness. Except as provided by these organizational characteristics, all national banks, notwithstanding their form of organization, will have the same rights and privileges and be subject to the same restrictions and enforcement authority.

Allowing a national bank to choose the business form that is most consistent with the banks' business plans improves the efficiency of a national bank's operations. For example, if the OCC should permit a national bank to organize as a limited liability national association, this may be a particularly attractive option for community banks. The bank may then be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends. Some states currently permit state banks to be organized as unincorporated limited liability companies (LLCs) and the FDIC recently adopted a rule that allows certain state bank LLCs to qualify for Federal deposit insurance. This amendment would clarify that the OCC can permit national banks to organize in an alternative business form, such as an LLC.

Section 401 of the Act also simplifies the requirements that apply to a national bank that wishes to expand interstate by establishing branches *de novo*. Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. Under the time frames set by the statute, interstate bank mergers were permissible in all 50 states as of September 2001. By contrast, *de novo* branching still requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. Some states have done so, generally conditioning such *de novo* branching on reciprocal *de novo* branching being allowed by the home state of the bank proposing to branch in such a state.

The effect of current law is to require that, in many cases, banks must structure artificial and unnecessarily expensive transactions in order to establish a new branch across a state border -- which in some cases, is simply across town in a multi-state metropolitan area. Section 401 repeals the requirement that a state must adopt an express "opt-in" statute to permit the *de novo* branching form of interstate expansion for national banks and contains

parallel provisions for state member and non-member banks. Both state and national banks and their customers would benefit significantly by this change, which would permit a bank to freely choose which form of interstate expansion is most efficient for its needs and customer demands. In today's internet age, when customers can communicate remotely with banks located in any state, restrictions on where a bank may establish "branch" facilities to directly serve customers are an unnecessary legacy from a protectionist era that detract from healthy competition and customer service.

Federal Branches and Agencies of Foreign Banks

The OCC also licenses and supervises Federal branches and agencies of foreign banks. Federal branches and agencies generally are subject to the same rights and privileges, as well as the same duties, restrictions, penalties, liabilities, conditions and limitations and laws that apply to national banks. Thus, Federal branches and agencies will benefit equally from the provisions in the FSRR Act that reduce burden on national banks. Branches and agencies of foreign banks, however, also are subject to other requirements under the International Banking Act of 1978 (IBA) that are unique to their organizational structure and operations in the U.S. as an office of a foreign bank. The FSRR Act also includes provisions amending the IBA that are intended to reduce certain unnecessary burdens on Federal branches and agencies. We are supportive of these efforts. However, we believe that one of the provisions can be improved to achieve the full benefits of burden reduction and to preserve national treatment with national banks.

Section 107 provides that the OCC can set the capital equivalency deposit (CED) requirements for a Federal branch or agency as necessary to protect depositors and other investors and to be consistent with safety and soundness. However, that amount cannot be less than the amount required by a state for a state-licensed branch or agency in which the Federal branch or agency is located. This approach is a substantial improvement over the inflexibility of the current law. However, the CED requirements could be made even more risk-focused. The OCC has provided the Committee with an alternate that allows the OCC, after consultation with the Federal Financial Institutions Examination Council, to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely resemble the risk-based capital framework that applies to both national and state banks.

Information Sharing With Foreign Supervisors

A new provision added to the bill will be particularly helpful to the OCC and the other banking agencies in negotiating information sharing agreements with foreign supervisors. Section 610 clarifies that the OCC, Federal Reserve Board, FDIC, and OTS cannot be compelled to disclose information obtained from a foreign regulator under an information sharing agreement, or pursuant to other lawful procedures, if public disclosure of the information would cause the foreign authority to violate foreign law. However, nothing in this provision would allow the agency to withhold information from Congress or prevent the agency from complying with a court order in an action commenced by the United States or the agency. This clear statement in the law will facilitate information sharing and will provide foreign supervisors with assurances that public disclosure of confidential

supervisory information will be limited in cases in which such disclosures will violate foreign laws.

Safety and Soundness Provisions

The FSRR Act also contains a number of provisions that further the objective of promoting and maintaining the safety and soundness of the banking system. One of the most important of these provisions is section 405, which expressly authorizes the Federal banking agencies to enforce written agreements and conditions imposed in writing in connection with an application or when the agency imposes conditions as part of its decision not to disapprove a notice, *e.g.*, a Change in Bank Control Act (CBCA) notice.

This provision also would supersede recent Federal court decisions that conditioned the agencies' authority to enforce such conditions or agreements on a showing that the non-bank party to the agreement was "unjustly enriched." Section 405 also contains a valuable measure that clarifies that controlling parties and affiliates of banks may not evade their capital commitments to the bank through bankruptcy. These changes will enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses. Finally, as stated earlier, this section also clarifies the banking agencies' authority to impose and enforce conditions in connection with the agency's decision not to object to a CBCA or other notice.

The Act also contains another provision that promotes safety and soundness by providing the Federal banking agencies with greater flexibility to manage resources more efficiently and deal more effectively with problem situations. Current law mandates that most banks be examined on-site on prescribed schedules. This can, in certain circumstances, interfere with the ability of the banking agencies to concentrate their supervisory oversight on the most problematic institutions. Section 601 of the bill would permit the agencies, when necessary for safety and soundness purposes, to adjust their mandatory examination schedules to concentrate resources on particularly troubled or risky institutions.

We also recommend that we and the other banking agencies have more flexibility in assigning our examiners to particular institutions. To further that goal, the banking agencies worked together to develop an amendment that broadly addresses particular ethical issues facing our examiners and we thank the Committee for including this provision in section 613 of the bill. Current law provides that criminal penalties may be imposed on a Federal bank examiner who examines a bank from which the examiner receives an extension of credit, including a credit card issued by that institution. The financial institution that extends such credit to the examiner also is subject to criminal penalties. This limits the flexibility of the OCC and the other banking agencies to assign examiners to particular institutions or examination teams, even if the extension of credit is on the bank's customary terms and the examiner's skills or expertise would contribute materially to the examination.

Section 613 provides that the Federal financial institutions regulatory agencies, including the Federal banking agencies, may grant exemptions from the prohibition to their

examiners by regulation or on a case-by-case basis if an extension of credit would not affect the integrity of the examination. The agencies must consult with each other in developing regulations providing for the exemptions and case-by-case exemptions only may be granted after applying certain specific factors. In addition, the amendment expressly provides that examiners may have credit cards without disqualification or recusal, but subject to the safeguard that the cards must be issued under the same terms and conditions as cards issued to the general public.

Section 603 of the FSRR Act also improves the Federal banking agencies' ability to keep bad actors out of our nation's depository institutions. This provision gives the Federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to *insured* depository institutions. Sec. 611 further would amend the law to provide the Federal Reserve Board with the authority to keep persons convicted of these offenses from participating in the affairs of a bank holding company or its nonbank subsidiaries, or an Edge or Agreement corporation. To further strengthen this authority, we recommend that this provision be expanded to clarify that the Federal banking agencies also can prohibit these persons from participating in the affairs of nonbank subsidiaries of the banks that we supervise.

Two other important new provisions have been added to the FSRR Act to promote safety and soundness. These provisions were developed on an interagency basis by the Federal banking agencies and, in my testimony last year, I recommended that these provisions be included in the bill.

First, under current law, independent contractors for insured depository institutions are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution (institution-affiliated parties). To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a Federal banking agency to take action against the accountant for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This standard is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. Section 614 of the FSRR Act removes the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other institution-affiliated parties.

Second, section 409 amends the CBCA to address issues that have arisen for the banking regulators when a stripped-charter institution (*i.e.*, an insured bank that has no ongoing business operations because, for example, all of the business operations have been transferred to another institution) is the subject of a change-in-control notice. The

agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a *de novo* charter and an application for deposit insurance. In general, the scope of review of a *de novo* charter application or deposit insurance application is more comprehensive than the statutory grounds for denial of a notice under the CBCA. There also are significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the Federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. To address these concerns, section 409 of the FSRR Act expands the criteria in the CBCA that allow a Federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider business plan information and would allow the agency to use that information in determining whether to disapprove the notice.

Additional Suggestion To Improve Information Sharing

Another item that we recommend be included in the bill is an amendment that would permit all of the Federal banking agencies -- the OCC, FDIC, OTS, and the Federal Reserve Board -- to establish and use advisory committees in the same manner. Under current law, only the Board is exempt from the public disclosure requirements of the Federal Advisory Committee Act (FACA). The OCC, FDIC, and OTS, however, also supervise insured depository institutions and these institutions and their regulators have the same need to share information and to be able to conduct open and frank discussions about important supervisory and policy issues. Because of the potentially sensitive nature of this type of information, the public meeting and disclosure requirements under FACA could inhibit the supervised institutions from providing the OCC, FDIC, or OTS with their candid views. Our amendment would enhance the free exchange of information between all depository institutions and their Federal bank regulators with resulting safety and soundness benefits.

Bank Parity with Special Provisions for Thrifts

Finally, I note that the bill contains provisions providing beneficial treatment to Federal thrifts in areas where there is no reason to particularly distinguish Federal thrifts from national banks or State banks. These provisions include section 213 (Federal court diversity jurisdiction determined only on the basis of where an institution has its main office, eliminating consideration of where it has its principal place of business) and section 503 (eliminating geographic restrictions on thrift service companies). Similar issues may exist with respect to some of the other sections. The nature of these provisions is such that, if they are considered appropriate by the Subcommittee, there is no basis not to make them applicable to banks as well as thrifts.

Conclusion

Once again, Mr. Chairman, on behalf of the OCC, I thank you for your leadership in pursuing this legislation. As I have indicated, the OCC supports the Act and believes that many of its provisions will go far to promote the objectives I have described today. In the areas in which we have recommended that you consider additional improvements, we would be pleased to work with your staff to develop appropriate legislative language for the Subcommittee's consideration.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.