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Regulation Comments
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Re: EGRPRA Burden Reduction: FDIC 12 CRF Chap. III; **FRB** Docket No. OP–1232; **OCC** Docket No. 05-15: **OTS** Docket No. 2005–26; 70 Federal Register 46779; August 11, 2005

Ladies and Gentlemen:

Section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) requires federal banking agencies (Agencies) to review their regulations at least once every 10 years. The Agencies in Round Five of the review are asking for comments on the ways in which the rules relating to Banking Operations; Directors, Officers and Employees; and Rules of Procedure may be outdated, unnecessary, or unduly burdensome. These regulations affect all commercial banks and savings associations. The American Bankers Association (ABA) brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership - which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks - makes ABA the largest banking trade association in the country.

Specific comments on the regulations proposed for comment in this fifth round of EGRPRA review are set out below, but ABA notes at the outset that the Agencies have been diligent in updating a number of these regulations in the last few years, particularly in updating the Agencies' Rules of Procedure.

Specific Comments

1. Banking Operations

(a) Prohibition of Payment of Interest on Demand Deposits
In 1997, ABA petitioned the Federal Reserve Board to change the definition of "demand deposit" to exclude a Money Market Deposit Account (MMDA) that allowed more than six transactions. The Board denied the petition, saying that it did not believe that it had the authority to make such a change, and urged the ABA to seek such a change from the Congress. Since then, ABA has supported legislation that would create a 24-transaction MMDA, but it has yet to be enacted. ABA urges the Agencies to report to Congress that the a business MMDA account needs to be authorized or the prohibition on paying interest on demand deposits must be modified.

ABA believes that the expanded MMDA is necessary for small and medium-sized banks to be competitive with nonbank competitors. Commercial entities are able to deposit or invest their idle funds into share draft accounts at credit unions or into Money Market Mutual Funds that allow unlimited checking or withdrawal privileges while receiving interest on the idle funds, but they are not able to deposit their funds into a checking account at a bank and receive interest. Corporate treasurers and CFOs and even "Mom and Pop" small businesses simply will not accept the restrictions on transactions and nonpayment of interest that banks are subject to as a legacy of Regulation Q. The financial world has changed dramatically in the last 15 years, and banks' transaction account deposit products have not kept pace.

Additionally, such a change would increase the availability of funds for bank lending: Making banks more competitive will result in keeping more commercial deposits in the banking system and available for lending. Large amounts of funds have either been lost completely to competitors or are now being swept out of the system nightly. Not only are the swept funds unavailable for lending, but smaller banks in particular are damaged because many are not able to offer a competitive sweep. Consequently, significant deposits are being transferred completely out of the banking system. Banking's market share of all financial assets has been in steady decline for over 30 years, dropping from more that 65% to less than 25% of financial assets. Part of this decline in market share must be attributed to the loss of commercial deposits to cash management accounts that allow unlimited withdrawals by check offered by securities firms and money market mutual funds. The expanded MMDA would at least offer banks added ability to reduce the rate of decline in market share and might actually stimulate deposit growth.

Third, ABA believes that such a change would reduce system risk: Overnight repurchase transactions with third parties increase system risk from the possible failure of a third party not subject to banking regulation. The risk is similar for sweeps into an MMMF. Additionally, there are compliance risks that, if not properly managed, could result in increased system risk. With a primary goal of bank supervision being the reduction of unnecessary risk, ABA believes that it would be furthering the efforts of supervision by making the reductions in risk that ABA believes would occur with the adoption of the expanded MMDA.

While ABA has supported a 24-transaction MMDA, some bills have been introduced that would simply repeal the prohibition on paying interest on demand deposits. ABA continues to be concerned that such an abrupt change in the law would administer a pricing shock to the banking system that would do no good. Because of the complex arrangements banks

have made to provide "free" services to corporate customers as well as creating daily sweep arrangements to move these demand deposits out of the bank into money market funds and other mechanisms to aid customers, some time is needed to unwind and reprice these arrangements. **Therefore, ABA still strongly recommends that the Agencies urge Congress to create a 24-transaction MMDA for businesses. If the Congress decides to repeal the prohibition, then a transition period of at least two years in which banks would offer a 24-transaction MMDA leading to a repeal of the prohibition is necessary in order for there to be an orderly unwinding of all of these account arrangements.**

(b) Availability of Funds and Collection of Checks (Regulation CC)
Under Section 229.10(c), checks drawn on the US Treasury, US Postal Service, state and local governments, or cashier's, certified, and teller checks must be made available for withdrawal not later than the business day following the banking day on which funds are deposited. This provision is now inadvertently aiding and abetting considerable fraud on banks and also harming consumers. For example, under a current common scam, crooks offer to pay for an item for sale with a fraudulent Postal Money Order or a cashier's check drawn for thousands more than the purchase amount. They then advise the recipient to wire the excess funds as soon as the funds become available. The check is then returned after the funds have been released, which can be as long as five or six months for Postal Orders and Treasury checks. The consumer customer is then liable for the amount of the counterfeit check. If they don't have the funds, the account is closed and the customer faces legal and financial trouble. Some victims have complained that the bank should not have given them the money until the bank knew that the financial instrument was good. With the availability of technology to more easily create counterfeits and the resultant increase in counterfeit checks, the availability schedules are too short to protect banks and customers against loss.

The U.S. Treasury and U.S. Postal Service have up to 6 months to return U.S. Treasury checks and Postal Service Orders. In contrast, banks generally must decide whether to return a check by midnight of the day after receipt. The delay in receipt means that banks are much less likely to be able to recover funds from a returned Treasury check or a U.S. Postal Service Order because the funds are much more likely to have been withdrawn. There is no reason why banks should have to return checks expeditiously but the U.S. Treasury or Post Office does not. **ABA recommends that the Treasury and the Post Office be mandated to return items within 7 days or lose the right of return. While the funds may have to be released before this period, the bank has a better chance of recovering the funds than if it must wait 6 months to learn that the item is fraudulent.**

The extremely long period that the Treasury and the Post Office have to return items drawn on them also creates problems with new accounts. While Regulation CC recognizes the potential problems posed by new accounts by permitting extended hold periods on deposits made during the first 30 days, Treasury and the Postal Service may return items long after the 30 days. **Therefore, ABA recommends that the definition of "new account" in 12 CFR 229.13 be changed to lengthen the period that an account is new from 30 days to 6 months in order to allow longer holds for these more vulnerable accounts.**

(c) Reimbursement for Providing Financial Records (Regulation S)
Regulation S implements the reimbursement provisions of the Right to Financial Privacy Act (12 USC 3415). Under it, in some circumstances, financial institutions are reimbursed for producing financial records to government authorities. However, this provision has numerous exceptions and requires the Federal Reserve Board to maintain a realistic cost structure. ABA's members tell us that

there are too many exceptions to reimbursement and that the reimbursement schedule underestimates the costs of providing the required financial records.

The statutory exceptions from reimbursement are much too broad; bankers also tell us that governmental demands for records under the exceptions are often quite broad, resulting in unreasonable document production requests, particularly when the government is conducting an inquiry into possible corporate fraud. Document requests also disrupt bank operations because the time frame for production is often very short. ABA believes that if the government were required to pay for such searches, then agencies and prosecutors would narrow their document production requests, reducing the burden these are imposing on financial institutions.

ABA believes that financial institutions should be reimbursed whenever they produce records for the Internal Revenue Service, Securities and Exchange Commission or other agency investigating the activities of a bank's customer or for an administrative subpoena issued by an administrative law judge in a proceeding between the government and the customer. While the exception for the production of documents in an investigation by a bank supervisory agency of possible illegal activity by the financial institution is understandable, **ABA believes that when a government authority is investigating the activities of a customer of the bank, the bank should be fully compensated for producing those records. ABA asks that the Agencies request the Congress to amend the statute to provide for reimbursement except in cases when the financial institution is one of the targeted parties in the investigation or proceeding.**

Finally, we note that the reimbursement schedule in Appendix A of Regulation S was last updated in June of 1996. The reimbursement should be updated regularly in order to reflect actual costs. **ABA recommends that the reimbursement schedule be reviewed no less than every two years and revised as needed.**

<u>(d) Reserve Requirements for Depository Institutions (Regulation D)</u>
Regulation D defines basic terms for savings accounts, transaction accounts, demand deposits, and others, and then sets reserves for liquidity. Unfortunately, these definitions are basic to the provisions of Regulation Q, as discussed above, and lead to considerable confusion and compliance problems for banks.

However, Regulation D's primary function is to allow the Federal Reserve Board to set reserve requirements. There are two basic problems with the current law on setting reserve requirements. First, reserves held by the Federal Reserve Banks do not earn interest for depository institutions that have them on deposit with the Reserve Banks, the so-called sterile reserves problem. Second, the Federal Reserve Board does not have complete flexibility in setting (or lowering) reserve ratios. **ABA supports changes in the legislation, such as are in H.R. 1224, that would pay interest on sterile reserves and that would increase the Board's authority to vary the reserve ratio.**

However, a number of banks have suggested changes in the eligibility for NOW accounts. Technically, NOW accounts are established by statute at 12 USC 1832 rather than being defined under Regulation D. Nonetheless, a common compliance burden for banks is having to explain to individuals who have been operating as sole proprietorships and thus have been able to have interest on their NOW accounts for their businesses that when they formed partnerships or small corporations, they lost their eligibility for NOW accounts. **As this becomes unimportant if the 24-transaction MMDA is authorized, ABA urges the Agencies to support a legislative change, as described in (a) above.**

(e) Assessment of BIF/SAIF Entrance or Exit Fees

Entrance and exit fees are required by the FDI Act in 12 USC 1815(d). However, the underlying purposes of the fees, to prevent dilution of the SAIF by exiting savings associations and to ensure the payment of the FICO bonds (which are now paid for by all FDIC-insured institutions), no longer exist. **ABA supports legislation that would merge the BIF and SAIF funds, which would render these fees and regulations moot.**

2. Directors, Officers and Employees

(a) Limits on Extensions of Credit to Insiders

1. 12 CFR 215.2(e)(1) defines an executive officer as a person who participates or has the authority to participate in major policymaking functions of the bank, as set out in the statute. However, Agency regulations also provide that officers with certain titles are considered executive officers unless the Board of Directors specifically passes a resolution excluding such officers from major policymaking functions. These titles include: chairman of the board, president, every vice president, cashier, secretary and treasurer. In many banks, vice presidents no longer have policy making functions. Thus the Board of Directors must continually review and pass resolutions excluding vice presidents from coverage by Regulation O. **ABA recommends that the regulation be revised to apply to senior vice presidents, executive vice presidents, and above.** Of course, under the regulation and the statute, banks are still required to treat as an executive officer any vice president who does have policy making functions.

2. Regulation O provides that no insider may borrow more than $500,000 without first getting prior approval of the bank's board. However, Regulation O also provides that directors and principal shareholders may borrow up to the bank's legal lending limit and executive officers may also borrow up to the legal lending limit for financing or refinancing a single residence. In major metropolitan markets today, median house prices are approaching the $500,000 threshold (if they have not already exceeded it). **We recommend creating an exception from the prior approval requirement for home mortgage loans that are made under the conditions of Regulation O that satisfy the executive officer provision, whether the loan is to a director, principal shareholder or executive officer.**

3. Regulation O provides in 12 CFR 215.5 additional restrictions on loans to executive officers, including a limit on extensions of credit in amounts greater than $100,000 (so-called "other purpose loans"), unless it is for a residence of the executive officer or to pay for the executive officer's children's education. These provisions were enacted before Home Equity Lines of Credit were common. **ABA recommends that banks be permitted to make HELOCs to executive officers without regard to the other purpose loan restriction, provided that the bank holds the first mortgage on the residence AND the total loan to value ratio of the first mortgage and the HELOC does not exceed 80% of value.** This would require amending the statute at 12 USC 375a.

4. As discussed above, 12 CFR 215.5 imposes additional restrictions on loans to executive officers. Regulation O currently imposes a limit on loans to executive officers for other purposes of 2.5% of capital and surplus or $25,000, but in no event more than $100,000. This limit was set by the Board

by regulation adopted September 1, 1983, which in today's dollars is just over $195,000. For many banks, 2.5% of capital and surplus is considerably more than $100,000, but this regulation continues to limit such lending to a 1983 standard. **ABA recommends that the limit on other purpose loans be raised to at least $200,000.**

5. The same problem exists on the overdraft provisions, which limit inadvertent overdrafts to no more than $1000 in total. **ABA recommends that the inadvertent overdraft limit be raised to $5000.**

(b) OCC Bank Activities and Operations – Corporate Practices
12 CFR Section 7.2010 - Directors' responsibilities – provides:

"The business and affairs of the bank shall be managed by or under the direction of the board of directors. The board of directors should refer to OCC published guidance for additional information regarding responsibilities of directors."

ABA is concerned that all of the Agencies' guidance on responsibilities of directors is becoming overly broad and blurring the lines between management and the board of directors.

Earlier this year, ABA, at the request of its Enterprise Risk Management Working Group, wrote to the banking agencies that "the apparent trend that regulators require an increasing level of detailed involvement of boards in fundamental management responsibilities" is overburdening the board of directors. We expressed our bankers' concern that each new guidance (and embedded in virtually all the recent examination reports) is blurring the distinction between senior management and the board. ABA wrote that "While well-intentioned, this regulatory trend diverts the attention of directors from providing strategic leadership and oversight to their institutions by getting them too involved – at times unnecessarily or unproductively – in an increasing amount of operational and other business-related detail. Requiring too high a level of detail is counterproductive to the goal of enhancing effective corporate governance of banks and bank holding companies."

In our letters, we gave examples of what our bankers thought were directives to the bank's board to attend to details and operations that we and our bankers believe are properly the purview of management rather than the bank's board. We wrote further that:

> "This trend of rising supervisory expectations for board involvement in senior management matters has significant adverse implications for effective corporate governance. First, the independence of the board may be compromised. Second, management has a finite amount of time with board members. If a substantial portion of that time is spent reviewing materials that are best handled by management, then there is less time available for important risk issues that the board needs to understand. This comment is not just coming from management; we are hearing it from frustrated directors as well.
>
> "Third, the over-specification of board responsibilities tends to convert board service into a compliance exercise of ticking off a checklist of regulatory chores rather than a broad principle-driven dynamic interaction that develops strategic direction and performance expectations tailored to the particular bank and its market. There must be latitude for directors to define their interface with

management, giving due consideration to economic circumstances, regulatory standards and complexity of the bank's operations."

We recommend that each of the Agencies, not just the OCC, which has this Corporate Practices' regulation under review:

1. **Conduct a study of examination reports to evaluate whether examiners are appropriately distinguishing management from board obligations in their exam findings, conclusions and recommendations.**
2. **Inventory the sources of existing regulatory obligations that examiners rely upon to support their prescriptions that directors undertake more managerial-type responsibilities.**
3. **Incorporate in examiner training and continuing education more detailed guidance on the distinct and different roles of bank management and the bank's board of directors.**

(c) OTS Board of Directors Composition

OTS regulations at 12 CFR 563.33 provides certain restrictions on the composition of a savings association's board of directors. Section 563.33(a)(i) provides that "A majority of the directors must not be salaried officers or employees of the savings association or of any subsidiary or (except in the case of a savings association having 80% or more of any class of voting shares owned by a holding company) any holding company affiliate thereof." Since control for purposes of the thrift holding company is 25% or more of any class of voting shares and since any amount over 50% would be total control, the restriction on composition of the board requiring 80% of shares seems excessive. ABA recommends that the percentage required to be held by a holding company of voting shares of a savings association be lowered to 60% in order to allow the composition of the board of the savings association to be exempt from this provision.

3. Rules of Procedure

These have largely been updated within the last five years, and no significant burden reductions were suggested by our bankers.

Conclusion

ABA appreciates the opportunity to comment on this phase of the EGRPRA regulatory burden reduction project. If there are any questions about any part of these comments, please call the undersigned.

Sincerely,

Paul Smith
Senior Counsel