Testimony of

America's Community Bankers

On

An Examination of

The Gramm-Leach-Bliley Act

Five Years After Its Passage

before the

Committee on Banking, Housing and Urban Affairs

of the

United States Senate

on

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and

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Introduction

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee, I am Harry P. Doherty, Vice Chairman of the Board of Directors of Independence Community Bank Corp of Brooklyn, New York. Independence Community Bank is a New York State-chartered savings bank, operating within an OTS-regulated holding company. Independence Community Bank has more than $17 billion in assets, 121 branches and 2500 employees.

I am here this morning representing America's Community Bankers. I am the First Vice Chairman of ACB's Board of Directors and will become Chairman in October. ACB is pleased to have this opportunity to participate in the Committee's review of the Gramm-Leach-Bliley Act.

America's Community Bankers supported the passage of the Gramm-Leach-Bliley Act in 1999 because, overall, it created new options for financial companies that wanted to offer diversified financial services. It also made positive changes in the capital structure and regulation of the Federal Home Loan Bank System and the law governing the FDIC's Savings Association Insurance Fund. However, the GLBA was in some ways a step backwards for an evolving financial services industry. After a lengthy and trying debate, it was decided in GLBA to undo provisions that had successfully permitted the creation of diversified financial services holding companies and to prohibit commercial firms from making any new acquisitions of savings associations. That change limited choices and holding company options for existing savings associations and deprived the financial services industry of an important source of capital, without any positive effect on the safety and soundness of the banking system.

GLBA has not always been implemented in a way to maximize its potential for bringing financial services to consumers efficiently. For example, savings associations have yet to achieve regulatory parity with banks under the securities laws. Savings associations should be given the same regulatory treatment as banks when they engage in the same securities activities as banks. The lack of parity requires savings association customers to pay more for services only because of their financial institution's charter. While ACB continues to work through the SEC's regulatory process to achieve parity, ACB believes that only a statutory change can ensure parity for savings associations under the securities laws.

Furthermore, the regulatory process established by GLBA to authorize new financial activities for banking organizations has not been allowed to work as intended, that is, through a notice and comment regulatory process that is based on safety and soundness considerations and administered by expert banking and financial regulators. Asa result of a highly politicized campaign by the realtor community, the Treasury and Federal Reserve have been unable to finalize a rulemaking allowing national banks and financial holding companies to offer real estate services.

GLBA created important new privacy rights for consumers and made other changes to consumer laws, such as the Community Reinvestment Act. However, some of these provisions created significant regulatory burden for all insured depository institutions without any benefit to consumers or safety and soundness. Congress and federal regulators should act to reduce the unnecessary regulatory burdens that result from these provisions.

I am pleased today to provide a more detailed discussion of ACB's views on these and other provisions in the GLBA.

Why Financial Modernization Was Important

In 1999, as they do today, ACB's members supported providing financial organizations choices in charters and business models that reflected the reality of integration of the financial services industry. Provisions of the Glass-Steagall Act, enacted during the Depression, and the Bank Holding Company Act of 1956 stood as barriers to the full integration of the banking, securities and insurance industry for those organizations that wanted to provide bank services through a bank charter, rather than a savings association charter. For years prior to 1999, securities, insurance and non-financial holding companies had owned savings associations. These institutions had given their holding companies the ability to offer an important array of financial services to their customers.

However, the Glass-Steagall Act hampered affiliations between commercial banks and bank holding companies, on one hand, and securities businesses, on the other. Although the Federal Reserve had loosened this restriction considerably, Glass-Stegall remained an anti-competitive anachronism. Bank holding companies could only acquire securities firms that fit within arbitrary size limits, while major securities firms were unable to acquire banks.

In a similar vein, the Bank Holding Company Act did not permit banks to associate with insurance underwriters. Beyond that, the Bank Holding Company Act limited banks to affiliations with firms "closely related" to banking. Banks that wished to sell insurance products faced a patchwork of state and federal statutes, as well as court and agency interpretations that sometimes permitted and sometimes prohibited insurance activities. Because ACB members firmly believed that each financial institution should have a full range of choices to meet the needs of their customers and communities, ACB urged Congress to expand choices for financial institutions by repealing these decades-old restrictions on affiliations.

The Pace of Financial Integration Has Been Slow

GLBA repealed the restrictions on the integration of banking, insurance and securities, and established a framework of functional regulation to supervise banking, insurance and securities activities of financial conglomerates. However, passage of the Act has had only a modest impact on the pace of integration of these activities.

Federal Reserve Vice Chairman Ferguson reported in a speech last November that while there were about 600 financial holding companies at the end of 2002, less than one-third reported actually engaging in any new activities authorized by the GLBA. Eighty percent of those activities were insurance agency activities, probably the "least new" and least risky of the activities authorized by the new law. Only forty institutions reported broker-dealer assets, around thirty reported insurance underwriting assets, and less than twenty held significant merchant banking assets using GLBA authority. Ferguson concluded that even accounting for the size of some these financial holding companies, and the activities conducted in previously authorized section 20 affiliates, no evidence exists that the overall market structure of the financial services industry has changed since the passage of the GLBA.

One of the promises of the GLBA was the relatively easy authorization of new financial activities for banking organizations. GLBA established a joint Federal Reserve and Treasury regulatory process for the authorization of permissible new financial activities for banking organizations. The hope was that under this process, safety-and-soundness would be the dominant factor in the decision-making process. However, in the first real test of this authority, the two agencies have not been able to complete their work on a regulation that would authorize for national banks and financial holding companies an activity, which is already authorized for federal savings associations and roughly half the state-chartered banks.

In January 2001, the Treasury and the Federal Reserve issued a proposed regulation to permit national bank financial subsidiaries and financial holding companies to provide real estate brokerage and real estate management services to their customers. However, due to a highly politicized campaign by the realtor community, Treasury and the Federal Reserve have not been allowed to complete their work on the regulation. In this particular instance, considerations other than safety and soundness have held sway.

GLBA Restricted an Important Holding Company Option

In 1999, we also urged Congress not to reduce choice by restricting the unitary savings and loan holding company. However, policy makers, ignoring the past success of the unitary savings and loan holding company, chose to reduce the benefits of the charter by prohibiting commercial (non-financial) firms from acquiring savings associations and grandfathered unitary savings and loan holding companies. Critics justified this limit by citing their concerns about mixing banking and commerce. However, unitary thrift holding companies did not then, and do not now, mix banking and commerce in any meaningful way. Savings associations are not permitted to lend to commercial affiliates under any circumstances. Savings associations' permissible commercial lending is strictly limited to 20 percent of assets, half of which must be small business loans. As a result of GLBA's restrictions on unitary savings and loan holding companies, the banking industry and its customers lost a potentially important source of capital.

Nevertheless, the unitary savings and loan holding company structure remains an important choice for financial firms. The expertise of the OTS in regulating diversified holding companies is one reason that firms continue to consider this holding company option to be an efficient choice.

SEC "Push-Out" Rule and Parity for Savings Associations

Before GLBA, banks—but not savings associations—enjoyed a blanket exemption from broker-dealer registration requirements for certain activities under the Securities Exchange Act of 1934 (Securities Exchange Act). The GLBA removed the blanket exemption and permitted banks to engage only in specified activities without having to register as a broker-dealer. All other broker-dealer activities must be "pushed out" to a registered broker-dealer affiliate. The SEC issued interim broker-dealer rules on May 11, 2001, to implement the new "push-out" requirements. As part of the broker-dealer "push out" rules, the SEC exercised its authority to include savings associations within the bank exemption. This interim rule treated savings associations the same as banks for the first time for purposes of broker-dealer registration. In the interim broker-dealer rule, the SEC recognized it would be wrong to continue disparate, anomalous treatment between savings associations and banks.

The SEC postponed the effective date of the interim rule several times. It published proposed amendments to the interim dealer rule on October 20, 2002 and the final dealer rule on February 24, 2003. The proposed rules gave savings associations the same exemptions as banks. On June 2, 2004, the SEC approved a new proposed rule governing when a bank or thrift must register as a broker.

Unlike the SEC's interim broker rule, the new proposal would no longer treat savings associations the same as banks in all respects. Although savings associations would be treated the same as banks for purposes of the 11 statutory activities they may engage in without registering as a broker with the SEC, as provided by the GLBA, three non-statutory exemptions provided banks would not be extended to savings associations. The SEC describes the three non-statutory exemptions as targeted exemptions that recognize the existing business practices of some banks. We understand that the SEC staff does not believe savings associations are engaged in the exempted securities activities and will only extend relief for savings associations to the securities activities they are currently performing. OTS General Counsel John Bowman recently testified that it appears that savings associations currently engage in some, if not all, of the securities activities covered by the three additional exemptions. The SEC's discriminatory approach makes no sense because the bank exemption applies to all banks—whether or not they are currently engaged in one of the exempted activities.

ACB vigorously supports providing parity for savings associations with banks under the Securities Exchange Act. As more savings associations engage in trust activities, there is no substantive reason to subject them to different requirements. They should be subject to the same regulatory conditions as banks engaged in the same services. ACB intends to file comments with the SEC opposing the discriminatory treatment of savings associations. However, the latest proposal from the SEC demonstrates that a legislative change is needed in order to ensure parity for savings associations under the Securities Exchange Act.

FHLBank Modernization

Title VI of GLBA made important and welcome changes to the laws governing the regulation, membership and capital structure of the Federal Home Loan Bank System. One of the important changes involved the membership status of federal savings banks and savings associations. Prior to the 1999 law, the institutions were required to be members of the Federal Home Loan Bank System, while other financial institutions' membership was voluntary. GLBA put federal savings associations on the same footing as others by making their membership voluntary. Voluntary membership enhances the cooperative nature of the System and provides incentives to Federal Home Loan Banks to work for the benefit of their member-borrowers. After eliminating mandatory membership, GLBA added stability to the System's capital base by establishing a leverage and risk-based capital requirement for the FHLBanks and by creating "permanent capital" through a second class of stock with a five-year "put" period.

The conversion of the FHL Banks to this new capital system has been a complex process. Nevertheless, nine of the twelve banks have already implemented their capital plans, and the other three are in the process of implementation. However, regulatory proposals to require the Banks to register certain equity securities with the SEC could significantly complicate the implementation of the remaining capital plans.

The GLBA also shifted much authority over the day-to-day operation of the FHLBanks from the Federal Housing Finance Board to the Banks themselves. The role of the Finance Board became more that of safety-and-soundness regulator rather than a co-equal or superior in the management of the system. For example, the GLBA gave the Finance Board new regulatory powers, such as the authority to issue cease and desist orders and to impose civil money penalties.

Title VI of GLBA made an important change to the formula for the FHL Banks' contribution to the debt service of the REFCorp bonds, issued in 1989 to fund the resolution activities of the Resolution Trust Corporation. The GLBA formula requires the Banks to pay 20 percent of net income to REFCorp. The old formula, eliminated by GLBA, had the potential to create disincentives for FHL Banks to provide advances for SAIF-insured financial institutions.

Financial Privacy

In Title V of GLBA, Congress passed the most sweeping law in American history to protect the privacy of consumers' financial information. Among other things, Title V of GLBA requires each financial institution to disclose its privacy policy to the consumers and customers it serves, and to restrict the sharing of nonpublic personal information sharing with most nonaffiliated third parties without first providing individuals the ability to prevent the exchange of their information ("opt-out"). In addition to an initial disclosure of an institution's privacy policy and an initial opt-out notice, GLBA requires a financial institution to provide annual disclosures and notices to its customers. GLBA required compliance with these provisions by July 1, 2001.

At the end of 2001, ACB conducted a survey to measure the costs incurred to comply with GLBA's privacy policy and opt-out disclosure requirements. The survey concluded that community banks spent a disproportionately higher amount than larger banks in providing customers copies of their privacy policies and opt-out disclosures. The survey also found that customers rarely exercised the option of prohibiting their bank from sharing customer financial information with non-affiliated third parties, and that a majority of customers did not find the disclosures useful.

The average compliance cost was $1.37 per customer, with total estimated compliance costs per bank ranging widely from as little as $1,000 to more than $2 million. The survey found the cost per customer averaged 27 cents at banks with assets of $10 billion or more, compared with per customer costs of $2.37 at banks with assets of less than $50 million -- almost nine times as much. As a percentage of non-interest expenses (salaries, employee benefits, occupancy costs, etc.), banks with less than $50 million in assets paid almost four times as much as the group of banks with assets of $10 billion or more. The survey interpreted these results to mean that larger banks with in-house legal and consulting staff were able to do most of the compliance work themselves, while smaller banks sought outside legal help and consultants.

A 2002 survey found that while compliance costs were reduced significantly, —as initial policies and procedures developed in 2001 have become institutionalized—they remained high. In 2002, ACB found that the estimated average compliance per customer was about $0.65 per customer. These costs are likely to increase.

I will tell you, community banks guard their depositors' information like Fort Knox and have built their reputations on the trust of their customers that their bank will actually do so. Most community banks do not share information in any way whatsoever. Others share information only under very controlled circumstances when certain operational functions are outsourced to a vendor. We suggest that Congress eliminate annual privacy notices for banks that do not share information with nonaffiliated third parties. Banks with limited information sharing practices should be allowed to provide customers with an initial notice, and provide subsequent notices only when terms are modified.

I am sure that you are all inundated by privacy statements each fall. I am equally confident that most or all of them remain unread. The complexity of the statements – which is dictated by GLBA and the implementing privacy regulations – certainly contributes to customers' disregard of the notices. ACB suggests that the regulators improve the quality and utility of GLBA privacy notices by developing an easy-to-understand short-form notice, and that Congress provide statutory relief as necessary to accommodate these changes.

Information Security Program

GLBA established new standards for ensuring the security and confidentiality of customer records and information. While the confidentiality and security of customer information has always been a cornerstone of community banking, the new GLBA information security standards brought increased focus to this issue.

The GLBA information security standards require every bank to conduct a risk assessment to identify and assess the risks that may threaten the security, confidentiality, or integrity of customer information. Each bank is then expected to implement a comprehensive written information security program appropriate to the size and complexity of the institution. Review of the information security program is a part of the regular safety and soundness examination of every depository institution.

In response to recent high profile cases of compromised personal information such as credit and debit card numbers, Congress and the banking regulators have considered what additional measures may be necessary to protect consumer financial information. Community banks were not involved in any of the recent high profile cases of compromised consumer financial information. The development and maintenance of a formal information security program is a significant responsibility for all banks, but the burden is especially hard felt by small community banks. Congress and the regulators should carefully study the causes of these recent security breaches and avoid new information security requirements that unnecessarily increase the regulatory burden of the banking industry.

CRA Sunshine Law

Section 711 of the GLBA enacted the so-called CRA Sunshine Law. Under the CRA Sunshine Law, parties to certain CRA-related agreements must make the agreements available to the public and the appropriate federal banking agency. Section 711 applies to written contracts, arrangements, and understandings that are entered into by an insured depository institution or an affiliate and a nongovernmental entity or person; and which are entered into pursuant to or in connection with the fulfillment of CRA; and which call for an insured depository institution or affiliate to provide cash payments or other consideration with an aggregate value of more than $10,000 in any year, or loans with an aggregate value of more than $50,000 in any year. The law requires both depository institutions and nongovernmental groups (consumer groups) to make a report of all such agreements annually to the appropriate federal banking agency.

The regulations implementing the CRA Sunshine Law are overly broad and impose significant paperwork, regulatory and cost burdens on banks that far outweigh possible benefits. Community banks, especially small- and mid-sized banks, are forced to spend considerable resources complying with the disclosure, reporting and recordkeeping requirements associated with CRA-related agreements rather than doing what really matters -- serving their communities with affordable credit and financial services. As a result of the CRA Sunshine Law and these regulations, fewer creative and innovative partnerships are formed because of competitive and privacy concerns. According to FDIC Vice Chairman Reich, both banks and consumer groups share these views. ACB believes that the CRA Sunshine Law should be repealed in order to reduce regulatory burden on depository institutions, consumer groups and federal banking agencies.

Deposit Insurance Reform

Finally, another important provision of GLBA eliminated the Savings Association Insurance Fund Special Reserve. The Deposit Insurance Funds Act of 1996 created a special reserve, effective as of January 1, 1999, of amounts in excess of the statutory designated reserve ratio of 1.25 percent. As a result, nearly $1 billion was removed from the SAIF on January 1, 1999. On the effective date of GLBA, November 12, 1999, those funds were restored to the SAIF, which resulted in an increase in the SAIF reserve ratio from 1.29 to 1.43 percent. The elimination of the reserve reduced the risk that the SAIF reserve ratio would fall below 1.25 percent, which triggers an FDIC insurance assessment on SAIF-insured deposits. ACB strongly supported the elimination of this costly, unnecessary reserve.

This change also established greater flexibility for the FDIC that improved the ability of the FDIC to manage the SAIF. ACB notes that many of the provisions currently being considered by the Committee to reform the federal deposit insurance system similarly increase the FDIC's operating flexibility, and would contribute to the security of the federal deposit insurance system. ACB urges the Committee to act on pending legislation as soon as possible.

Conclusion

I wish to again express ACB's appreciation for this opportunity to present its perspectives in connection with the Committee's review of the impact of the GLBA.