Approved: Feb3, 2004

MINUTES OF THE SENATE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE

The meeting was called to order by Chairperson Ruth Teichman at 9:30 a.m. on January22, 2004 in Room 234-N of the Capitol.

All members were present.

Committee staff present:
Nancy Shaughnessy, Committee Secretary

Conferees appearing before the Committee:

Others attending:
See Attached List.

Sandy Praeger, Insurance Commissioner, over viewed the Kansas Insurance Department. .(Attachment 1) The Agency is the third largest revenue producer in the State, is entirely fee funded and does not use State General Funds to operate.

Bill Introductions

Commissioner Praeger introduced the following bills that the Department would like to address this session.

- How agents are appointed in agencies and a small increase in agent's fees
- Benefit payment, language change in statute from or to and
- Risk based Capital, date needs to be updated annually
- Homeowner's coverage, that companies may not drop a policyholder based on one weather related incident
- Consumer Protection Bill, Clue (Comprehensive Loss Underwriters Exchange)
- HSA (health savings account) change statutory reference from medical to Health
- Limit the amount forfeiture penalties when a policy holder cashes in policy prior to maturity date

Senator Corbin made a motion to accept the bills as introduced, seconded by Senator Steineger. The motion was carried.

Chuck Stones from the Kansas Banker's Association presented a report to the committee.(Attachment 2) He hoped to give the Committee a sense of the Industry as they go through the legislative session. Kansas banks employ 14,000 Kansans with the average bank employing 10 persons.Kansas ranks 5th in the Nation in the number of chartered banks.

Shari Weber, Community Banker's Association presented a historical perspective of how the community banker's fit into the Kansas banking system. (Attachment 3) The trade Association is a not for profit organization founded 25 years ago.

The meeting was adjourned 10:30 a.m.

The next meeting is scheduled for January 27, 2004

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE
COMMITTEE GUEST LIST

DATE: 1-22-04

NAME	REPRESENTING
Bill Sneed	State Farm
Lee Wright	Farmers Ins.
Richard E. Miller	Farmers Alliance
Natalie Haag	Security Benefit
Kevin Davis	Am. Family
Charlie Keller	Hein Law Firm
Shari Weber	Community Bankers CBA
Bill Henry	Ks Credit Union Assn
Lane Welsh	KS Dept. on Aging
Kathy Olsen	KS Bankers Assn.
Matt Goddard	Heartland Community Bankers Assoc.
Kevin Glendening	Banking Department
Clancy Norris	Banking Dept.
David Hanson	KS Insur Assns
Matt Jordan	Commerce

PLEASE PRINT

Kansas Insurance Department

Sandy Praeger COMMISSIONER OF INSURANCE

January 22, 2004

Madame Chair and Members of the Senate Financial Institutions/Insurance Committee:

Kansans will spend more than $10 billion dollars on insurance products this year. That's more than twice the amount they spend on state taxes. As your Insurance Commissioner, I want to share with you some important facts about the Kansas Insurance Department and the insurance industry in our state.

The Kansas Insurance Department:

- Is the third largest revenue producer in state government, contributing $94,900,938 in fees, taxes and assessments in FY 2002
- Is entirely fee-funded and does not use state general funds to operate
- Operates on a budget that is approximately one-tenth of one percent of the amount of insurance purchased in Kansas

I want to provide you with an overview of how the insurance industry impacts Kansas and your constituents. Attached is a fact sheet about the Kansas Insurance Department, the most recent report outlining the distribution of the Firefighter's Relief Fund and information about licensed insurance agents in Kansas.

I'm confident that you share my view that informed Kansans make better insurance choices. We need to work together to ensure that our citizens have access to affordable insurance coverage. We must also work to make the Kansas marketplace attractive to insurance companies, so that our constituents have as many insurance options as possible.

If you ever have a question, concern or comment about any insurance issue, please remember that I am just across the street—working with you on behalf of the consumers of Kansas. Please let me know if I can be of assistance.

Best of luck to you in the 2004 session!

Sincerely,

Sandy Praeger

Sandy Praeger
Kansas Insurance Commissioner

P.S. Our Consumer Assistance Division is here to help with constituents' questions and concerns about insurance. Our toll-free number is 1-800-432-2484. The Kansas Insurance Department web address is: www.ksinsurance.org.

Senate F I & I Committee
Meeting Date: Jan 27, 2004
Attachment No.: 1

420 SW 9TH STREET
TOPEKA, KANSAS 66612-1678

PHONE 785.296.3071
FAX 785.296.2283

CONSUMER HOTLI
800.432.2484

Kansas Insurance Department

Sandy Praeger COMMISSIONER OF INSURANCE

FY 2003 Fact Sheet

Total fees, taxes and assessments collected by the Kansas Insurance Department in FY 2003: **$109,138,790**

Total tax dollars contributed to the State General Fund in FY 2003: **$94,900,938**

Total workers compensation paid in FY 2003 to Kansas employees who re-injured a previous injury in the workplace: **$1,564,051**

Consumer Complaints
Cases closed in Calendar Year 2003: 5056

Insurance dollars recovered for Kansas consumers in Calendar Year 2003: **$7,078,811**

Summary of Insurance companies doing business in Kansas:

	Kansas-based	Non-Kansas Based	Kansas Fraternal Societies	Total Companies
Life	12	569	29	610
Fire and Casualty	30	928	0	958
HMO	6	9	0	15
TOTAL	**48**	**1506**	**29**	**1583**

FY 2003 Statewide Firefighters Relief Fund: (revenue collected) — **$7,580,884** (2% of fire/lightning coverage premium on all homeowners' insurance policies)

Insurance agents licensed statewide:
22,830 (Resident)
42,088 (Non-resident)

420 SW 9TH STREET
TOPEKA, KANSAS 66612-1678

PHONE 785.296.3071
FAX 785.296.2283

CONSUMER HOTLINE
800.432.2484

WEBSITE
www.ksinsurance.org

Kansas Insurance Department

Sandy Praeger COMMISSIONER OF INSURANCE

COMMENTS
ON
STATUS OF THE KANSAS INSURANCE DEPARTMENT
AND
LEGISLATIVE REQUESTS
SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURNACE
January 22, 2004

Madam Chair and Members of the Committee:

Thank you for the opportunity to visit with you on behalf of the Kansas Insurance Department. We had a good 2003 and I look forward to 2004. In addition to the department report, I am here to request five bills for introduction:

AGENT/AGENCY APPOINTMENTS

This legislation would provide a structural change to the agency and agent appointment process. Companies will be able to send electronic appointments to our Agents division and have an almost immediate turnaround. These changes will aid the department in our goal to be paperless by January 1, 2005. In addition, this bill would raise appointment fees to $75 for all agencies covering all agents within each agency. Currently, companies pay an appointment fee for both the agent and the agency.

BENEFIT PAYMENTS

This legislation would change the way benefit payments are calculated for individual health policies to more accurately reflect actual market conditions. By changing "or" to "and" the statute would require insurers to consider all relevant factors, as opposed to simply choosing one or the other.

RISK-BASED CAPITAL
This simple date change from 2002 to 2003 is our annual re-up legislation adopting the current risk-based capital requirements.

HOMEOWNERS COVERAGE
This legislation would prohibit insurers from canceling or non-renewing a consumer based on a *single* weather related claim. Based on consumer complaints, we know individuals are being dropped simply for using their coverage and this runs counter to the very idea of insurance. This is not a wide spread problem, but one that needs to be addressed.

C.L.U.E.
Some insurers turn phone inquiries to the Comprehensive Loss Underwriting Experience (C.L.U.E.) database that can potentially adversely affect the rates or coverage of consumers. This legislation would prohibit companies or their agents to report to the C.L.U.E. system unless a claim is actually filed and paid.

HEALTH SAVINGS ACCOUNTS
Now that Congress has passed legislation allowing Health Savings Accounts (HSAs) to be offered, we need to amend our statutes to reflect the name change to allow the products to be offered in Kansas.

NONFORFEITURE LAW
This legislation would apply to companies offering individual deferred annuities. It would lower the current maximum surrender rate from 35% to 12.5%. This legislation would also allow companies to index the guarantee rate to the five-year treasury rate.

KANSAS BANK FACTS

(Based on 9/30/03 data)

** Kansas has 363 chartered banks of which 262 are state charters and 101 are national charters. Kansas ranks 5th in the nation behind Texas, Illinois, Minnesota, and Iowa in the number of chartered banks.

** There is at least one chartered bank in 101 of the 105 Kansas counties. Only Cheyenne, Wichita, Wallace, and Edwards counties are without a chartered bank. 17 other counties have only one chartered bank while Johnson County has the most with 24 charters.

** Kansas law has allowed multi-bank holding companies since 1985. There are currently 24 multi-bank holding companies in Kansas that control 52 Kansas banks and eight out-of-state banks.

** Interstate branching began in Kansas in 1997. There are currently 18 out-of-state banks operating 182 branches in Kansas while five Kansas banks have a total of 36 out-of-state branches.

** There are banking facilities in 443 Kansas towns and cities. Nearly 70% of all chartered banks in Kansas are located in towns with a population of less than 5,000. 19% of all chartered banks are located in towns of less than 500. There are chartered banks in 37 Kansas towns where the population is less than 250. The smallest town in the state with a chartered bank is Aliceville (pop. 37). The smallest town with a branch facility is Freeport (pop. 6)

** There are 1,322 banking facilities (home offices and branches) throughout Kansas. Johnson County has the most facilities with 169 while Sedgwick County has 125. There are 20 counties that have three or fewer facilities. 16% of all bank facilities are held by out-of-state banks.

** Out-of-town branching was allowed in Kansas on a limited basis starting in 1986 and statewide branching has been possible since 1990. There are 526 out-of-town branch offices operated by 183 banks and more than 160 Kansas towns have only branch facilities of an out-of-town bank. One-half of all Kansas banks do not have out-of-town branch operations and nearly 40% do not have any in-town branch offices.

Senate F I & I Committee
Meeting Date: Jan 22 2004
Attachment No.: 2

** Kansas chartered banks have total assets of $39.9 billion. The largest chartered bank in Kansas is Intrust of Wichita with $2.54 billion in assets while the TriCentury Bank of Simpson is the smallest with $2.9 million in assets.

** The average asset size of Kansas banks is $110.3 million, but the median asset size is $48.7 million. 26% of all Kansas banks have less than $25 million in assets while 52% have less than $50 million in assets. Only 24% of all Kansas banks have more than $100 million in assets.

** Total deposits for Kansas banks currently stands at $31.9 billion. The ten largest banks in Kansas hold 28.3% of the total deposits in the state. Kansas ranks 32nd among the 50 states in statewide bank deposits.

** The ratio of equity capital to total assets is 10.28% - well above the national average of 9.22%

** Loan volume for Kansas banks totals exceed $25 billion with a median loan to deposit ratio of 71.9% - an all-time high. The largest segment of loans are in non-farm real estate (48.7%) followed by commercial and industrial loans (20.2 %), and agricultural production and farm real estate loans (17%).

** The statewide ROA average for Kansas banks as of 9/30/03 was 1.26% which was 13 basis points below the national average. The statewide ROE average was 12.40% as compared with a national average of 15.12%.

** Kansas banks currently employ 14,300 people. Over ¼ of all Kansas banks have fewer than 10 employees and 62% of all banks employ fewer than 25 people.

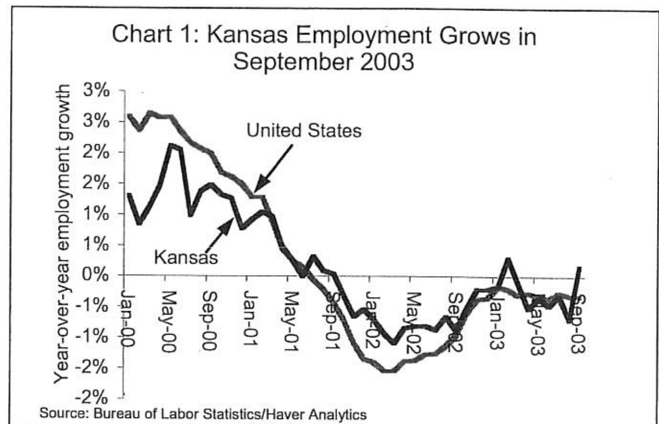
FDIC State Profile

WINTER 2003

Kansas

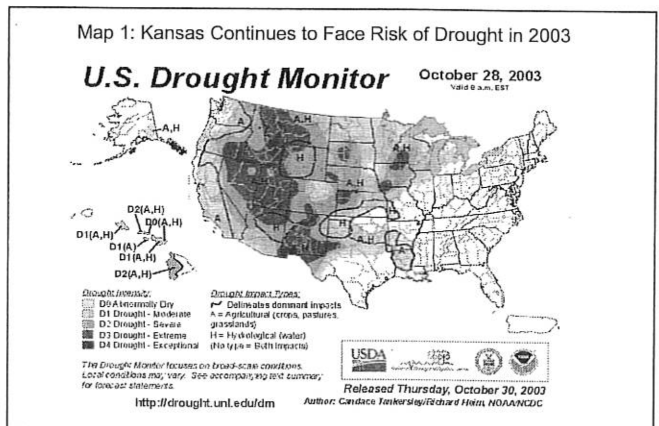
Kansas labor economy shows modest signs of improvement in the third quarter.

- The Kansas economy added jobs in September, only the second month in the previous two years where employment has not declined (see Chart 1).
- While manufacturing employment continued to decline, these losses were offset by strong gains in wholesale and retail trade, finance, insurance and real estate, and the government sector.
- The unemployment rate was reported at 4.7 percent in September, compared to 5.0 percent a quarter earlier, and 5.2 percent one year earlier.



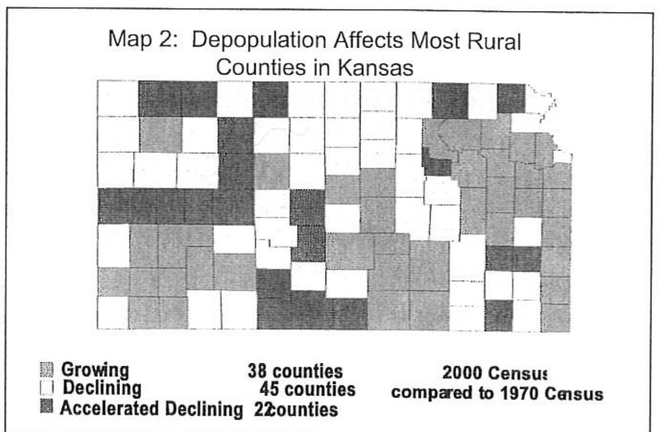
Drought situation improves in 2003, but effects persist.

- Rain fall and snowmelt in 2003 have reduced the severity of drought in Kansas, but most of the state still remains abnormally dry, as shown in Map 1.
- Reservoirs, streams, and farm ponds remain below normal levels, reflecting the shortages experienced in 2002.
- An August 4 survey by the United States Department of Agriculture rates 55 percent of the state's pasture and rangeland as "Poor" or "Very Poor" suggesting continuing risks to cattle ranchers.



Depopulation in rural areas continues to be a challenge.

- Sixty-seven of 105 counties in Kansas have lost population since 1970, and 22 of those counties also lost population at an increasing rate in the 1990s (see Map 2).
- Technological changes and consolidation in the agricultural sector have reduced the demand for farm labor, and farmers have become less dependent on nearby small towns to purchase inputs and professional services.
- As a result, people have migrated from rural to metropolitan areas to seek better employment opportunities.
- Counties that are losing population more rapidly may lose economic viability, as shrinking tax rolls may make essential infrastructure, such as utilities and school systems, difficult to maintain.



Continuing drought conditions are contributing to weakening asset quality among many of the state's farm banks.

- Northern Kansas remains in "moderate" drought, following "moderate" to "severe" drought conditions in 2001 and

2002. These weather problems follow four years of very low crop prices that left many farm banks with substantial levels of carryover debt.

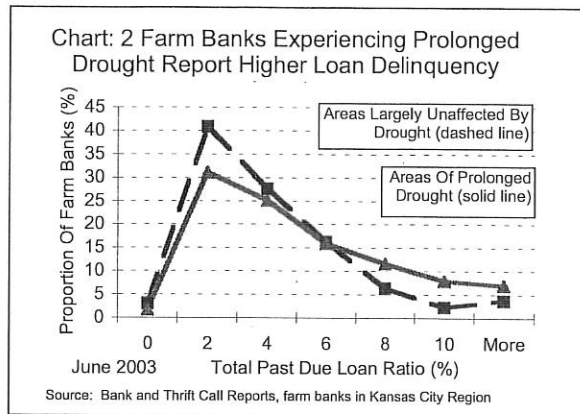
- Chart 2 shows that farm banks in areas of prolonged drought (predominately in Nebraska and northwest Kansas) report higher loan delinquency levels than areas less seriously affected by the drought.
- On a positive note, the March 2003 median capital ratio of 10.2 percent reported by banks headquartered in Kansas remains high by historical standards and well above levels during the 1980's farm crisis and 1988 drought.

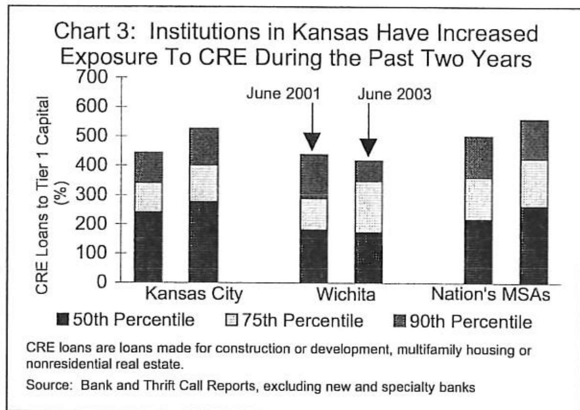
Softening commercial real estate markets are a concern to metropolitan commercial lenders headquartered in Kansas.

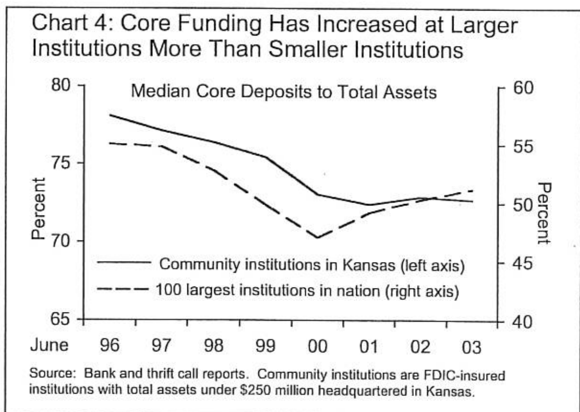
- Many institutions operating in the state's largest metropolitan markets have increased reliance on commercial real estate (CRE) loans during the past two years (see Chart 3).
- This increased exposure has come as metropolitan CRE markets, most notably office and industrial, softened significantly during the past two years. Office vacancy rates have risen to the highest level in nearly a decade.

Community institutions in Kansas continue to face funding challenges.

- Utilization of core funds to support assets declined steadily throughout the 1990s, because of negative population trends, competitive challenges from larger banks and nonbanks, and significant disintermediation of funds into the stock and bond markets. As a result, the median core deposits of total assets ratio for community institutions declined from 82 percent to 73 percent between June 1993 and June 2003.
- To counter declining deposits, community institutions headquartered in Kansas increased reliance on noncore funds, such as large time deposits and borrowings.
- The use of borrowings, primarily Federal Home Loan Bank advances, has increased dramatically. Between June 1993 and June 2003, the proportion of community institutions with borrowings making up at least 10 percent of total funds increased from 7.8 percent to 16.9 percent.
- The weak economy and significant declines in the stock market have prompted a great shift of deposit funds into the banking system. However, as seen in Chart 4, most of the benefit has accrued to the nation's largest banks.







- See "Kansas City Regional Perspectives Despite Recent Deposit Growth, Community Banks Continue to Face Funding Challenges," *FDIC Outlook*, Spring 2003, for further discussion about funding.

Kansas at a Glance

General Information	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
Institutions (#)	379	385	393	392	408
Total Assets (in thousands)	52,179,566	49,436,339	50,741,240	47,553,961	42,950,623
New Institutions (# < 3 years)	8	8	8	7	5
New Institutions (# < 9 years)	18	17	16	13	11

Capital	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
Tier 1 Leverage (median)	9.48	9.59	9.67	9.68	9.45

Asset Quality	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
Past-Due and Nonaccrual (median %)	1.83%	1.78%	1.93%	1.60%	1.63%
Past-Due and Nonaccrual > = 5%	52	39	45	23	35
ALLL/Total Loans (median %)	1.42%	1.41%	1.41%	1.40%	1.45%
ALLL/Noncurrent Loans (median multiple)	1.70	1.91	1.70	2.35	2.05
Net Loan Losses/Loans (aggregate)	0.32%	0.27%	0.26%	0.26%	0.39%

Earnings	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
Unprofitable Institutions (#)	13	22	23	12	13
Percent Unprofitable	3.43%	5.71%	5.85%	3.06%	3.19%
Return on Assets (median %)	1.08	1.13	1.11	1.23	1.13
25th Percentile	0.71	0.80	0.74	0.86	0.81
Net Interest Margin (median %)	3.98%	4.14%	4.15%	4.34%	4.13%
Yield on Earning Assets (median)	5.85%	6.75%	8.11%	8.08%	7.70%
Cost of Funding Earning Assets (median)	1.87%	2.57%	3.96%	3.78%	3.57%
Provisions to Avg. Assets (median)	0.09%	0.09%	0.08%	0.06%	0.04%
Noninterest Income to Avg. Assets (median)	0.61%	0.59%	0.59%	0.56%	0.54%
Overhead to Avg. Assets (median)	2.90%	2.91%	2.96%	2.95%	2.87%

Liquidity/Sensitivity	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
Loans to Deposits (median %)	73.58%	74.46%	75.57%	73.92%	69.27%
Loans to Assets (median %)	61.22%	61.97%	63.08%	62.96%	59.50%
Brokered Deposits (# of institutions)	47	43	40	31	26
Bro. Deps./Assets (median for above inst.)	3.07%	3.27%	2.54%	1.92%	2.18%
Noncore Funding to Assets (median)	15.81%	15.55%	15.97%	15.42%	13.18%
Core Funding to Assets (median)	71.70%	72.21%	71.89%	72.90%	75.31%

Bank Class	Jun-03	Jun-02	Jun-01	Jun-00	Jun-99
State Nonmember	234	238	244	248	257
National	99	104	108	107	110
State Member	29	26	24	20	24
S&L	10	10	10	10	10
Savings Bank	7	7	7	7	7
Mutually Insured	0	0	0	0	0

MSA Distribution	# of Inst.	Assets	% Inst.	% Assets
No MSA	291	20,700,759	76.78%	39.67%
Kansas City MO-KS	44	12,756,466	11.61%	24.45%
Wichita KS	27	7,195,021	7.12%	13.79%
Topeka KS	10	10,788,588	2.64%	20.68%
Lawrence KS	7	738,732	1.85%	1.42%

2-5

Kansas City Regional Perspectives

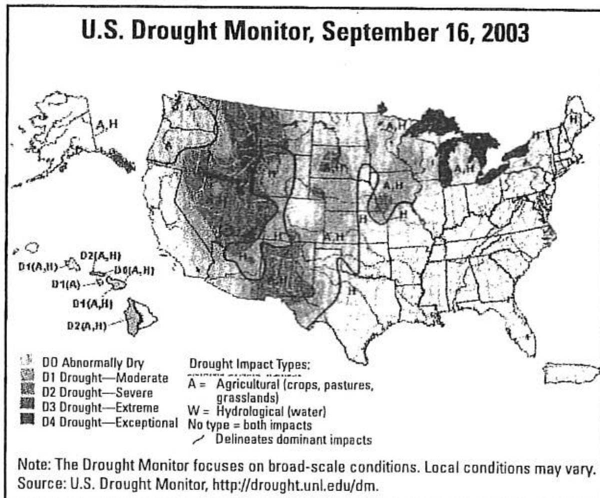
Drought conditions remain a significant issue in the Kansas City Region, with implications for the Region's economy and insured institutions. This article describes the effects of drought conditions on the Region's cattle and crop producers and assesses their effects on farm bank credit quality.

Drought Continues to Stress Much of the Western Part of the Kansas City Region

Nearly half the nation experienced severe drought conditions during spring and summer 2002. The hardest-hit parts of the Kansas City Region were much of western **South Dakota**, a large portion of **Nebraska**, and northwestern **Kansas**. The duration and intensity of the drought devastated much of the pastureland in these areas and severely damaged wheat, corn, and soybean production. Crop yields dropped significantly, and many cattle producers were forced to liquidate some or all of their herds because of a lack of forage.

Rainfall in the spring and early summer of 2003 helped alleviate the situation throughout much of the Region. However, the hot, dry weather pattern that characterized late July and August further eroded topsoil moisture conditions. As a result, almost the entire Region is now experiencing at least moderate agricultural drought conditions (see Map 1), and certain areas have been subject to more long-term stress (see Map 2). In areas of persistent drought, farm bank performance has begun to deteriorate.

Map 1

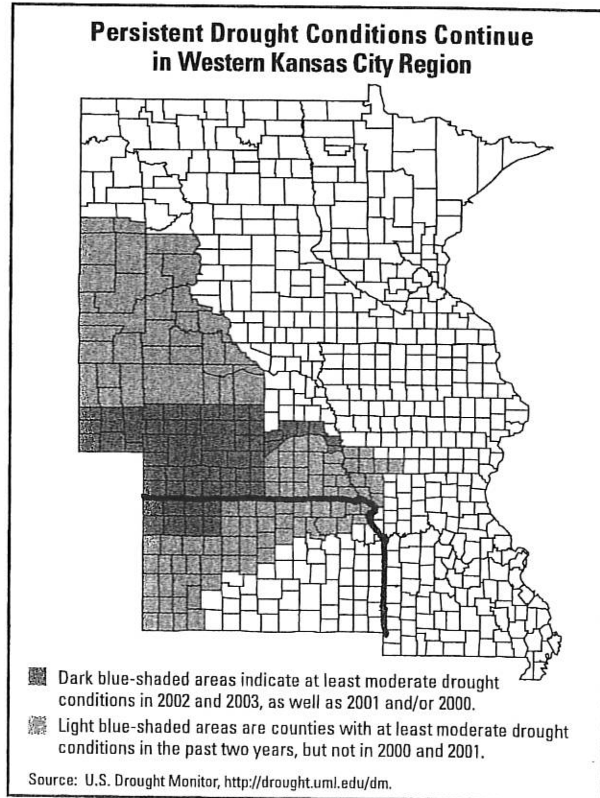


Note: The Drought Monitor focuses on broad-scale conditions. Local conditions may vary.
Source: U.S. Drought Monitor, http://drought.unl.edu/dm.

The Region's Economy Was Affected Adversely by the 2002 Drought

The 2002 drought caused sharp declines in prices and rising feed costs that hurt cattle industry revenues throughout the Region. Faced with a shortage of feed and water, many cattle producers liquidated herds, resulting in a precipitous drop in cattle prices and producer revenues. The Nebraska Choice Steer Price declined 20 percent from $79 per hundredweight in first quarter 2001 to a four-year low of $63 per hundredweight in third quarter 2002.[1]

Map 2



Source: U.S. Drought Monitor, http://drought.uml.edu/dm.

[1] *Livestock Price Outlook*, July 2003, Table 5. Purdue University and University of Illinois, http://www.farmdoc.uiuc.edu/marketing/livestockoutlook/07003cattle/0703cattle_text.html.

2-6

Table 1

The Region's Western States Experienced Higher Acreage Abandonment and Lower Crop Yields in 2002

	Wheat						Corn					
STATE	Planted Acres (000s)	Regional Share	Percent Abandoned[1] 2002	Historic Abandon Rate	Yield (bu/acre)	Historic Yield[2]	Planted Acres (000s)	Regional Share	Percent Abandoned[1] 2002	Historic Abandon Rate	Yield (bu/acre)	Historic Yield[2]
Kansas	9,600	36%	16	8%	33	44	3,250	8%	23	7%	116	138
Nebraska	1,650	6%	8	7%	32	41	8,400	21%	13	4%	128	138
North Dakota	9,080	34%	13	5%	27	30	1,230	3%	19	18%	115	110
South Dakota	3,030	12%	46	12%	26	37	4,400	11%	27	10%	95	110
	23,360	89%	18	7%	30	37	17,280	44%	19	7%	117	130
Iowa	20	0%	20	18%	50	46	12,300	31%	3	2%	165	144
Minnesota	2,040	8%	10	3%	34	41	7,200	18%	7	8%	157	142
Missouri	900	3%	16	9%	45	51	2,800	7%	4	4%	105	120
	2,960	11%	12	5%	37	44	22,300	56%	4	4%	155	141

Source: Various USDA commodity reports.

[1] The term 'abandon' is used to signify that the crop was not harvested for grain as intended. Wheat producers typically let cattle forage on abandoned wheat acreage, and corn producers harvest abandoned corn as silage for livestock.

[2] Historic abandon rate and historic yield rate based on five-year averages 1997 through 2001.

Many crop producers in Kansas, Nebraska, and the **Dakotas** also were affected adversely by drought conditions. Persistent drought contributed to declining production, particularly in areas without irrigation. Producers of wheat and corn were forced to abandon historically high acreage because of crop failures, and yields on harvested acres were low (see Table 1). Reduced crop yields resulted in rising commodity prices, which minimized some of the production loss, but these price increases were offset somewhat by a decline in government subsidies.

Because of extremely low commodity prices, government subsidies to the Region's farmers averaged $8.7 billion, or 96 percent of net farm income, from 1999 through 2001. However, when commodity prices improved in 2002, rising above target prices established in the 2002 Farm Bill, farmers received significantly lower subsidies. The level of government payments to the Kansas City Region declined to $3.2 billion, or 62 percent of net farm income, in 2002. No consensus exists as to whether higher commodity prices helped increase net farm income for successful producers during 2002. A study conducted by the ***Food and Agricultural Policy Research Institute*** suggests that, in the aggregate, the loss of subsidies can outweigh the benefits of moderate gains in commodity prices.[2] Farmers who experienced low yields not only benefited little from higher commodity prices, but also received less government assistance. As for the cattle industry, the 2002 Farm Bill does not include subsidies for cattle farmers, and producers received only $250 million in assistance as part of the disaster bill enacted in 2003.[3]

When government payments are excluded, the Region's net farm income was $2 billion in 2002, double the 2001 figure and the third consecutive increase since 1999. However, when government payments are included, net farm income declined by almost half, from $9 billion in 2001 to $5.2 billion in 2002.

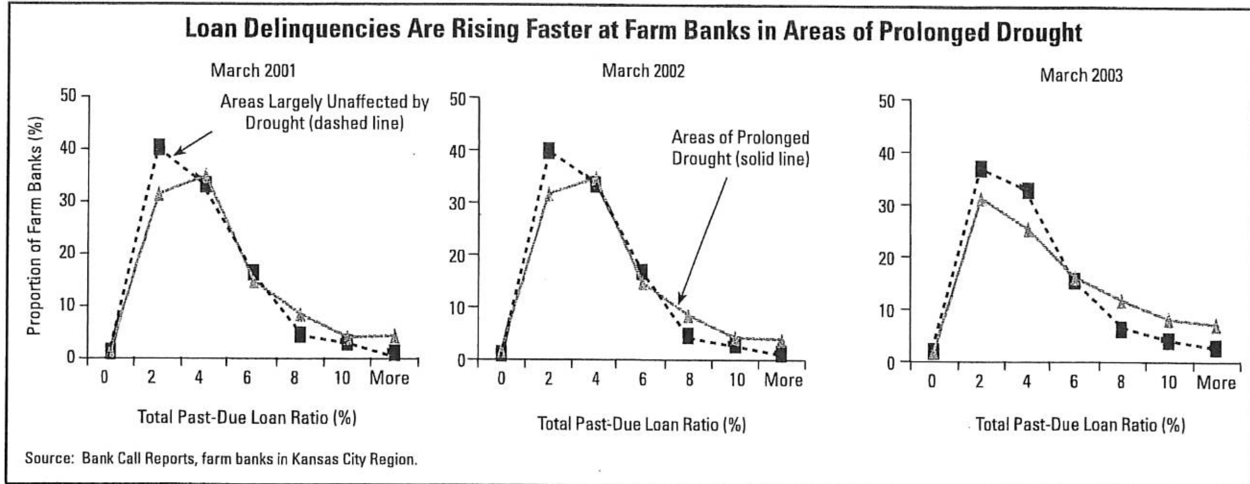
Farm Bank Loan Portfolios Are Now Showing the Effects of the Drought

A considerable lag typically exists between the time serious problems occur in the agricultural industry and the time farm banks report weakening credit quality, in large part because of "carryover debt." Farm revenues generally are volatile, as they are subject to swings in production levels and prices. Therefore, it is not uncommon for borrowers to carry over operating loans to the next season, pledging equity in real estate and

[2] See Patrick Westhoff, "Income and Risk in Today's Agriculture," presentation to the National Agricultural Credit Committee meeting, Chicago, Illinois, September 2003, http://www.fapri.missouri.edu/FAPRI_Publications.html.

[3] Cattle producers are eligible for an aggregate $250 million in assistance under the Livestock Assistance Program authorized by the Agricultural Assistance Act of 2003.

Chart 1



Source: Bank Call Reports, farm banks in Kansas City Region.

machinery to shore up collateral margins. Federal Deposit Insurance Corporation (FDIC) examiners began observing rising levels of carryover debt among borrowers in the Kansas City Region in 1998 as a result of declining commodity prices. Between 1998 and 2002, one-quarter to one-half of FDIC examinations of farm banks indicated increasing levels of carryover debt; a much smaller percentage reported declining levels of carryover debt.[4]

Many agricultural borrowers in the Kansas City Region have been under stress since 1999, when prices for corn, wheat, and soybeans declined substantially. Many farm operations would have failed had it not been for the high government assistance to farmers. Although the payments prevented widespread farm failures, net farm income remained under pressure, and farm banks continued to work out repayment arrangements with agricultural borrowers.

Delinquency data are beginning to show some deterioration in credit quality. Farm banks based in areas of persistent drought (shaded areas in Map 2) have reported higher delinquency levels than those based in areas largely unaffected by persistent drought (unshaded areas in Map 2) (see Chart 1). The share of farm banks in persistent drought areas with delinquency ratios of at least 8 percent was 17.1 percent in 2001and 16.9 percent in 2002, nearly twice that of farm banks in areas largely unaffected by persistent drought. Although farm banks in both areas reported rising delinquency levels in March 2003, the increase was larger for those based in areas characterized by persistent drought. The difference was even greater among farm banks based in the dark-shaded counties of Map 2, areas under the most persistent drought conditions. An extremely high 41 percent of those institutions reported loan delinquency ratios of at least 8 percent as of March 31, 2003.

The greater increase in loan delinquencies among farm banks based in the hardest-hit areas (some of the most rural and agriculturally dependent parts of the Region) has occurred not only because these areas have suffered from repeated years of poor yields, but because these banks tend to hold higher concentrations of direct agricultural credits. In March 2003, farm banks based in dark-shaded areas of Map 2 reported a median agricultural production loan concentration of 40 percent, versus 28 percent for farm banks in lightly shaded areas and 25 percent for farm banks in nonshaded areas. As a result, the effects of poor production are exacerbated among farm banks based in drought-persistent areas.

Owing to their reliance on the agricultural sector, farm banks in the persistent drought areas find it difficult to shift concentrations away from agricultural lending. Farm banks in less rural areas have been more successful at diversifying exposures and have scaled back concentrations in agricultural loans. Moreover, although all farm banks have reported rising exposures in loans secured by farmland, this is occurring for different reasons. Banks based in the less rural areas could be experiencing increased demand for hobby farms and rural estate living. However, among banks based in the more rural areas, the increase in loans

[4] *Reports on Underwriting Practices, Kansas City Region.* These reports aggregate safety and soundness loan underwriting survey results in six-month periods ending March 31 and September 30.

2-8

secured by farmland is probably attributable to increases in carryover debt.

The Agricultural Outlook Remains Mixed

Prospects for many cattle producers are much improved over 2002. Smaller herds and lower levels of imports from Canada have contributed to higher prices.[5] Revenues of cattle producers are expected to grow overall; however, producers who were forced to liquidate herds will face higher prices to rebuild them.

The outlook for crop production is mixed. Winter wheat production has increased, and prices are up as well. Estimates for spring wheat production also are favorable. However, the late summer drought is expected to have an adverse effect on corn and soybean yields. Although production should improve from 2002 levels, it could remain well below historical averages in the most drought-stricken areas.

Not All the News Is Bad for the Region's Farm Banks

Credit quality appears to be eroding somewhat among the Region's farm banks, particularly those in the areas hit hardest by drought. However, there is positive news.

Capital protection and loan loss reserve coverage remain high among the Region's farm banks, even in areas significantly hurt by the drought. Farm banks headquartered in areas of the most persistent drought reported a median leverage capital ratio of 10.0 percent as of June 30, 2003, down slightly from recent years, but well above levels during the 1980s agricultural crisis and the 1988 drought. Moreover, these banks reported a historically high ratio of median loan loss reserves to total loans of 1.8 percent. In addition, farm real estate prices remain stable or have risen in many areas, providing ongoing collateral protection.

Still, the effects of drought remain a critical issue for farm banks headquartered in the Kansas City Region. A high 18.4 percent of farm banks based in the areas of most persistent drought are rated 3, 4, or 5 for asset quality, compared with 10.1 percent of farm banks in areas largely unaffected by persistent drought.

The FDIC continues to monitor drought conditions closely, engaging in outreach activities with bankers, other regulators, and trade groups, and, as needed updating bank management on farm lending best practices. For example, FDIC staff from the Kansas City Region hosted roundtable discussions on agricultural trends and conditions in Grand Island, Nebraska, and Hays, Kansas, on May 21 and May 22, 2003, respectively. These outreach events helped the Region develop a best practices document entitled, "Effective Strategies for Managing Agricultural Credit Risk." The Region provided copies of this document to all state nonmember banks located in the drought areas of Nebraska and western Kansas.[6]

Richard D. Cofer, Jr.
Senior Financial Analyst

[5] In May 2003, Canada reported an incident of bovine spongiform encephalopathy (BSE, or "mad cow disease"). In response, the United States, the primary importer of Canadian cattle, temporarily banned Canadian cattle imports. The United States imported 1.7 million head of cattle from Canada in 2002. Source: *USDA Backgrounder*, report updated July 10, 2003. http://www.usda.gov/news/releases/2003/05/bg0166.html.

[6] Interested parties may request a copy of this document by submitting an e-mail to Assistant Regional Director Pamela Farwig at PFarwig@FDIC.gov.

2-9

COMPARISON OF THE OCC'S PREEMPTION RULES WITH THE OTS'S AND NCUA'S CURRENT RULES JANUARY 7, 2004

Types of State Laws Generally Preempted	OCC Rules	OTS Current Rules	NCUA Current Rules
Abandoned and dormant accounts (deposit-taking)	✓	✓	✓
Aggregate amount of funds that may be lent on the security of real estate	✓*		
Checking/share accounts (deposit-taking)	✓	✓	✓
Covenants and restrictions necessary to qualify a leasehold as security property for a real estate loan	✓*		
Access to, and use of, credit reports	✓	✓	
Terms of credit	✓*	✓	✓
Creditor's ability to require or obtain insurance of collateral or other risk mitigants/credit enhancements	✓	✓	
Due-on-sale clauses	✓	✓	✓
Escrow, impound, and similar accounts	✓	✓	
Funds availability (deposit-taking)	✓	✓	
Interest rates	✓**	✓	✓
Fees	✓***	✓	✓
Licensing, registration, filings and reports	✓	✓	
Loan-to-value ratios	✓*	✓	✓
Mandated statements and disclosure requirements	✓	✓	✓
Mortgage origination, processing and servicing	✓	✓	
Disbursements and repayments	✓*	✓	✓
Savings account orders of withdrawal (deposit-taking)	✓	✓	
Security property, including leaseholds	✓	✓	✓
Special purpose saving services (deposit-taking)	✓	✓	

* Already preempted by the OCC's existing real estate lending regulation at 12 C.F.R. Part 34.

** National banks' authority to charge interest is established by 12 U.S.C. § 85, and the OCC's existing regulation at 12 C.F.R. § 7.4001.

*** National banks' authority to charge fees is already addressed by the OCC's existing regulations at 12 C.F.R. § 7.4002.

Types of State Laws Generally <u>NOT</u> Preempted	OCC Rules	OTS Current Rules	NCUA Current Rules
Contracts	✓	✓	
Commercial		✓	
Torts	✓	✓	
Criminal law	✓	✓	
Homestead laws specified by Federal statute	✓	✓	
Debt collection	✓		
Acquisition and transfer of real property	✓	✓	✓
Taxation	✓		
Zoning	✓		
Collections costs and attorneys' fees			✓
Plain language requirements			✓
Default conditions			✓
Insurance			✓
Incidental effect only	✓	✓	

lending decisions on repayment capacity.

practices in individual cases without regard to a rule defining the

not wait for a definition of specific practices before punishing

the first to codify a requirement that loans be based on repay-

expected that the collateral will b used to repay the debt."

Preemption

Continued from page 1

sumers from deceptive or illegal conduct engaged in by national banks in New York."

The OCC preemption rule articulated a new standard in claiming authority to preempt state laws that "obstruct, impair, or condition a national bank's exercise of its lending, deposit-taking, or other powers granted to it under federal law."

In materials accompanying the rule, it said the new standard was "a distillation of the many preemption standards applied by the Supreme Court over the years" and that it "captures the essence of the tests" used by the court.

"We have tried to codify the principles that have been articulated by the courts over the years, and to do it in a regulation that will give banks predictability and the ability to plan their affairs with more certainty than they've had before," Comptroller of the Currency John D. Hawke Jr. said in an interview. "In recent years we have seen a proliferation of state and local laws that purport to apply to national banks ... and they seem to come cascading out of these legislatures. We thought it was important to define the types of laws that would normally apply to national banks, and the types that would not."

Many, though not all, of those laws have been crafted to prevent predatory lending, and the OCC's decision to sweep aside state laws that offered protections hit resistance from consumer groups.

"They are selling consumers a pig in a poke," said Travis Plunkett, the legislative director for the Consumer Federation of America. "They are asking us to accept on blind faith they will transform themselves into a consumer protection agency while at the same time handcuffing the states. There is not a lot to be happy about."

Supporters of state-bank charters portrayed the OCC's efforts as a blow to the dual banking system.

"The audacity and arrogance of the comptroller's actions are pretty astounding," said John Ryan, the executive vice president for policy at the Conference of State Bank Supervisors. "A regulatory agency has ignored the concerns of the U.S. Congress, state legislatures, the nation's governors, the nation's attorneys general. ... There's really something wrong in the democratic process when all those concerns can be completely ignored and not addressed and calls for oversight dismissed — and done during a congressional recess."

The Comptroller's Office responded to such comments in its other rule — which is an essential complement to the agency's strategy because it prevents states from examining, or enforcing laws against, national banks.

It said that complaining about the threat to the dual banking system "mischaracterizes the essence of the dual banking system. Differences in national and state bank powers and in the supervision and regulation of national and state banks are not inconsistent with the dual banking system; rather they are the defining characteristics of it."

But Mr. Ryan, noting that all 50 state attorneys general had objected to broad preemptions, said: "They don't do those things without the intention of following through. You will probably have a very collaborative effort; this is not just the New York AG on his own."

Mr. Spitzer has hinted that he would sue to protect state laws in the interest of consumer protection. He was unqualified in his disgust with the rules.

"It is bad public policy and it demonstrates an utter disregard for the dual banking system that has existed in this country for over 100 years," his news release said. "The OCC's actions are a thinly disguised attempt to shield national banks from important state consumer protection laws, and to entice state-chartered banks to obtain a national charter and seek the immunity that the OCC is offering."

The next chapter could also unfold in Congress, given that federal lawmakers in both the House and the Senate had sent letters to the comptroller asking him to delay a preemption rule.

"The laws of 50 states should not be preempted by a federal regulator without public debate," Rep. Sue Kelly, R-N.Y., the vice chairman of the House Financial Services Committee, said in a news release. "This is a significant change to banking regulation that requires the oversight and investigation of Congress to ensure that we are protecting all Americans. I am concerned that exclusive federal regulatory oversight of these entities will result in lesser, not greater, protections for consumers."

Mr. Hawke claimed the opposite. Preemption has "turned into a consumer/anti-consumer type of confrontation, and I think that really misses the point," he said. "There is a growing awareness ... that uniform national rules are generally in the consumer's interest, because they reduce the cost of extending credit. A nationwide credit card lender, for example, that has to comply with the varying laws of 50 states and innumerable local jurisdictions takes on huge cost burdens."

The Consumer Bankers Association and the American Bankers Association both voiced strong support for the OCC's moves. The Independent Community Bankers of America looked to the middle ground, saying that it in the past it supported the regulator's preemption decisions but that it would have preferred the historical approach of case-by-case decisions to the assertion of blanket authority. ■

Claiming Turf

Where the OCC says its authority over national banks does or does not preempt state or local powers

PREEMPTED

Real estate lending

- Amount that may be lent upon security of real estate
- Processing, originating, servicing mortgages
- Due-on-sale clauses
- Covenants to qualify leasehold as security for real estate loan

All lending

- Licensing, registration, filings, or reports by creditors
- Requiring insurance for collateral or other credit enhancements
- Loan-to-value ratios
- Terms of credit
- Escrow and similar accounts
- Security property, including leaseholds
- Access to and use of credit reports
- Disclosure, and advertising
- Disbursements and repayments
- Interest rates on loans

Deposit taking

- Abandoned and dormant accounts
- Checking accounts
- Disclosure requirements
- Funds availability
- Saving account orders of withdrawal
- State licensing or registration requirements
- Special purpose savings services

NOT PREEMPTED

- Contracts and torts
- Criminal law
- Debt collection
- Acquisition and transfer of property
- Taxation
- Zoning
- Homestead laws

Source: OCC

"Talking Points" to the OCC Preemption Proposal

1. **OCC preemption threatens to undermine the unique American dual banking system, which promotes the strongest banking market in the world and provides critical fuel to the US economy.**
   - The dual banking system is critical to the strength of the US banking market.
   - Unlike Canada, Europe and other developed countries, the dual banking system has guided the development of a decentralized banking market where banks of widely different sizes efficiently disperse credit to all sectors of the U.S. economy to serve diverse needs of local, regional, and national markets.
   - By waving the banner of wholesale preemption of state laws and state oversight, the OCC proposed rule threatens to undermine the integrity of the dual banking system and moves towards a centralized, European-style regulatory model that would severely weaken the ability of states to respond to local economic needs.
2. **The OCC has identified federal preemption as a tool to offer national banks a major advantage over state banks and to increase the attractiveness of the national charter**
   - OCC preemption serves the interests of the largest multi-state national banks, which pay the greatest assessments to the OCC and fund a disproportionate percentage of the OCC's operations.
   - Banking industry consolidation in recent years has dramatically reduced the number of banks regulated by the OCC, which has rendered the agency increasingly dependent for its funding on a handful of large banks.
3. **The proposed rule would radically rewrite the time honored standard for federal preemption as interpreted by the courts and intended by Congress.**
   - The courts have consistently required national banks to comply with state laws except where they "prevent or significantly interfere" with a national bank.
   - The OCC proposed rule would arbitrarily rewrite the standard to preempt virtually **all** state banking laws for national banks and their operating subsidiaries.
4. **State bank regulators and law enforcement officials have a long history of protecting consumers – often through regulatory programs and laws that would be preempted by the OCC's recent proposals.**
   - This sweeping proposal reaches beyond preempting state laws for national banks. It also bars the states from licensing, examining and otherwise regulating state-chartered corporations that are subsidiaries of national banks. This shields non-banking firms like title companies, finance companies, leasing companies, securities firms and mortgage brokerages that are owned by national banks from state licensing and examination requirements that ensure professional conduct and protect consumers.
   - State regulators return millions to consumers after investigations identify bad actors. In 2002, state banking agencies returned $500 million to consumers after

2-13

investigations uncovered fraud and deceptive practices. So far in 2003, 27 state banking agencies have returned $18 million to consumers due to fraud and misconduct. **(New Insert)**

- Removing the resources of state regulators from the oversight of non bank subsidiaries, with no comparable oversight plan described by the OCC that would fill the vacuum is a lose/lose for consumers.

5. **No case has been made to dramatically expand the standards of preemption of the National Bank Act as interpreted by the OCC.**

- Existing and long standing standards that characterize the dual banking system have served America's economy well for more than one hundred years.

- America's 9,000+ banks have earned record earnings even during the recent economic slowdown, with the most recent quarter reaching a record high of $30 billion.

- The result would be significant erosion of the dual banking system and increased risk of unanticipated supervisory problems.

6. **Concentrating regulatory control at the OCC ensures that regulatory and consumer protection problems that emerge will be solved with a one-size fits all approach.**

- The OCC proposed rule would concentrate regulatory power in the hands of a single individual—the Comptroller—with virtually no direct congressional oversight –until problems or scandals emerge.

- Problems or scandals that may emerge in national banks or their subs in one or a few states will then be solved, not by legislation crafted to correct the problems in the effected states, but by the Congress in a manner that generally applies new standards, with costly compliance price tags, to **all** depository institutions.

- One needs to look no further than the paperwork required for a mortgage settlement to see the results of a regulatory solution that applies to <u>all</u> lenders that was enacted due to the misconduct of relatively few bad actors. **(New Insert)**

- Such an imbalance threatens the viability of the states' historic role in serving as laboratories for innovation in new products and consumer protection, as well as a safety valve against the imposition of out-dated or rigid regulatory control.

State bank supervisors support the ability of banks and their subsidiaries to operate efficiently in multiple states. Our position on the Fair Credit Reporting Act preemption that provides national standards for credit reporting and facilitates the flow of credit is a recent demonstration. However, operational efficiency does not require the rampant, reckless preemption proposed by the OCC. The potential impact of the OCC's proposal on the banking system and consumers is enormous. For that reason, the OCC proposal should be withdrawn until an investigation of its potential effects is carefully reviewed.

January 12, 2004 **OCC Adopts Pre-emption, Visitorial Rules**

Ignoring the objections of congressional and state leaders, the Office of the Comptroller of the Currency on Jan. 7 adopted two final rules on the pre-emption of state laws and the agency's visitorial authority. The Conference of State Bank Supervisors said it was stunned that OCC would adopt the far-reaching pre-emption proposal in the face of widespread opposition from members of Congress, state banking and financial regulators and many others. "The arrogance and audacity of the Comptroller's actions are astounding," CSBS said. The association said it is asking both houses of Congress to address the Comptroller's actions by convening oversight hearings as soon as the Congress reconvenes later this month. Both rules go into effect 30 days after they are published in the Federal Register. The pre-emption rule says that state laws that "obstruct, impair or condition a national bank's powers in the areas of lending, deposit taking and other national bank operations are not applicable to national banks." The other rule gives OCC's exclusive visitorial authority for national bank activities authorized under federal law, except areas that have nothing to do with the business of banking, such as environmental laws and fire codes.

Comptroller of the Currency
Administrator of National Banks

PUBLIC AFFAIRS

September 9, 2003

Remarks by John D. Hawke, Jr.
Comptroller of the Currency

Before Women in Housing and Finance

Washington, D.C.

I'm delighted to appear before this distinguished group once again. This is my third outing with Women in Housing and Finance as Comptroller of the Currency. In my past visits with you I have spoken about the dual banking system and preemption. And just so you won't think I am losing my focus, I want to speak today about – preemption and the dual banking system.

In my last talk, about a year and a half ago, I detailed the historical roots of preemption, reminding that this is a doctrine that has its origins in the Supremacy Clause of the Constitution and the landmark 1819 Supreme Court decision in *M'Culloch* v. *Maryland.* The principle that the states cannot constitutionally restrict the powers of entities created under federal law has been a bedrock precept of federalism for more than 180 years. It has had special importance for the national banking system – a system that was created by Congress to advance the **national** interest in a uniform and nationwide system of federally chartered financial institutions.

The federal courts have consistently applied this principle over the years, and a wide variety of state laws have been held constitutionally inapplicable to national banks. Indeed, so clearly established is this principle that when we recently issued an order preempting the Georgia anti-predatory lending law, the Georgia Attorney General declined the opportunity to take us to court. The State AG informed the State Banking Commissioner, after conducting a thorough review of the precedents, that "state regulation of national banks has been severely limited by federal law" and "so long as the OCC's legal conclusions are related to the banking activities of national banks [its] decision will be difficult to challenge successfully." The AG was absolutely correct in this judgment. In fact, the last time an OCC position on preemption was rejected by a federal court was the Court of Appeals decision in the *Barnett* case—which, of course, was reversed by the Supreme Court of the United States and subsequently reaffirmed by Congress in the Gramm-Leach-Bliley Act.

Against this background, the recent clamor we have been hearing about OCC actions on national bank preemption is really quite surprising – surprising not only because of its utter disregard of history and precedent, but because of its unusually intemperate tone. For example, one State Attorney General has attacked the OCC for sticking "a dagger in the heart of federalism." Another, with a proclivity for making headlines, has charged us with "unrelenting efforts . . . to undermine the states' ability to protect their citizens." A consumer advocate has accused the OCC of being "out of control" – a particularly startling charge in light of the stream of recent federal court decisions upholding our positions. And even my good friends at the Conference of State Bank Supervisors (CSBS) have accused us of hatching a dark conspiracy to create "a whole new financial regulatory structure without any democratic debate or process."

It's easy to dismiss these extravagant and meritless statements as a kind of constituent posturing. But the simple fact is that OCC has been doing nothing new. We are **not**

2-16

engaged in a campaign to obliterate federalism or to create a new financial regulatory structure, and we have just as much interest in the protection of consumers as any State AG. Far from being "out of control," we are fully subject to judicial review, and those unhappy with our decisions seem to have no hesitation in taking us to court – where our record of success has been overwhelming. We have simply been applying long settled – and constantly reinforced – principles of federalism, and we have been doing so with great regard for the interests of consumers.

What **is** truly surprising – and worthy of serious note — is that it has been the **states** that have persistently ignored the mandates of federalism. Notwithstanding the fact that "state regulation of national banks has been severely limited by federal law," as the Georgia AG forthrightly recognized, we see state after state passing laws intended to limit the powers and regulate the business of national banks. These include such laws as those that would regulate the fees that national banks may charge, the services they must provide, the attributes of various kinds of loans they make, their ability to act as fiduciaries, and even their right to do business in the state. We routinely prevail when these laws are challenged on preemption grounds.

We also see efforts by State Attorneys General to assert enforcement authority directly against national banks — notwithstanding two very clear federal statutes vesting in the OCC exclusive visitorial powers with respect to national banks. When we met with a group of State AGs earlier this year to discuss their ambitions in this regard, they asserted that because of their nationwide networking ability they could be more effective than the OCC in bringing national banks to heel – a proposition with which, as you might expect, we vigorously disagreed.

In truth, the attack on the "heart of federalism" is coming from the states, not from us.

I think it is fair to ask what is going on at the state level. Why are the states now becoming so aggressive in seeking to assert authority over federally chartered institutions? Why are they now trying to undermine the distinctions between state and national banks that go to the heart of the dual banking system?

One obvious answer is that there is enormous political appeal in doing so. For example, no one likes to pay a fee for the use of an ATM, so a law prohibiting banks from charging fees for the use of their ATMs by individuals who are not their customers is undoubtedly going to be very popular — never mind that the predictable result of such laws is likely to be that banks will shut off access to their ATMs by non-customers. And what better pose for a crusading enforcer aspiring to greater glory than to be seen as a basher of big banks.

Of course, it is not that state legislatures or AGs are unaware of the underlying principles or precedents. Many of the state laws that purport to apply to national banks are drafted with express "preemption parity" provisions that operate to make the law inapplicable to state banks if it is preempted for national banks. The Georgia anti-predatory lending law had such a provision, as have others, such as the ATM surcharge laws that were the subject of earlier litigation. The inclusion of these provisions reflects a clear awareness by these legislatures that by extending coverage to federally chartered institutions, preemption is likely – that they are walking on thin legal ice. But by this means state lawmakers can effectively cover all the bases: they satisfy consumer interests by passing broadly applicable, politically popular laws, while regarding the interests of local state chartered banks by automatically rendering the law inapplicable to them if it should be held inapplicable to national banks.

One would wish for a better-informed understanding of the law on the part of State AGs. Yet the law on visitorial powers could not be clearer. Since the earliest days of the national banking system, federal law has provided that no national bank shall be subject to any visitorial powers except as authorized by federal law, vested in the courts of justice or directed by Congress – and Congress has never vested such powers in State law enforcement officials. Indeed, in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, Congress explicitly addressed the question of the applicability of host state consumer protection laws to branches of national banks that are established interstate — laws regarding community reinvestment, consumer protection, fair lending, and interstate branching. It said that such state laws apply to such national banks branches in the state, **except** when they are preempted by federal law, and it further provided that the enforcement against a national bank of any such state law that was **not** preempted was the exclusive domain of the OCC. Current efforts to enforce such state laws against national banks simply fly in the face of Riegle – Neal.

Of course, the OCC shares a common interest with state law enforcement authorities in the protection of customers of national banks, and we would hope that cooperation, rather than competition, would characterize our relationships. To this end we have adopted special procedures at the OCC to handle referrals of consumer complaints from State AGs and state banking departments. I have personally sent letters to the State AGs describing the new processes we have put in place in order to work cooperatively **with** them. I have also invited the State AGs to enter into a cooperative arrangement with the OCC that would be embodied in a memorandum of understanding setting up a framework for addressing consumer protection issues relating to national banks. I regret to say that to date we have had no response to our invitation, only rhetoric. If the interest of consumers **were** paramount, as they should be, one might expect that a proposal such the one we have made would be embraced rather than ignored.

I should also point out that, at least in the area of predatory lending, which is where most of the current controversy seems to focus, the state AGs themselves have recognized that federally regulated banks are not the problem. In an **amicus** brief filed recently in connection with litigation over an Office of Thrift Supervision (OTS) preemption regulation, 22 State AGs (including the two I quoted earlier) stated unequivocally that, based on their investigations and enforcement actions, "predatory lending abuses are largely confined to the subprime mortgage lending market and to non-depository institutions," and "not banks or direct bank subsidiaries."

In an earlier letter to the OTS, 46 State AGs stated: "In the experience of the state Attorneys General, predatory lending is perpetrated primarily by non-depository lenders and mortgage brokers," which "unlike depository institutions, are subject to little regulation by . . . federal agencies."

In light of these statements, the charge that OCC preemption actions constitute an "unrelenting effort" to undermine state consumer protections has to be seen for what it is – inflated and hollow rhetoric.

Despite the hyperbole about undermining state consumer protections, any fair examination of the record should make clear that the OCC can and will move vigorously to remedy abuses. We have a world-class, best-in-the-business Customer Assistance Group that last year helped to process more than 79,000 cases. We have taken significant enforcement actions to require restitution to consumers who have been injured by abusive practices. We have defeated the strategy of payday lenders to

2-18

use national banks as a cover for evading state consumer protection laws. And we have issued the most comprehensive supervisory guidance ever issued by any federal banking agency – and, I suspect, any state agency – defining and describing predatory lending, warning banks about the supervisory consequences of engaging in such abusive practices, and stating that if we find predatory practices in a national bank it will reflect adversely on their CRA ratings – something no one else has ever done.

To be fair to CSBS, I suspect their recent remarks were addressed not so much to preemption generally – the principles with which CSBS has long been familiar — but more to our position that national bank preemption extends to operating subsidiaries of national banks. It was more than two years ago that the OCC codified our position on this issue in a rule, and since that time we have had two federal court decisions sustaining our position. Since operating subsidiaries have long been recognized as the corporate equivalent of divisions of the bank itself, and since they can perform only activities eligible for the bank itself to perform, it is exceedingly difficult to see what the rationale is for treating them differently from the bank for preemption purposes, and our regulation simply reflects this principle. While we may have a difference of view on this issue, I think it is rather excessive to charge that we are engaged in an effort to create "a whole new financial regulatory structure without any democratic debate or process."

This rising chorus of complaints from the states, and the increasingly aggressive posture of state legislatures and enforcement authorities with regard to national banks, gives me another cause for concern, because I believe they may mask serious underlying problems in the dual banking system. Indeed, these problems could prevent the dual system from functioning in the future in the essential role it has played in our economy over the past 140 years.

The driving dynamic of dualism, of course, is freedom of choice. Implicit in choice is the existence of meaningful differences. In times past, there have been significant differences between the national and state charters – differences reflecting supervisory philosophy, supervisory responsiveness, examination quality, and the scope of permissible activities. But today truly meaningful differences are increasingly difficult to find, and the **states** are largely responsible for this.

Consider the question of permissible powers and activities. State supervisors pride themselves on being laboratories of innovation. And, indeed, many staples of banking practice, from checking and NOW accounts to mortgage loans, were first introduced by state-chartered institutions. But where has the innovation been in recent years? Indeed, I think the most significant of the **recent** innovations coming out of state banking departments has been the continuing effort to afford state banks the same opportunities as national banks. For example, 47 of the 50 states have passed some form of "wild card" law, automatically authorizing for state banks many of the powers and activities permitted for national banks.

This same motivation – emulation rather than innovation — has been present in the interstate branching context, where state supervisors have worked creatively to try to secure for state banks some of the natural advantages that accrue to national banks. Recognizing that national banks would likely be able to operate under a single set of rules when branching interstate, state authorities obtained federal "parity" legislation providing that host state laws would apply to local branches of out-of-state state banks only to the same extent they would apply to an out-of-state national bank.

2-19

And recognizing that state banks branching interstate might be faced with the need to deal with multiple state regulators, while national banks answered only to the OCC, state supervisors adopted a protocol under which they agreed that the home state supervisor would have the basic responsibility for supervising the interstate branches of their banks. These were creative steps that addressed the need to maintain competitive equity, but they did not reflect the spirit of innovation of which state supervisors were so proud. In the face of some recent indications that CSBS's interstate protocol might be feeling some internal stresses, as some individual states have taken different views of their own interests, it is striking that state supervisors are now seeking robust **federal** legislation that would define the respective powers and responsibilities of home- and host-state supervisors with respect to the supervision of state banks branching interstate. What are we to say about federalism and the dual banking system in a world of "wild cards" and parity laws, a world in which state authorities have to resort to **federal** laws to sort out their respective **state** jurisdiction?

More to the point, what do the state systems offer in the way of real charter choice to financial institutions in a world in which the objective seems to be to blur any charter distinctions that hold any competitive significance? What happened to state systems as "laboratories of innovation"?

Earlier this summer, a CSBS witness stated, in Congressional testimony supporting continuing preemption of state laws under the Fair Credit Reporting Act (it seems federal preemption is not **always** bad), that "state bank supervisors are strong advocates for a system that allows the states to serve as laboratories for innovation and change, not only in bank powers, but also in the area of consumer protections." But where has innovation in consumer protection been in Georgia and those other states that have adopted parity preemption provisions scuttling laws applicable to state banks that happen to be preempted for national banks? These laws could have been left in place for state banks, and an appeal might have been made to local consumers that customers of state banks had different, arguably **better,** protections than those of national banks, thus providing a competitive advantage to state banks. Rather than bucking almost two centuries of federal law curtailing the authority of the states to limit the powers of federally chartered institutions, why are the states not addressing their attention to their **own** institutions?

The answer is clear, of course: the overwhelming value for state banks and their supervisors is competitive parity, not competitive distinction, and they want to blunt any competitive advantage that national banks may have. They are willing to be "innovative" when it gives **them** competitive advantages, but not when it subjects them to burdens that they can't impose on their national bank competitors.

Yet another reason the dual banking system is under stress is because the states are under stress themselves. After a decade of budget surpluses, the states started running deficits in 2001, and further deterioration took place in 2002 and 2003. Some truly breathtaking shortfalls have been announced for the current budget cycle: California, $38 billion, with headline-making political implications; New York, $12 billion; Texas, $10 billion. One governor has called the current situation the "toughest times for states since World War II."

These developments not only make me wonder why state officials have ignored our offers to work with them to address consumer complaints and alleged abuses, but they also have serious implications for state bank supervision. In 2002, Maryland declared a moratorium on *de novo* charter applications, since lifted, because it didn't have the staff to process them — or sufficient numbers of examiners to oversee the banks that

2-90

would be organized if those applications were approved. We are told that examiners in the Florida State Banking Department have seen their pay frozen for two years in a row, and that they're facing the possibility of a third. In Illinois, the governor's proposed FY 2004 budget called for a 100 percent increase in state bank assessments, and a reduction in bank examiner positions. Those modest hardships seem to have been averted for now, but it took a full-scale mobilization of state bankers to do it.

State bank supervision is also particularly vulnerable to structural changes in the industry. Over the past decade, the number of banks in the U.S. has dropped by roughly a third. With that trend has come increased asset concentration – and growing dependence on a dwindling number of assessment-paying institutions.

In fully half the states, a single bank now accounts for 25 percent or more of the asset base on which the state bank supervisor imposes the assessments needed to fund its office. In New York, one state bank accounts for nearly two-thirds of the assets under state supervision. In Georgia, one bank accounts for 70 percent of assets. In Rhode Island, it's 76 percent. Needless to say, the loss of a large bank in such a highly concentrated state could have a crippling effect on a state supervisor's ability to provide quality supervision.

These perceptions are reinforced when state supervisors actively proselytize for charters. We have a growing collection of soliciting materials used by state supervisors in recent years in their direct merchandising efforts aimed at inducing national banks to convert to state charter, and these efforts seem to get bolder by the minute. Notably absent from these materials is evidence of the vaunted "innovation" that state supervisors are so fond of extolling. Rather, the pitches are generally based on two arguments: One, we are more "accessible", and two, we are cheaper.

I suppose we all have our own ideas about just what is intended to be conveyed by the "accessibility" pitch. Whatever may be intended, however, it is likely that some will read "more accessible" to mean "more compliant," and if that is so one must ask whether such promotion is consistent with the interests of systemic safety and soundness – let alone what kinds of banks and bank managers are likely to be attracted by this pitch.

As far as state supervision being "cheaper," I'm sure you have all heard me declaim about fee disparity, and I will not go into that subject again. Suffice it to say, state supervision is cheaper because the Federal Reserve and the FDIC subsidize the cost of state bank supervision to the tune of about $1 billion a year, while national banks pay the full cost of their supervision. In the final analysis, it is this subsidy, rather than "innovative" supervision, that is the defining characteristic of the state system.

But like any subsidy there is a danger that this one can become an addiction with state banking systems becoming dependent on it.

There are those who believe that absent this subsidy, in a world in which all banks bore the full costs of their supervision, there would be little reason to maintain a state charter, and, consequently, state banks would convert to national charter in droves. I don't share this view. While we have not seen a great deal of innovation in recent years, state banking is not so moribund that it needs a federal "fix" to stay alive. I think that the overwhelming number of banks make their charter choice based on qualitative considerations other than the costs of supervision. In my view, that explains why some 1900 community banks under $1 billion in size – those banks likely to be most sensitive to such cost factors – hold on to their national charters and value OCC supervision.

But if I am wrong – if eliminating fee disparity **would** encourage a wave of conversions – then we should all be concerned about it, and we should be exploring means to breathe new vitality into the state system, rather than keeping the system on federal life support. Obliterating distinctions that are the essence of the dual banking system, however, is not the solution.

One might conclude from my remarks today that I see prospects for the dual banking system itself to be somewhat uncertain. Yet it would be profoundly premature – as well as ahistorical – to suggest that its days are numbered. The dual banking system has confounded legions of doomsayers over the years. Its resilience is legendary. I believe it's possible to restore real qualitative value to state banking. I believe it's possible to make state supervisors a more dynamic presence in the supervision of their own institutions. I believe it's possible to revive real innovation in financial services. And I believe it's possible to restore real supervisory competition – based not on cost or subtle suggestions of leniency, but on competence, professionalism, and the kind of competition that benefits consumers and promotes safety and soundness. A system that seeks to obliterate differences rather than encourage the competitive benefits that come from innovation and real distinctions between service providers; a system that trumpets the value of duality while attacking the basic distinctions that lie at the heart of duality; a system that has developed a dependency on a shot in the arm from the federal government that dulls rather than promotes competition, is a system that has unfortunately lost touch with its roots, and with the true genius of our dual banking system.

FEDERAL RESERVE FINANCIAL SERVICES

Check 21 Legislative Overview

December 2003

The Check Clearing for the 21st Century Act (Check 21) is designed to foster innovation in the payments system and to enhance its efficiency by reducing some of the legal impediments to check truncation.

When Will Check 21 Take Effect?

Check 21 was signed into law on October 28, 2003, and will become effective on October 28, 2004.

Members of the Federal Reserve Board's staff are currently drafting the implementing regulation, including model disclosure language for depository institutions to use in notifying consumers of their rights under the law. The proposed regulation is expected to circulate for public comment in early 2004.

What Does Check 21 Authorize?

Check 21 authorizes the use of a new negotiable instrument called a substitute check. Check 21 provides the legal framework for the creation of substitute checks, which can be used in place of the original paper document, without an agreement in place with other financial institutions.

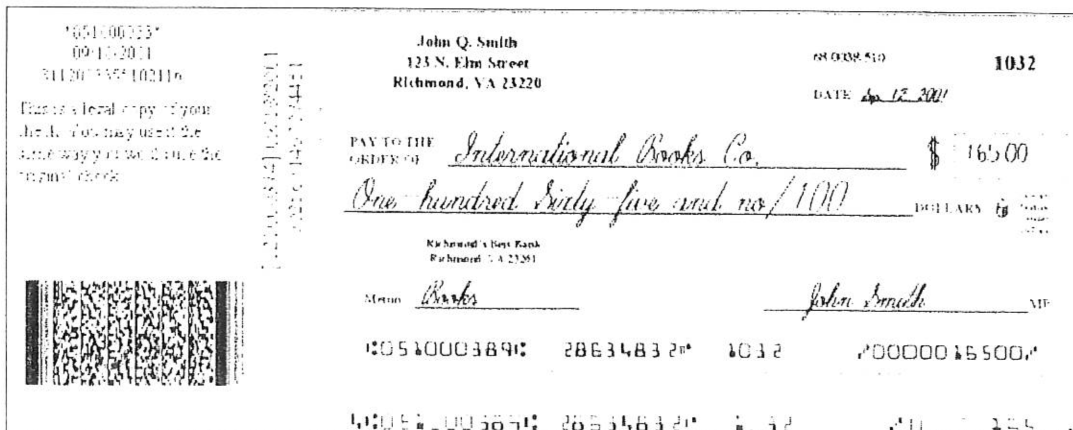
What is a Substitute Check?

The substitute check is a paper reproduction of the original check that must (1) contain an image of the front and back of the original check; (2) bear a MICR line containing all the information appearing on the MICR line of the original check; (3) conform, in paper stock, dimension, and otherwise, with generally applicable industry standards for substitute checks; and (4) be suitable for automated processing in the same manner as the original check.

A substitute check is the legal equivalent of the original check if it (1) accurately represents all the information on the front and back of the original check at the time the original was truncated and (2) bears a legend that states "This is a legal copy of your check. You can use it the same way you would use the original check."

What Does Check 21 Require?

- Check 21 requires financial institutions to accept a substitute check from a presenting institution and grant it equivalent status as the original check, if the substitute check meets prescribed requirements.
- Check 21 requires a reconverting bank to meet the warranties and indemnities enacted through the legislation and subsequent regulations.
- Check 21 requires financial institutions to provide education to individual consumers on substitute checks and consumer recredit rights.



Existing Consumer Protections

Substitute checks will be subject to all of the consumer protections granted under existing check law:

- UCC Articles 3 and 4: A bank may only charge a properly payable check to a customer's account, and must resolve claims timely in order to limit liability
- Federal Reserve Board's Regulation CC (Expedited Funds Availability Act)

Warranties and Indemnities Under Check 21

Check 21 also provides additional warranties and an indemnity protection. Under Check 21, a bank that transfers, presents, or returns a substitute check would:

- Warrant that the substitute check meets legal equivalence requirements
- Warrant that payment will not be requested based on a check that has already been presented (no double debit)
- Indemnify substitute check recipients for a loss that is due to the receipt of a substitute check instead of the original check

Q. What amount is indemnified?

A. The indemnity applies to any loss (up to the amount of the substitute check, interest and expenses) incurred by any recipient of a substitute check if that loss occurred due to the receipt of a substitute check instead of the original check. If the loss is due to a warranty breach, the indemnity could also include approximately caused damages.

Q. Are there limitations on indemnification amounts?

A. The bank is only liable for losses up to when the original or copy is provided, and the bank is entitled to a return of any funds in excess of that amount.

Q. Can the indemnifying bank recover damages from other parties?

A. Yes, the indemnifying bank can recover from other parties. The indemnified party must comply with all reasonable requests for assistance from an indemnifying bank. The comparative negligence provision reduces the indemnity in proportion to the amount of negligence or bad faith.

Expedited Recredit Provisions

Check 21 also includes expedited recredit provisions for consumers who suffer a loss because of a substitute check. A consumer may file a claim for expedited recredit within 40 days of receipt of the relevant statement or substitute check if certain conditions apply. Under the legislation, every bank must distribute to its customers an informational brochure, including descriptions of the substitute check process and consumer recredit rights.

For additional legislative information, visit the Federal Reserve Board site at http://www.federalreserve.gov/paymentsystems/truncation/default.html

For more information about the Federal Reserve's Check 21 plans, or to discuss opportunities that could help your institution prepare for this legislation, contact your Financial Services Account Executive. In addition, visit http://www.frbservices.org/Retail/Check21.html.

The Financial Services logo, "FedLine" and "FedImage" are registered or unregistered trademarks or service marks of the Federal Reserve Banks. A complete list of marks owned by the Federal Reserve Banks is available at www.frbservices.org.

Community Bankers Association Presentation for
Senate Financial Institutions and Insurance Committee
January 22, 2004

Directed By The Members We Serve

Madam Chairman and Members of the Committee,

Thank you for the opportunity to appear before you today. I am appreciative of the time and attention that you give to me to relate the story of community banking in Kansas from the perspective of the Community Bankers Association.

As you may know, I have been with the association office less than one year; however, during that time I have traveled the state and come to know the citizens of our state who are community bankers. It is their story that I share with you briefly today. Much of the information about community banking that I bring to you is recorded in a recent publication entitled, *The History of Community Banking in Kansas,* by Sue Anderson, published by the Donning Company. The association has placed a copy of this resource in the State Library here in the Capitol building.

In many states, banking laws were nearly non-existent until the late 1800's. In that regard, Kansas was no exception. The first banking laws for Kansas were enacted in 1891, but the subject of branch banking was not addressed. Branch banking was prohibited on the legal premise that "corporations may exercise only the power which the law expressly confers and do only the things which the law expressly sanctions." Therefore, since the law did not address the issue of bank branches, Kansas was established as a unit banking state. Every bank in business had an individual bank charter. In the early 1900's, branch banking was thought to be contrary to good public policy. It was perceived that the concept violated the basic principles of our government. It could possibly concentrate the credit of the nation and the power of money in the hands of a few. Between 1919 and 1929, more than twelve states passed legislation restricting or forbidding branch banking. In 1929, the Kansas legislature enacted a law prohibiting state-chartered banks from establishing branches. From that base, a unit banking system of independently owned community banks was built throughout Kansas.

Following World War II (1941-1945), Kansas experienced the beginning of what was to be a continuous migration of its citizens from the rural areas to the cities. As the cities grew from this influx of people, there came a perceived need to make it easier for bank customers to get in their cars, get to their banks located in the crowded center of the city, transact their business and return to their jobs. As a convenience to customers, motor bank windows were authorized as long as they were attached to the bank itself and were within nine hundred feet of the bank. In 1957, the legislature approved legislation to permit banks to establish an additional 'drive-in bank' without the requirement of being attached to the bank. It became legal for any bank to establish one auxiliary teller office as long as it was within twenty-six hundred (2,600) feet of the main bank. The name 'detached facilities' was used for these additional teller windows since branch banking was prohibited in Kansas.

Senate F I & I Committee
Meeting Date: Jan 22, 2004
Attachment No.: 3

3003 SW Van Buren, Suite A • Topeka, Kansas 66611-2224 • Phone 785.271.1404 • FAX 785.271.1508 • E-mail: info@cbak.com • www.cbak.com

Then came the year 1963. Legislation to both expand the geographic boundaries and increase the number of bank facilities was considered by the Legislature in Senate Bill 217. When the hearing was held, there were 45 bankers from fourteen counties present in the room opposing the measure. An Ad Hoc Committee of independent bankers was formed and it was from those roots that the committee evolved into the Community Bankers Association of today. They were small businessmen who believed that defending the cause was worth volunteering their time and efforts. Against these determined independent bankers, it took the proponents thirty-five years to get the legislature to adopt several pieces of major legislation. Multibank holding companies were legalized in 1985 and statewide branch banking in 1987. With the dismantling of federal laws that once limited cartel banking across state lines, interstate branching was legalized in 1997. As a result, that which was predicted has transpired. Many of those power-oriented banks are now owned by out-of-state banks. However, the tenacity and determination of the independent community bankers in Kansas was not unrewarded. In 2004, Kansas still has a solid core of independent banks. Many have had opportunities to sellout at large personal monetary gain but have not. Their commitment to the ideal of independence has prevailed. Local community banks are still prevalent. A new generation of bankers is rewarded with opportunity to serve their communities and keep the flame burning brightly for the future of community banking.

The Community Bankers Association of Kansas is a not-for-profit statewide organization of community banks. Organized in 1963 and founded as a trade association in 1978, member banks are locally owned and operated – intent on preserving local credit for local development. Member banks are as diverse as Kansas itself and as varied as the economies and aspirations of the communities they serve. Approximately 1/3 of the chartered banks in Kansas adhere to the community banking philosophy of understanding that Kansans are best served by local dollars being reinvested locally, thereby enriching communities throughout Kansas. They are members of CBA because they believe the best financial decisions are made close to home, backed by all the resources necessary for customers' prosperity and growth. These community banks come in all sizes – from the smallest banks to some of the largest. They are the kind of banks that have helped to build America . . . chartered for the purpose of helping people and communities develop economically. The membership directs CBA. Each active bank member, regardless of monetary size or number of branches, receives one vote (per bank or holding company) on issues submitted to the association for a vote.

The association is made of bankers who live and work in the communities where they do business. As strong advocates for the community banking industry, the association is directed by the members to provide quality product and service venues to assist members in remaining competitive in business. The association also offers education programs for bank employees and information for the communities they serve. A recent example of this is the Security Awareness Program, which was designed by CBA to help deter the bank robberies of all financial institutions in the state of Kansas. Brightly colored posters and supporting materials respectfully request all patrons entering financial institutions to remove hats, hoods or sunglasses. Mindful of the safety of bank customers and employees in the community, this program was established in cooperation with local law enforcement agencies.

Last, but not least, is a CBA presence before the Kansas Legislature and the banking regulatory agencies of state government. We work exclusively to advocate for community banking issues. We monitor legislative issues that affect communities, bank regulations, public funds, agriculture and a wide variety of economic development interests - all of which impact community banks. The community bankers are concerned with the ever-changing banking industry from which develops ramifications for people in communities across Kansas. Community banks are successful not because they have discovered a new strategy, but because they continue to do the business of banking to individual customers and small businesses in the community setting. On key issues, CBA uses a grass-roots process to connect community bankers with state legislators and regulators in an effort to provide information and educate policy-makers. Communication is imperative.

I am often asked, "What is community banking?". This question brings to mind a variety of different images for people. A community bank is integrally tied to almost everyone and everything in a community. These bankers are the people that have a passion for their communities – who are involved not because they have to be, but because it's part of their character. This association thanks you for your time spent in reviewing banking history and offers itself as a resource to each of you. We look forward to working with you toward good public policy for the citizens of Kansas.

Thank you,

Shari Weber, Executive Director
Community Bankers Association of Kansas

A Profile of 2003-2004 CBA Membership

(as of 01/22/03)

AVERAGE

Average size by Assets	$46,112,849.00
Average size by Deposits	$32,088,669.00

MEDIAN

Median size by Assets	$30,245,000.00
Median size by Deposits	$24,313,000.00

Membership as of 10/28/03

Main Banks:....................114

a. National Charters....................17

b. State Charters....................97

Security Awareness Program Materials

CRIME *Prevention*

POSTERS
12" x 16"
Members-$5.00 each
Non-Members-$7.00 each

STATIC WINDOW SIGNS
8.5" x 11"
Members-$3.50 each
Non-Members-$5.50 each

STATEMENT STUFFERS
3.5" x 8.5", Packages of 250 or 500
Members-$12.00 (250 pack), $20.00 (500 pack)
Non-Members-$14.00 (250 pack), $22.00 (500 pack)

TABLE TENTS
5" x 7" folded, Package of 10
Members-$15.00 package
Non-Members-$17.00 package

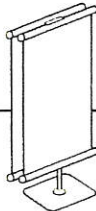


TABLE TOP STAND AND SIGNS
Two laminated prints, Size-11" x 19", Price includes stand
Members-$75.00 • Non-Members-$100.00
*Second print, optional **Thank You Sign**, with your bank logo ($40.00 additional charge).*

FLOOR STAND AND SIGNS
Two laminated prints, Size-21" x 36", Price includes stand
Members-$175.00 • Non-Members-$200.00
*Second print, optional **Thank You Sign**, with your bank logo ($40.00 additional charge).*

This *Security Awareness Program* is sponsored by Community Bankers Association of Kansas.

For additional information or to place an order, contact:
Community Bankers Association • 3003 SW Van Buren, Suite A • Topeka, KS 66611-2224
785-271-1404 • www.cbak.com • info@cbak.com

Only **ROBBERS** wear disguises to hide their identity!

Guarding your safety while in the bank is important to us. That's why we are participating in the *Security Awareness Program*, helping to decrease the possibility of robbery and fraud in our community.

No Hats

We appreciate your business and value your safety. When you remove hats, hoods and sunglasses while in this financial institution, we can easily identify our customers.

No Hoods

Together we can help keep our community safe by participating in the *Security Awareness Program* in cooperation with Community Bankers Association of Kansas and law enforcement agencies. **Thank you!**

No Sunglasses

It's for your SAFETY!

(Space for your bank stamp if desired)

FBI

Example Statement Stuffer

Robbery Prevention for Financial Institutions Seminar

CBA is offering seminars to address the immediate concerns of bank employees who need training in proper techniques of the **prevention of bank robberies**. These informative seminars include law enforcement agencies' participation, thereby enhancing the communication in robbery prevention strategies and techniques between front-line bank employees and law enforcement officers. The response received from these seminars is so overwhelming that CBA will offer the "Robbery Prevention for Financial Institutions" seminar in your area. Please contact the CBA Office (800-258-4589) as soon as possible if you would like to educate your employees on the prevention procedures of what to do before, during and after a bank robbery.

ROBBERY OF FINANCIAL INSTITUTIONS & ARMED ROBBERY PREVENTION

PRESENTED BY:

SCOTT TEESELINK

LEARN WHAT TO DO

Before, During and After a Robbery

Topics Include:

Suspect Identity Safety Procedures Alarm Activation

Bait Money Crime Scene & Evidence Issues

DATES:

February 17, 2004 – HIAWATHA

February 19, 2004 - KINGMAN

About the Presenter:
Scott Teeselink has thirty-five years of law enforcement experience. This includes working as a patrolman in the Wichita Police Department, a Detective at the Shawnee County Sheriff's office, and thirty years with the Kansas Bureau of Investigation where he held responsibilities as an undercover narcotics agent, development for the KBI Anti-Crime Unit, KBI Training Coordinator, KBI Narcotics Agent, and the KBI Crime Prevention Program for robbery of financial institutions. Currently, Scott works as a crime prevention specialist and security consultant in addition to his work with Washburn University as a police office investigator.

For more information on this seminar and other education programs offered by the Community Bankers Association of Kansas, please call the CBA office.

3003 SW Van Buren, Ste A
Topeka, KS 66611
Phone: (785) 271-1404
Fax: (785) 271-1508
www.cbak.com