



November 9, 2005

Ms. Jennifer Johnson, Secretary Board of Governors of the Federal Reserve System 20 <sup>th</sup> Street and Constitution Avenue, NW Washington D.C. 20551	Office of the Comptroller of the Currency 250 E Street, SW Mailstop 1-5 Washington D.C. 20219
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Robert E. Feldman, Executive Secretary Federal Deposit Insurance Corporation 550 17 <sup>th</sup> Street, NW Washington, D.C. 20429	Chief Counsel's Office Office of Thrift Supervision 1700 G Street, NW Washington D.C. 20552
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Re: Request for Burden Reduction Recommendations; Rules Relating to Banking Operations; Directors, Officers and Employees; and Rules of Procedure; Economic Growth and Regulatory Paperwork Reduction Act of 1996 Review  
70 FR 46779 (August 11, 2005)

Dear Sir or Madam:

America's Community Bankers (ACB)<sup>1</sup> is pleased to comment on the federal banking agencies' (the agencies)<sup>2</sup> review of regulatory burden imposed on insured depository institutions.<sup>3</sup> Required by section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA),<sup>4</sup> the agencies are reviewing and identifying outdated, unnecessary, and unduly burdensome regulatory requirements. This comment letter responds to the request for comments regarding banking operations; directors, officers and employees; and rules of procedure.

### **ACB Position**

ACB strongly supports the inter-agency effort to reduce regulatory burden. ACB believes that effective regulation is an important element of our banking system. However, the burden imposed by outdated and unnecessary rules precludes community banks from reaching their full potential as financial service providers. Our comments and suggestions below reflect the need to

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<sup>1</sup> America's Community Bankers is the national trade association partner for community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit [www.AmericasCommunityBankers.com](http://www.AmericasCommunityBankers.com).

<sup>2</sup> Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

<sup>3</sup> 70 Fed. Reg. 46779 (February 3, 2005).

<sup>4</sup> Pub. L. 104-208, Sept. 30, 1996.

ensure that community banks are able to remain competitive and provide products and services that are relevant in today's marketplace. We also address fraud issues and regulations that create a disincentive for individuals to serve as a director or executive officer of a financial institution.

ACB specifically recommends that:

- The Federal Reserve review the maximum hold periods for U.S. Treasury checks, postal money orders, state and local government checks, and cashier's, certified, and teller's checks. However, we believe that hold periods for all other checks should remain unchanged.
- The banking agencies issue guidance that 1) identifies ways financial institutions can reduce the risk of loss associated with fraudulent Treasury and cashier's checks and 2) requests all depository institutions to cooperate in addressing this common problem.
- Regulation CC be amended to change the allocation of liability for an unauthorized remotely created demand draft.
- Regulation D be amended to allow for an expanded number of transfers and withdrawals from money market deposit accounts.
- The limitations on extensions of credit in Regulation O be increased.
- The thresholds in the regulation prohibiting certain management interlocks be increased.
- OTS regulations be amended to permit a majority of the directors of a savings association to be officers or employees of the association as long as the holding company owns at least 60 percent of any class of voting shares of the association.
- Shareholders of OCC regulated institutions be permitted to waive notice of shareholder meetings.
- OCC regulations be amended to increase the permissible corporate purposes for buying back stock or engaging in a reverse stock split.

## **Funds Availability**

### **1. Check Fraud**

Check fraud is a significant concern for community banks. Cashier's checks, checks drawn on the U.S. Treasury, postal money orders, and checks issued by state and local governments, have become the tool of choice for conducting check fraud due to Regulation CC's next day availability requirements.

ACB believes Regulation CC's current funds availability schedule increases the loss exposure for depository institutions. Checks drawn on the U.S. Treasury, U.S. postal service money orders, checks issued by state and local governments, and cashier's checks must be available for withdrawal by the business day after the banking day on which the funds are deposited.<sup>5</sup> In

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<sup>5</sup> 12 CFR 229.10(c).

limited circumstances, an exception hold may be placed on these instruments, but only on amounts in excess of \$5,000.

It is not unusual for depository institutions to suffer a loss with these instruments because the funds must be made available to the customer before the check or money order has time to be returned as a fraudulent document. Criminals are knowledgeable about Regulation CC and are well informed and are using technology to perpetrate fraud. Fraudsters often deposit fraudulent checks at the end of the day and withdrawal the funds early the next day. Home printers and scanning equipment have become very sophisticated and have made it easier for fraudulent checks to appear legitimate. Accordingly, ACB requests the Federal Reserve to review the maximum hold periods for U.S. Treasury, postal money orders, state and local government checks, as well as cashier's, certified, and teller's checks.

Due to increased reports of check fraud and associated losses, depository institutions are searching for controls and internal procedures to mitigate check fraud risk. Many community banks try to contact the issuing institution to verify the issuance of a cashier's check. However, ACB members report that increasing numbers of depository institutions are unwilling to confirm that a cashier's check has been issued. Because fraudulent cashier's checks have become so common, we request the federal banking agencies to issue guidance that 1) identifies ways financial institutions can reduce their risk of loss and 2) urges all depositories to be cooperative in addressing this common problem.

## 2. Check 21

President Bush signed into law the Check Clearing for the 21<sup>st</sup> Century Act (Check 21) on October 28, 2003 and the Act became effective one year later. Check 21 is intended to allow depository institutions to clear checks electronically, thereby reducing the dependency on the physical transportation of paper items. Check 21 will help modernize the check clearing process and create a more efficient payments system. This legislation will lower costs for consumers and banks and will strengthen the infrastructure of the U.S. financial system.

Despite the benefits of this important legislation, some consumers and consumer advocates believe that banks will quickly clear checks written by consumers while taking longer to process deposits in order to collect more fees for checks drawn on accounts with insufficient funds. These interest groups have called for shortened funds availability periods to take into account the authority that Check 21 gives banks to clear checks electronically.

ACB strongly disagrees with this suggestion. Many depository institutions are still processing paper checks. While Check 21 became effective more than one year ago, few institutions have adopted electronic check clearing systems. The number of Check 21 items currently being processed represents a very small percentage of the total number of items processed.

By April 28, 2006, the Federal Reserve must submit a report to Congress that evaluates the impact of Check 21 on the Federal Reserve's funds availability schedule. ACB does not believe that the Federal Reserve's maximum check hold times should be amended at this time.

Electronic check clearing has not been implemented across the banking industry, and shortening the hold times would increase the susceptibility to fraud for those institutions that do not clear checks electronically.

### 3. Remotely Created Demand Draft Warranty

ACB strongly believes that Regulation CC should be amended to change the allocation of liability for a remotely created demand draft that is disputed by a customer. We specifically request the Federal Reserve to:

- Create a new warranty pertaining to remotely created demand drafts that reallocates fraud loss from the paying bank to the presenting bank;
- Apply the new warranty to all types of accounts;
- Specify that such an amendment governs in the event of a dispute relating to inconsistent or non-existent state laws;
- Establish general loss recovery procedures for unauthorized remotely created demand drafts; and
- Provide six months for financial institutions to implement the amendment.

A remotely created demand draft is created when a consumer agrees to pay for goods and services by allowing a vendor to prepare a pre-authorized check drawn on the customer's bank account. The consumer provides the necessary account and bank information and the vendor generates a check with "Debit of Account Authorized By Customer" or similar language printed in the signature line. While this payment method is convenient for consumers who do not want to be troubled with ensuring that bills such as monthly health club dues or utility payments have been made, the number of unauthorized remotely-created demand drafts has become a significant problem.

Community banks report that unauthorized demand drafts are becoming common and losses associated with this problem are increasing. In most states, banks agreeing to recredit a customer's account for losses associated with unauthorized drafts cannot look to the depository bank for indemnification. This is because these unauthorized debits are treated like checks with forged signatures. Under the commercial code of most states, a paying bank that pays a check cannot shift that loss to the depositing bank for a check that it later determines was forged.<sup>6</sup>

In March 2005, the Federal Reserve issued a proposed amendment to Regulation CC to address the problem of unauthorized remotely created demand drafts. Under the proposal, a presenting bank would warrant that any remotely created check it presents to a paying bank is authorized by the account holder. This approach would allow a drawee bank to shift the loss to the bank of first deposit, which can charge the disputed item back to the account of its customer. ACB reiterates our support for this proposal and we urge the Federal Reserve to expeditiously adopt a final rule.

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<sup>6</sup> UCC § 3-418.

*National Standard.* ACB believes it is important to establish a national standard that will eliminate the potential legal conflicts that may arise when a paying bank and a depository bank are subject to different presentment/warranty rules because they are located in different states. We request the Federal Reserve to specify how the final rule will apply to inconsistent state laws. Any final rule should clarify that Regulation CC applies in the event of a dispute relating to inconsistent or non-existing state laws governing the presentment and warranty of remotely created items.

*Account Type.* While ACB members report that the majority of unauthorized remotely created items are directed against consumer accounts, commercial and non-profit accounts are not immune to this type of fraud. As a result, any rule regarding remotely created demand drafts should allow paying banks to return unauthorized items drawn on all types of accounts – including the accounts of consumers, commercial entities, and non-profit organizations.

*Loss Recovery Procedures.* Establishing presentment and transfer warranties for remotely created checks will not provide a comprehensive solution to the problem of unauthorized items. It is important that any amendment to Regulation CC also include general loss recovery procedures. However, any expedited recredit provisions should apply only to consumers.

Unauthorized remotely created demand drafts are operationally analogous to unauthorized ACH transactions. Therefore, ACB suggests that any return framework be similar to that for processing an unauthorized ACH transaction and provide a 60-day right of return to enable a consumer adequate time to identify unauthorized transactions and report them to his or her financial institution. Additionally, the procedures should include provisions similar to safeguards in Check 21 and Regulation E that protect paying banks against fraud by allowing an institution to delay availability of recredit under certain circumstances, such as new accounts and suspected fraud.

*Implementation Time.* Due to the level of fraud and abuse associated with remotely created checks, ACB believes that it is important that the Federal Reserve act expeditiously to address this problem. ACB suggests the Federal Reserve issue a final rule and allow the industry six months to implement the amendment, adjust procedures, and train staff.

## **Limits on Money Market Deposit Accounts**

ACB urges the Federal Reserve to examine Regulation D's transfer limits on money market deposit accounts (MMDA's). These restrictions are antiquated and prohibit community banks from offering relevant products and services to customers in the Twenty First Century. Therefore, we specifically request the Federal Reserve to amend the definition of "savings deposit" in Regulation D to allow for an expanded number of transfers and withdrawals.

### **1. Background**

A money market deposit account is a "savings deposit" within the meaning of Regulation D. In order for a savings deposit to avoid being deemed a "transaction account" under Regulation D,

there must not be more than six transfers per calendar month or statement cycle from the savings deposit by preauthorized or automatic transfer or by telephonic agreement to another account of the depositor at the same institution. Furthermore, no more than three of the six transfers may be made by check, draft, debit card, or similar device. To ensure this limit is not exceeded, Regulation D requires that institutions either prevent withdrawals or transfers in excess of the limitation or “adopt procedures to monitor those transfers on an ex post basis and contact customers who exceed the established limits on more than an occasional basis.” If the limits continue to be violated after such notification, the bank must either close the account or remove the transfer and draft capacities of the account.

The statutory prohibition against paying interest on commercial checking accounts is a related problem. Many community banks spend countless hours trying to devise products to attract commercial customers without running afoul of the prohibition against paying interest on business checking and the Regulation D transaction limits.

## 2. Competitive Issues

Banks of all sizes, as well as investment firms and other financial service companies, are courting small business customers. However, community banks are at a competitive disadvantage in attracting small businesses because investment firms and other non-bank institutions are not subject to Regulation D’s transfer limits. Furthermore, large banks have instituted complex sweep operations to circumvent the prohibition against paying interest on business checking and the Regulation D transfer restrictions.

There is a demand in the small business community for a financial product that generates some rate of return on deposited funds while providing more options for accessing those funds. A money market deposit account allows commercial depositors to earn interest, but small business customers often complain that Regulation D’s withdrawal limitation on MMDA’s is too strict.

These restrictions are anti-competitive and limit the ability of community banks to customize products and services to meet the needs of their small business customers. As a result, many small businesses look to large banks and non-bank institutions to meet their financial needs.

## 3. Technological and Cultural Shifts

The evolution of the Internet and the use of electronic banking have changed the way that consumers conduct their banking business. Many consumers rarely conduct business at their local bank. They receive their paychecks via direct deposit, pay their bills online, and transfer funds between checking and savings over the Internet. Likewise, business customers are making fewer trips to the bank. Many are converting checks into electronic documents and are transferring funds to their payroll accounts and other accounts online. In light of this technological and cultural shift, we request the Federal Reserve to increase the number of permissible transfers from an MMDA.

## **Regulations Affecting Directors and Officers**

ACB believes that certain regulations affecting directors and officers should be revised to reduce the burden of serving in these roles. As a result of passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the increase in other regulatory requirements, serving as a director or executive officer of a regulated depository institution has become less and less attractive. This reduces the pool of candidates, as many qualified individuals do not want to put in the necessary time and effort that is required of these positions or incur the potential liability. The pool of director candidates is further reduced by new independence requirements. It would help greatly if unnecessary regulatory requirements that further dissuade or prevent individuals from serving in these capacities were removed or revised. We have the following suggestions to reduce burden in this area.

### 1. Limits on Extensions of Credit to Directors, Officers and Principal Shareholders

ACB believes that some of the limitations on extensions of credit in Regulation O should be increased to reflect the trend of individuals to incur and properly manage higher levels of debt. For example, it has become quite common for people to take out home equity loans to purchase goods and services as well as cover tuition and home improvement costs. In light of these developments, some of the limits in Regulation O no longer seem reasonable.

Regulation O places certain restrictions on loans to executive officers. The regulation allows for credit extended to finance education or the purchase of a house, and adequately secured credit. Beyond that, credit to an executive officer is limited to the higher of 2.5 percent of unimpaired capital and surplus or \$25,000, but in no event can the credit be higher than \$100,000. We believe that the lower cap should be increased to at least \$50,000 and the overall cap of \$100,000 should be increased to at least \$200,000.

Regulation O prohibits a depository institution from extending credit to an insider in an amount that, when aggregated with the amount of all other credit to that person and his or her related interests, exceeds the higher of \$25,000 or five percent of unimpaired capital and surplus, without prior approval of the board. We believe that the \$25,000 cap should be increased to at least \$50,000.

Regulation O requires that if during a calendar year an executive officer or principal shareholder, or a related interest, has credit outstanding to an institution's correspondent bank, he or she must make a written report to the board of directors. We believe that a minimum amount of debt should be used to trigger this requirement. We would suggest that a report not be required unless consumer credit incurred is in an aggregate amount of at least \$50,000, rather than the current threshold of \$5,000.

## 2. Management Official Interlocks

Thresholds in the regulation prohibiting certain management interlocks should be increased to take into account the significant increase in the size of depository institutions and to increase the availability of director candidates for community banks.

We suggest that the definition of a management official be revised to exclude an advisory or honorary director. An alternative would be to continue to include these directors, but only if they serve an institution with \$500 million or more in assets rather than the current \$100 million threshold.

The regulators also should consider increasing the threshold in the provision that prohibits interlocks if the institutions have offices in the same RMSA and each has total assets of \$20 million or more. The threshold should be increased to at least \$250 million.

## 3. OTS Regulation on Director Composition

Under section 563.33 of the OTS regulations, a majority of the directors of a savings association cannot be officers or employees of the association or a subsidiary, or any holding company parent unless the holding company owns 80 percent or more of any class of voting shares of the association. We believe that this 80 percent threshold should be reduced to 60 percent.

## **OCC Regulations on Corporate Practices**

Section 7.2001 should be revised to allow shareholders to waive notice of shareholder meetings. The regulation currently permits this only if the bank is a wholly owned subsidiary of a holding company. Mailing a notice of a meeting is not necessary in a closely held bank if all shareholders are willing to provide waivers.

Sections 7.2020 and 7.2023 should be amended to increase the permissible corporate purposes for buying back stock or engaging in a reverse stock split. In light of passage of Sarbanes-Oxley and the overall burden of being a public company, many community banks are considering going private. This often involves the buy-back of stock or other corporate action to reduce the number of shareholders and allow withdrawal from registration with the Securities and Exchange Commission. The legitimate corporate purposes should be expanded to include these actions provided that any required shareholder and OCC approvals are obtained.

## **Conclusion**

ACB appreciates this opportunity to submit suggestions for reducing regulatory burden. We believe there are numerous opportunities to provide relief for community banks.

- Deposited funds should be made available to consumers quickly; however, funds availability requirements should not unnecessarily expose depository institutions to fraud loss.

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- Paying banks should not be saddled with losses caused by unauthorized remotely created demand drafts.
- Community banks must be able to offer meaningful products and services to consumers and businesses and must be able to compete under the same rules as other financial service providers.
- Unnecessary regulations that dissuade or prevent individuals from serving as directors and officers of depository institutions should be revised.

Thank you for the opportunity to comment on this important matter. Should you have any questions, please contact the undersigned at 202-857-3187 or [kshonk@acbankers.org](mailto:kshonk@acbankers.org).

Sincerely,



Krista J. Shonk  
Regulatory Counsel