HB 2872

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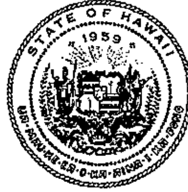
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR



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SENATE COMMITTEE ON COMMERCE & CONSUMER PROTECTION
TESTIMONY REGARDING HB 2872 HD 1
RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: MARCH 16, 2010
TIME: 9AM
ROOM: 229

This measure suspends the requirement that $2,000,000 from the franchise tax be deposited into the compliance resolution fund from July 1, 2010 until June 30, 2015.

The Department of Taxation (Department) **opposes** this measure. The Compliance Resolution fund is an important component of the Department of Commerce & Consumer Affairs' ability to regulate entities.

This bill would increase general fund revenues by $2 million per year from fiscal year 2011 until fiscal year 2015.

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TO THE
SENATE COMMITTEE ON COMMERCE AND CONSUMER PROTECTION

THE TWENTY-FIFTH STATE LEGISLATURE
REGULAR SESSION OF 2010

Tuesday, March 16, 2010
9:00 a.m.

TESTIMONY ON H.B. NO. 2872, H.D. 1, RELATING TO TAXATION

THE HONORABLE ROSALYN H. BAKER, CHAIR,
AND MEMBERS OF THE COMMITTEE:

My name is Nick Griffin, Commissioner of Financial Institutions ("Commissioner"), testifying on behalf of the Department of Commerce and Consumer Affairs ("Department") in opposition to House Bill No. 2872. The Department opposes this bill which has, among its stated purposes, the temporary repeal of the requirement that $2,000,000 of the tax revenues from banks and other financial corporations be deposited into the Compliance Resolution Fund, and temporary authorization for the Commissioner to expedite the imposition of new fees on banks and other financial corporations.

The bill, in part, diverts the primary funding source for the Department's Division of Financial Institutions ("Division"). Specifically, the bill would, for five years, divert $2

million from the Compliance Resolution Fund and redirect those monies to the general fund. To compensate for the loss of those monies to fund the operations of the Division, the bill would authorize the Commissioner to adopt new rules, or amend existing rules to impose or increase fees authorized to be charged to banks and other financial corporations under Hawaii Revised Statutes ("HRS") Chapter 412, without regard to public notice and public hearing requirements of section 91-3, HRS, the small business impact review requirements of HRS Chapter 201M, or the limit on fee increases under section 92-28, HRS.

Our first objection relates to the proposed amendment of section 241-7, HRS, which was enacted by the Legislature in 1999, to provide a stable, financial services industry-derived source of funding, independent of the general fund, for the operations of the Division, to meet the Accreditation Guidelines of the Conference of State Bank Supervisors (CSBS). As part of the Department's initiative to become fully self-sufficient, the transfer of funds from the taxes paid by banks and other financial corporations to the Compliance Resolution Fund (CRF) was established in 1999 in order to provide the Division with the necessary revenues to support all of its operations. Self-sufficiency was also part of the Division's continuing efforts to achieve and maintain its accredited status by the Conference of State Bank Supervisors ("CSBS"). The CSBS accreditation program, which recognizes those state banking departments that meet the highest standards and practices in state supervision, requires that a department have adequate funding to supervise and regulate its licensees and recommends that the department be self-supporting.

Removing this assured, stable source of funding for the Division's operations, and replacing it with a fee-based alternative source of funds ignores the CSBS requirement that accredited regulators need a secure source of funding, leaving the Division instead to the uncertainty and unpredictability of funding that would somehow have to be derived from new or increased fees established by rule.

Additionally, the measure's purported dispensation of public notice and hearing requirements, the small business impact review, and the limits on fee increases could be challenged by affected persons, thereby leaving the Division without any source of funding whatsoever.

Further, from a policy standpoint, the imposition of new or increased fees, or both, while maintaining the requirement that banks and other financial corporations continue to pay the tax required under section 241-4, HRS, is inconsistent with the Department's long standing focus on reducing the cost of doing business in Hawaii. Because the Division would have to make up the loss of these funds through new or increased fees, the net result is that the affected financial institutions would face a $2 million increase in their cost of doing business. Ultimately, that must be balanced against the need for additional general fund revenues.

If the $2 million is not deposited into the Compliance Resolution Fund (CRF) and the revenue from the increased fees does not generate $2 million, the Division will be required to significantly reduce its operations (including reducing staffing levels) since personnel expenditures comprise approximately 85% to 90% of the Division's

expenditures. This could be potentially damaging to Hawaii's consumers and State licensed or chartered financial institutions because:

- Division examinations, investigations, and complaints processing involving State licensed or chartered financial institutions have resulted in administrative enforcement actions that directly benefited Hawaii consumers, with more than $8 million refunded or returned to consumers and the State since 2006. Should the Division be required to significantly reduce staffing levels, no resources will be available to examine Hawaii financial institutions in order to enforce compliance with State and federal consumer protection statutes.
- The current economic crisis, which has been affecting Hawaii's banks for the past eighteen months, has required a significant increase in the frequency and scope of on-site examinations and off-site supervisory efforts. Examinations and supervisory efforts regarding banks and depository financial institutions are most often conducted jointly by the Division and its regulatory colleagues from the Federal Reserve Bank ("FRB") and the Federal Deposit Insurance Corporation ("FDIC"). However, should the Division be required to significantly reduce staffing levels, there will be no State resources available to examine Hawaii financial institutions and the "local voice" currently provided by the Division will be lost, to the obvious detriment of our State chartered and licensed financial institutions.

It should be noted that a significant reduction in staffing cannot be considered a "temporary" downsizing of the Division since trained and experienced examiners will not be easily replaced when and if the Division is able to hire again. The Division currently employs 24 staff, the majority of whom joined the Division within the past five years. The Division's financial institution examiners, who comprise the majority of the Division's staff, generally have an undergraduate degree in accounting, finance, or related fields when they join the Division. They are then required, particularly in the case of field examiners, to attend a variety of formal schools, administered by either the FRB or the FDIC, and to undergo on-the-job training under the guidance of either a senior Division examiner or FRB/FDIC examiners, before they are ready to take on independent financial services industry examinations on their own. This formal classroom training process takes from three to five years, with an additional two to three years of on-the-job training before a field examiner is fully qualified in their position. Should funding for the Division's operations be redirected to the general fund and revenue from new or increased fees fall short of $2 million, resulting in a significant reduction in the Division's ability to fulfill its mission, those examiners could doubtless find employment in the private sector or with the federal government; however, the State has invested a significant amount of time and money training its existing Division staff and that investment should be preserved, rather than lost.

For these reasons, the Department remains strongly opposed to House Bill No.2872, H.D. 1 and respectfully urges your Committee to hold this bill.

Thank you for the opportunity to testify. I would be pleased to respond to any questions you may have.

HAWAII FINANCIAL SERVICES ASSOCIATION

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March 16, 2010

Senator Rosalyn H. Baker, Chair
and members of the Senate Committee on Consumer Protection
Hawaii State Capitol
Honolulu, Hawaii 96813

Re: **House Bill 2872, House Draft 1 (Taxation)**
Hearing Date/Time: Tuesday, March 16, 2010, 9:00 A.M.

I am the attorney for the **Hawaii Financial Services Association** ("HFSA"). The HFSA is the trade association for Hawaii's financial services loan companies which make mortgage and other loans and which are regulated by the Hawaii Commissioner of Financial Institutions.

The HFSA **opposes** this Bill as drafted.

This Bill: (1) repeals the requirement that $2,000,000 of tax revenues from banks and other financial corporations be deposited into the Compliance Resolution Fund; (2) authorizes the commissioner of financial institutions to expedite the imposition or increase of fees on banks and other financial corporations; and (3) Takes effect on July 1, 2010 and sunsets on December 31, 2015.

The Hawaii franchise tax is paid by various financial institutions such as banks, savings and loan associations, financial services loan companies, and other entities. Currently $2 million of the franchise tax collected annually goes to the credit of the Compliance Resolution Fund of the Department of Commerce & Consumer Affairs ("DCCA"). The Compliance Resolution Fund is used to fund the operations of the DCCA, including the Division of Financial Institutions ("DFI"). The $2 million is earmarked for the DFI.

But under Sections 1 and 4 of this Bill, the $2 million franchise tax would be diverted from the DCCA to the Hawaii General Fund until December 31, 2015. As a result, the revenue of the DFI will be negatively impacted. To make up the shortfall in revenue, the fees that Hawaii financial institutions currently pay to the DFI will probably be increased. Those increased fees could be expeditiously imposed on financial institutions by the DFI using the authority of Section 2 of this Bill.

The HFSA understands Hawaii's challenging fiscal situation. However, there should be a cap on the anticipated increase in fees. Otherwise, with no cap, the fees could increase to the extent where they will financially burden Hawaii financial institutions which need to maintain capital levels and add to reserves. Any added costs of doing business in Hawaii could ultimately be passed on by the financial institutions (lenders) to Hawaii consumers (borrowers). All these increases will hinder Hawaii's economic recovery.

Accordingly, we ask that you amend this bill to have a cap on the anticipated increase in fees. Thank you for considering our testimony.

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Presentation to the Senate Committee on Commerce and Consumer Protection

Tuesday, March 16, 2010, at 9:00 a.m., Conference Room 229

Testimony on HB 2872, HD 1, Relating to Taxation

TO: The Honorable Rosalyn H. Baker, Chair
The Honorable David Y. Ige, Vice Chair
Members of the Senate Committee on Commerce and Consumer Protection

My name is Neal Okabayashi testifying on behalf of the Hawaii Bankers Association (HBA). We oppose the bill in its present form because it places the entire onus for replacement of the diversion of franchise taxes from the Compliance Resolution Fund ("CRF") to the general fund on 5 state chartered banks, 1 state charted depository financial services loan company, the two state credit unions, and various nondepository financial services loan companies.

The measure would divert $2,000,000 from the CRF to the general fund and permit DFI to arbitrarily raise fees without notice or hearing. Most of the increase in DFI expenses results from their expansion of supervisory activities over nonbanking industries, such as money transmitters, mortgage service companies, escrow companies and soon mortgage loan originators, but yet such industries will not be subject to any fee increases under this bill because their fees are set by statute, not by rule. Only fees for banks and financial services loan companies are set by rule making.

However, a review of the Compliance Resolution Fund reports for the past 5 y ears reveals that at most, a modest increase in fees will be necessary. Over the past 5 years, DFI has amassed a surplus of $2,095,558 on revenue of $12,375,323 or a profit of 17%, a number that most Hawaii businesses would have been happy to earn, and this number would have been higher except DFI did waive examination fees for two of those years.

According to the 2009 Annual Compliance Resolution Fund Report to the Legislature submitted by DCCA, for fiscal year 2008-2009, DFI's rev enue was $2,599,918 and expenses were $2,421,699 or a profit of $178,219 or a 6.85% profit margin. In FY 2006-2007, the DFI surplus was $917,140. From FY 2004-2005, DFI's personnel costs escalated from $1,670,117 to $2,174,258 or an increase of 30% in personnel costs over the five year period. If measured from the low of $1,576,298, the personnel cost increase is actually 38% compared to the overall DCCA personnel cost increase of 25%. It is possible that the required DFI skill set necessitates a higher pay grade but since the number of state chartered banks has remained relatively the same in terms of assets (only

two very small banks were added in that time frame), it is clear to us that the increase results more from the other activities of DFI especially as it relates to money transmitters.

It should be noted that DFI's expenses are heavily tilted towards personnel costs as the ratio of personnel expenses to operating expenses is 8.79 to 1 while the overall ratio of personnel expenses to operating expenses for DCCA is 3.17 to 1. DFI also used to receive $2,500,000 from franchise taxes which was reduced to $2,000, 000 beginning FY 2001.

In essence, the essence of this legislation will be borne by the 5 state chartered banks, financial services loan companies and two state credit unions. But yet the increase in DFI costs appears to stem not from services performed for the state banks and others but because of increased DFI activities in other areas.

None of the other DFI supervised industries are subject to increased federal banking regulatory fees. The 6 insured depositories are all subject to increased FDIC deposit insurance premiums, including a three year prepayment charge. In addition, one of the insured depositories is potentially subject to the President's banking tax to repay TARP and that same insured depository is also potentially subject to a huge assessment to fund what the House of Representatives calls the Systemic Resolution Fund and what the Senate calls the Orderly Liquidation Fund, but also known as the Too Big To Fail Fund.

It should be noted that two of Hawaii's largest banks are two of the safest banks in the country. Unlike the other DFI regulated entities, the 5 banks and the 1 depository financial services loan company are supervised by a federal banking regulator thus resolving any uncertainty about safety and soundness issues. At least as to the three large banks, the FDIC or Federal Reserve Board is the lead examiner in joint examinations, and that role will continue.

To add an unknown amount of fees to be arbitrarily set by an agency that has demonstrated its willingness to garner enough revenue to have a 17% surplus rate is onerous.

We do recognize that the State is in a precarious economic situation and are willing to pay more although the monies will not go to support the insured depositories. We request that if this Committee is to adopt this bill, it amend the bill by deleting " . . . , or the limit on fee increases under section 92-28, Hawaii Revised Statutes." In effect, this will limit the fee increases to 50% which is basically an examination fee of $60 an hour. We also request that a new sentence be inserted at the end of Section to read as follows: "Any rule adopted under this section shall be repealed on December 31, 2011."

We also request that in section 4, the Act be repealed on December 31, 2011 and not 2015.

We thank you for allow us to testify and for your consideration of this matter. We would be pleased to answer any questions you may have.

L E G I S L A T I V E

TAXBILLSERVICE

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SUBJECT: BANKS AND FINANCIAL INSTITUTIONS, Disposition of funds

BILL NUMBER: HB 2872, HD-1

INTRODUCED BY: House Committee on Finance

BRIEF SUMMARY: Amends HRS section 241-7 to suspend the deposit of $2 million into the compliance resolution fund and clarify that the tax on banks and other financial institutions shall be deposited into the general fund.

Directs the commissioner of financial institutions, between July 1, 2010 and December 31, 2010, to adopt new or amend existing rules to impose or increase fees authorized to be charged to banks and other financial corporations without regard to the public notice and public hearing requirements of HRS section 91-3, the small business impact review requirements of HRS chapter 201M, or the limit on fee increases under HRS section 92-28.

This act shall be repealed on December 31, 2015; provided that HRS 241-7, shall be reenacted in the form in which it read on the day before the effective date of this act.

EFFECTIVE DATE: July 1, 2010

STAFF COMMENTS: It appears that this measure temporarily suspends the deposit of $2 million into the compliance resolution fund in an attempt to generate additional revenues to address the state's financial crisis. In a down economy, taxpayers are examining their spending priorities and paring back their spending - a concept that state government has to adopt to regain control of their finances.

Although this draft of the measure does not increase the bank franchise tax rates, it should be remembered that the bank franchise tax is imposed on financial institutions in lieu of the general excise tax and corporate net income tax. When the 1990 Tax Review Commission made recommendations to restructure the Hawaii tax on banks and other financial institutions, it had intended to eliminate many of the exceptions the financial institutions enjoyed under the general excise tax so that it could bring the franchise tax rates into line with the net corporate income tax rates. However, because the banks did not want to give up their preferences under the general excise tax which were not bank unique, the rate could not be reduced to the top corporate income tax rate of 6.4%. This effort was intended to prepare Hawaii banks to be able to compete in the multi-state banks movement that was sweeping the nation at the time. Thus, consideration might be given to eliminating the general excise tax preferences and then adjusting the bank franchise tax rate in accordance with any adjustment to the corporate income tax rates. If not, then any adjustment of either the general excise or corporate income tax rate should engender a similar adjustment in the bank franchise tax rate.

Digested 3/10/10