THRIFT BAD DEBT RECAPTURE

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

OCTOBER 26, 1995

Serial 104–39

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THURSDAY, OCTOBER 26, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 9:09 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing, and the text of H.R. 2494, the Thrift Charter Conversion Tax Act of 1995, follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225-1721
October 19, 1995
No. FC-10

Archer Announces Hearing on Thrift Bad Debt Recapture

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995." H.R. 2494 was introduced on October 18, 1995 by Chairman Archer and Congressman Jim Leach (R-IA), Chairman of the Committee on Banking and Financial Services. **The hearing will take place on Thursday, October 26, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

The Committee on Banking and Financial Services included in their budget reconciliation recommendations the adoption of several reforms to the banking system. Included among these reforms is the merger of the Banking Insurance Fund and the Savings Association Insurance Fund, and a requirement that thrift institutions convert their charters to bank charters.

In announcing the hearing Chairman Archer stated, "The thrift charter conversion proposal raises several banking, tax, housing, and accounting issues. It is not always easy to reconcile these sometimes competing policies. Nonetheless, it is clear that the thrift charter conversion proposal must contain transitional tax relief cushioning the blow to thrifts required to convert to banks. H.R. 2494 is intended to modify the tax laws to permit the conversion of thrifts to banks, consistent with the policies behind the thrift charter conversion proposal, and in a manner that is fair to the thrifts and consistent with our deficit reduction goals."

Chairman Archer further stated, "I believe that the conceptual proposal set forth in H.R. 2494 is a good resolution of these sometimes conflicting banking, tax, housing, and accounting policies. This is a complex area, however, and so I particularly welcome technical comments on the bill. I look forward to working with Chairman Leach in expeditiously including these provisions in the appropriate legislation."

Included in H.R. 2494 are two provisions which relate to the thrift charter conversion proposal. The first provision would generally repeal Internal Revenue Code section 593. Section 593 generally permits domestic building and loan associations, mutual savings banks, and certain cooperative banks to use a more favorable bad debt reserve method in determining their taxable income. Under the bill, entities currently eligible to use the reserve method under section 593 would be required to recapture the portion of their reserve attributable to reserve deductions taken after 1987. The portion of the reserve, attributable to taxable years before 1988, would not be recaptured. This recapture of post-1987 reserves would be treated as a change in accounting method under Code section 481, with the previously taken deductions included in income ratably over 6 years. An exception to this recapture rule would apply to a thrift that originates more than a certain level of mortgage loans. In such a case, the recapture would be deferred during any period in which the institution originates mortgage loans in excess of its moving 6-year average (generally based upon the average level of mortgage loans originated in preceding 6 years).

The second provision would clarify the deductibility of the "special assessment" required to be paid by thrifts. The thrift charter conversion proposal recommended by the Committee on Banking and Financial Services would require a thrift to pay a special assessment to capitalize the Savings Association Insurance Fund. H.R. 2494 would provide that the special assessment is treated as a deductible expense rather than as a capital expenditure.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business, Monday, October 23, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than 12:00 noon on Tuesday, October 24, 1995.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business on October 30, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least two hours before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

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104TH CONGRESS
1ST SESSION

H. R. 2494

To amend the Internal Revenue Code of 1986 to provide for the treatment of bad debt reserves of savings associations which are required to convert into banks, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 18, 1995

Mr. ARCHER (for himself, Mr. LEACH, and Mrs. ROUKEMA) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to provide for the treatment of bad debt reserves of savings associations which are required to convert into banks, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Thrift Charter Conversion Tax Act of 1995".

SEC. 2. TREATMENT OF RESERVES FOR BAD DEBTS OF SAVINGS ASSOCIATIONS WHICH ARE REQUIRED TO CONVERT INTO BANKS.

(a) IN GENERAL.—Section 593 of the Internal Revenue Code of 1986 (relating to reserves for losses on loans) is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Subsection (e) of section 52 of such Code is amended by striking paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(2) Subsection (a) of section 57 of such Code is amended by striking paragraph (4).

(3) Section 246 of such Code is amended by striking subsection (f).

(4) Clause (i) of section 291(e)(1)(B) of such Code is amended by striking "or to which section 593 applies".

(5) Subparagraph (A) of section 585(a)(2) of such Code is amended by striking "other than an organization to which section 593 applies".

(6) Section 596 of such Code is hereby repealed.

(7) Subsection (a) of section 860E of such Code is amended—

(A) by striking "Except as provided in paragraph (2), the" in paragraph (1) and inserting "The",

(B) by striking paragraphs (2) and (4) and redesignating paragraphs (3) and (5) as paragraphs (2) and (3), respectively, and

(C) by striking in paragraph (2) (as so redesignated) all that follows "subsection" and inserting a period.

(8) Paragraph (3) of section 992(d) of such Code is amended by striking "or 593".

(9) Section 1038 of such Code is amended by striking subsection (f).

(10) Clause (ii) of section 1042(c)(4)(B) of such Code is amended by striking "or 593".

(11) Subsection (c) of section 1277 of such Code is amended by striking "or to which section 593 applies".

(12) Subparagraph (B) of section 1361(b)(2) of such Code is amended by striking "or to which section 593 applies".

(13) The table of sections for part II of subchapter H of chapter 1 of such Code is amended by striking the items relating to sections 593 and 596.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1995.

(d) 6-YEAR SPREAD OF ADJUSTMENTS.—

(1) IN GENERAL.—In the case of any taxpayer who is required by reason of the amendments made by this section to change its method of computing reserves for bad debts—

(A) such change shall be treated as a change in a method of accounting,

(B) such change shall be treated as initiated by the taxpayer and as having been made with the consent of the Secretary, and

(C) the net amount of the adjustments required to be taken into account by the taxpayer under section 481(a) of the Internal Revenue Code of 1986 (as modified by paragraph (2)) shall be taken into account ratably over the 6-taxable year period beginning with the first taxable year beginning after December 31, 1995.

(2) NO INCLUSION OF PORTION OF RESERVE.—In the case of a taxpayer to which paragraph (1) applies and which is a large bank (as defined in section 585(c)(2) of such Code) for its first taxable year beginning after December 31, 1995—

(A) no amount shall be includible in gross income by reason of the reduction of its reserve for bad debts to the extent that the amount of such reserve as of the close of its last taxable year beginning before January 1, 1996, does not exceed the amount applicable to such taxpayer under section 585(b)(2)(B) of such Code for such last taxable year, and

(B) the net amount of adjustments taken into account under paragraph (1)(C) shall be reduced by the amount not includible in gross income by reason of subparagraph (A) of this paragraph.

(3) SUSPENSION OF RECAPTURE IF RESIDENTIAL LOAN REQUIREMENT MET.—

(A) IN GENERAL.—In the case of a taxpayer which meets the residential loan requirement of subparagraph (B) for any taxable year—

(i) no adjustment shall be taken into account under paragraph (1) for such taxable year, and

(ii) such taxable year shall be disregarded in determining—

(I) whether any other taxable year is a taxable year for which an adjustment is required to be taken into account under paragraph (1), and

(II) the amount of such adjustment.

(B) RESIDENTIAL LOAN REQUIREMENT.—A taxpayer meets the residential loan requirement of this subparagraph for any taxable year if the principal amount of the residential loans made by the taxpayer during such year is not less than the average of the principal amounts of such loans made by the taxpayer during the 6 most recent testing years ending before such taxable year.

(C) TESTING YEARS.—For purposes of subparagraph (B), the term "testing year" means—

(i) each taxable year ending on or after December 31, 1990, and before January 1, 1996, and

(ii) each taxable year ending after December 31, 1995, for which the taxpayer meets the residential loan requirement of subparagraph (B).

(D) RESIDENTIAL LOAN.—For purposes of this paragraph, the term "residential loan" means any loan described in section 7701(a)(19)(C)(v) of such Code.

(E) CONTROLLED GROUPS.—In the case of a taxpayer which is a member of any controlled group of corporations described in section 1563(a)(1) of such Code, subparagraph (B) shall be applied with respect to such group.

(F) COORDINATION WITH ESTIMATED TAX PAYMENTS.—For purposes of applying section 6655(e)(2)(A)(i) of such Code with respect to any installment, the determination under subparagraph (A) of whether an adjustment is required to be taken into account under paragraph (1) shall be made as of the last day prescribed for payment of such installment.

(4) CONTINUED APPLICATION OF PARAGRAPH (2) UNDER SECTION 585 TRANSITIONAL RULES.—In the case of a taxpayer to which paragraph (1) applied and which was not a large bank (as defined in section 585(c)(2) of such Code) for its first taxable year beginning after December 31, 1995—

(A) IN GENERAL.—Rules similar to the rules of paragraph (2) shall apply for purposes of applying section 585(c)(3) of such Code with respect to the amount of such taxpayer's reserve for bad debts as of the close of the last taxable year before the disqualification year.

(B) TREATMENT UNDER ELECTIVE CUT-OFF METHOD.—No amount shall be includible in gross income under section 585(c)(4) of such Code by reason of the reduction of such taxpayer's reserve for bad debts below the amount applicable to such taxpayer under section 585(b)(2)(B) of such Code for the last taxable year before the disqualification year.

(5) CONTINUED APPLICATION OF SECTION 593(e).—Notwithstanding the amendments made by this section, in the case of a taxpayer to which paragraph (1) of this subsection applies, section 593(e) of such Code (as in effect on the day before the date of the enactment of this Act) shall continue to apply to such taxpayer as if such taxpayer were a domestic building and loan association but the amount of the reserve taken into account under such section 593(e) shall be only the amount of such taxpayer's reserve for bad debts which is not includible in gross income by reason of paragraph (2) or (4) of this subsection.

(6) REGULATIONS.—The Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out this subsection, including regulations providing for the application of paragraph (3) in the case of mergers, spin-offs, and other reorganizations.

SEC. 3. DEDUCTION FOR SPECIAL ASSESSMENTS.

For purposes of subtitle A of the Internal Revenue Code of 1986, the amount allowed as a deduction under section 162 of such Code for the taxable year shall include the amount paid during 1996 as a special assessment under section 7(b)(6)(B) of the Federal Deposit Insurance Act, as amended by the Thrift Charter Conversion Act of 1995, as proposed by H.R. 2491, as introduced in the 104th Congress.

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Chairman ARCHER. The Committee will come to order.

We meet today to hold a hearing on H.R. 2494, the Thrift Charter Conversion Tax Act of 1995. This is a bill that I introduced with Jim Leach, Chairman of the Banking and Financial Services Committee, and also with Marge Roukema, Chairwoman of the Financial Institutions and Consumer Credit Subcommittee.

When the banking reform movement began to reach fruition in the Banking Committee, it became clear that there were certain tax aspects that needed to be considered. The recapture of reserves posed a problem, and the question of the deductibility of premiums to the insurance fund began to pose a problem. So we are here today to discuss the tax aspects of the changing developments relative to thrifts and banks in the bank reform efforts.

H.R. 2494 contains tax provisions designed to facilitate the conversion of thrifts. It is intended to be consistent with the policies behind the thrift charter conversion proposal, fair to the converting thrifts, and consistent with our deficit reduction goals.

It would repeal the special bad debt reserve rules applicable to thrifts; the recapture of those bad debt deductions, however, would be greatly ameliorated, especially for those financial institutions that continue to make residential mortgages.

We believe that it is a good approach. It may not be a perfect one, and we welcome our witnesses today so that we can get more information.

[The prepared statement follows:]

STATEMENT OF THE HONORABLE BILL ARCHER HEARING ON THRIFT BAD DEBT RECAPTURE THURSDAY, OCTOBER 26, 1995

Today, the Committee on Ways and Means will hold a hearing on H.R. 2494, "the Thrift Charter Conversion Tax Act of 1995," a bill that I introduced with Jim Leach, Chairman of the Committee on Banking and Financial Services, and Marge Roukema, Chairwoman of the Financial Institutions and Consumer Credit Subcommittee.

This bill is intended to address the tax issues raised by the Thrift Charter Conversion Act, which is included in the "Seven-Year Balanced Budget Reconciliation Act." The Thrift Charter Conversion Act would generally require Federal Savings and loans to convert their charters to Federal bank charters.

Requiring thrifts to convert to banks raises several banking, tax, housing, and accounting policy issues. It is not easy to reconcile these sometimes competing policies. Nonetheless, it is clear that the thrift charter conversion proposal must contain transitional tax relief cushioning the blow to thrifts required to convert to banks.

H.R. 2494 contains tax provisions designed to facilitate that conversion. It is intended to be consistent with the policies behind the thrift charter conversion proposal, fair to the converting thrifts, and consistent with our deficit reduction goals.

The bill would repeal the special bad debt reserve rules applicable to thrifts. The recapture of those bad debt deductions, however, would be greatly ameliorated, especially for those financial institutions that continue to make residential mortgages.

This bill's approach is a good resolution of the various relevant policies. However, this is a complex area, and so I particularly welcome technical comments and improvements to the bill.

I look forward to the testimony of the Treasury Department and our panel of witnesses.

Chairman ARCHER. We also welcome Cynthia Beerbower, who is with us at the witness table today.

Ms. Beerbower is the Deputy Assistant Secretary for Tax Policy with the Treasury and is our first witness. We would be pleased to hear from you.

STATEMENT OF CYNTHIA G. BEERBOWER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Ms. BEERBOWER. Thank you very much, Mr. Chairman and Members of the Committee.

I am pleased this morning to present the views of the Treasury Department on H.R. 2494, the Thrift Charter Conversion Tax Act. The bill, as the Chairman has already stated, repeals section 593 of the Internal Revenue Code, and generally ends the bad debt reserve method of accounting for thrift institutions. However, small thrifts, similar to small banks, would be permitted to compute bad debt reserves using the experience method under section 585. In addition, the bill ensures the deductibility of the 1996 special assessment that would be levied on thrifts in order to insure the deposits of SAIF, the Savings Association Insurance Fund.

We want to express our support for the bill. We very much appreciate the efforts of the drafters to try to reconcile what are often competing considerations of tax, banking, housing, and accounting policies that are involved in the decision of how to go forward on the tax side.

As a purely tax policy matter, we also support the bill as representing another very important step toward the financial modernization of the tax law. That is a goal that is very important to this Treasury, and we applaud the step of making the thrifts and banks subject to a common tax regime by eliminating the bad debt reserve method of section 593.

This morning our comments are really in response to the Chairman's letter and of a technical nature.

Our support for the basic repeal of the bad debt reserve method is consistent with very longstanding Treasury policy, regardless of political affiliation. We believe that this method of accounting distorts the timing of taxable income. In addition, the uniformity of the treatment of financial intermediaries, wherever possible, is an important goal of this administration.

We believe on a prospective basis that banks and thrifts should be taxed similarly and that we should minimize, as a banking and as a tax matter, the incentives for thrifts to maintain a narrow focus with respect to their investment activities.

The bill repeals the percentage-of-taxable-income method for all thrifts. However, small thrifts are permitted to continue to compute bad debt reserves using the experience method. We support these rules.

We think the percentage-of-taxable-income method might have been appropriate at one time as an incentive to encourage mortgage lending, but that it should not be retained at a time when our objectives are to remove the barriers to diversification within the thrift industry and move toward uniform taxation of financial institutions.

Concerning the recapture of the bad debt reserve with respect to prior years, the bill would require a thrift to recapture only its increase in reserves since 1987, and it would forgive the recapture of amounts prior to that. In addition, in the case of a thrift that is treated as a small bank, the bill would limit the amount of recapture to the post-1987 increase that could not have been claimed under the experience method.

As the Chairman mentioned, the bill suspends this recapture for any taxable year in which the taxpayer meets a residential lending requirement, and the requirement is satisfied if the principal amount of residential loans made by the taxpayer during that year is not less than one-sixth of the principal amount of residential loans made by the taxpayer during the 6 most recent testing years. I think this will essentially force thrifts to exceed the average of the 6 previous years in order to be certain they satisfy the residential loan requirement.

The Treasury supports the elimination of recapture for the pre-1988 reserve amounts, but this is a very difficult decision. We appreciate the difficulty that the Chairman and other drafters must have faced in resolving this issue. As a purely tax policy matter, we would require the recapture of reserves to the extent that they reflect the experience method of accounting. This would prevent the double counting of losses that are essentially the same losses.

However, it is our understanding that deferred tax liabilities have not been recorded on the thrifts' books with respect to the pre-1988 additions to the bad debt reserves. To recapture these pre-1988 reserves at this point would require thrifts to record an immediate $3 billion increase in their liabilities for financial accounting purposes.

As a banking policy matter, we are concerned that adding this additional liability to their financial accounts at this point perhaps could have a significant effect on the capital of some institutions. At a minimum, under the pending banking legislation that the Chairman referred to, the thrifts will be required to pay an approximately $6 billion special 1996 assessment. In general, this assessment must be paid in full in 1996, so a further $3 billion addition to their liabilities could constrain the resources of the thrifts.

For these reasons, we support the exemption from recapture for the pre-1988 reserves. The spirit of wanting thrifts to be encouraged to become banks and to level the playingfield in this particular case is persuasive to us.

The suspension of the recapture with respect to the residential lending troubles us more, and Treasury questions the suspension in the event that a thrift continues to specialize in residential lending. As a matter of both banking and tax policies, Treasury believes that artificial incentives that encourage financial institutions to specialize in certain areas rather than allowing them to respond to the market incentives should generally be avoided. Rewarding thrifts for continuing to increase their residential lending does just this.

Treasury has technical concerns about the residential loan requirement; specifically the suspension of the recapture, the way the provision is currently drafted is perpetual. It would continue theoretically for hundreds of years. We think if for no other reason than just reducing recordkeeping burdens, that the suspension period should be limited and sunset.

Second, we also question the types of loans that are included in the definition of residential lending. The Committee needs to consider what it wants to achieve with respect to the suspension. Currently, the definition includes refinancing, and a thrift could refinance its existing portfolio and count the principal from these refinancings toward satisfaction of the residential loan requirement.

Similarly, for reasons that are not clear, the draft does not include mortgage modifications. So, for example, if you have a home mortgage and there is a modification to it, a thrift would be encouraged to redo all the paperwork in order to convert the modification to a refinancing that would count toward satisfaction of the requirement. As most of you know, when you do new paperwork on a mortgage in certain circumstances, you incur recording fees and other types of costs.

The definition of residential lending also includes home equity loans which can be used for general consumer spending. The Committee needs to consider whether its objectives are to encourage this type of activity. Alternatively, the Committee could concentrate on a different sort of test, such as residential lending for new homes, that would not have the complexities associated with refinancing and the other aspects I mentioned.

Third, I think Treasury questions the methodology by which thrifts will determine whether they satisfy the residential lending requirement. The bill requires that you average a 6-year period, and then in order to qualify for one particular year, you must equal or exceed that average. If, as is likely, you exceed the average, over a period of time you will be increasing the standard. As a result, thrifts will be encouraged to increase their residential lending activity rather than have it decline. This will mean that thrifts will concentrate their activities more on residential lending.

The particular years that have been chosen as base years for the test are somewhat questionable from our standpoint because they include years in which there were a large number of refinancings and a large amount of real estate activity. The resulting standard may be set artificially high, and as I suggested, will tend to increase over time.

In addition, residential lending is extremely cyclical, as well as varying regionally, and we question whether these testing years are appropriate as a base.

We recommend that if a suspension is to be allowed, it be based on a common standard for all thrifts rather than one that is determined by reference to a particular thrift's prior experience. A common standard would not penalize thrifts that have concentrated more heavily than others in mortgage lending.

Fourth, we question the use of loan origination as the basis for the test. It is not clear as a legal matter what loan origination is. It can mean simply initiating the paperwork. However, with brokers involved in the introduction of customers, it certainly is not clear to me that increased paperwork is really intended to be the standard for satisfying the residential lending requirement.

I think the Committee needs to know, or certainly be aware, that in our current financial environment, securitization of mortgage loans is a relatively easy process. We would expect that thrifts that are required only to originate loans would originate them and immediately sell them off as part of a securitization. What this amounts to is really a debt-financed origination incentive. And, again, we question whether origination is what the drafters intended to encourage.

Instead, we recommend a more portfolio-based standard similar to the 60-percent asset test in current law, but preferably with a reduced percentage. Compliance with a portfolio-based standard would tend to even out the cyclical fluctuations in the mortgage market and might better take care of the region-specific fluctuations.

Treasury does support the recapture of the pre-1988 reserves if thrifts make distributions in excess of their post-1951 earnings and profits to shareholders. We think this bill should not eliminate recapture of windfalls to shareholders by reason of excess distributions. There is a delegation authority in the legislation for Treasury to come up with regulations that address situations such as mergers and other reorganizations, and we will consider what types of adjustments would need to be made for those situations.

Regarding the deductibility of the special assessment, we have no objection to the bill establishing that the 1996 special assessment imposed by the Thrift Charter Conversion Act of 1995 is deductible, provided it is an ordinary and necessary business expense. This act would address the underfunding of the SAIF by imposing a one-time special assessment on the thrifts. The fee will be sufficient to increase the SAIF reserves to a level of $1.25 per $100 of insured deposits. This special assessment, as we understand the legislation, is due in January 1996 and would be based on March 31, 1995 deposit levels.

We understand that the purpose of this special assessment is to increase the capitalization of the SAIF so that insurance coverage is available for 1996. As a separate matter, to address the long-term weaknesses of SAIF, the Thrift Act would cause SAIF to be merged with the Bank Insurance Fund and eliminate Federal charters for thrift institutions. But these objectives are separable. We understand that the special assessment is due regardless of whether the funds merge. In fact, any excess in SAIF would be placed in a special reserve of the merged fund and would not be available for any assessment credit, refund, or any other payment.

We understand that the 1996 special assessment is entirely related to 1996 and is not a prepayment of any future liability with respect to the insurance within the fund. We understand that the assessed institutions have no ownership interest in SAIF and they won't receive a separate or distinct asset as a result of the assessment. We understand the special premium is not rebatable or otherwise recoverable.

Now, if those understandings are correct, under current law we believe the 1996 special assessment would be deductible. On the other hand, we have no problem with the bill including a provision to say that. It simply codifies the current law treatment.

That concludes my prepared technical remarks, and I am happy to answer any questions that you may have.

[The prepared statement follows:]

STATEMENT OF
CYNTHIA G. BEERBOWER
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Treasury Department on H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995" (the "Bill"). The Bill repeals section 593 of the Internal Revenue Code and the bad debt reserve method of accounting for thrift institutions (other than small institutions permitted to use the experience method under section 585 of the Code), as well as ensuring the deductibility of the 1996 special assessment on deposits insured by the Savings Association Insurance Fund (SAIF). We support the Bill, and we appreciate the efforts of its drafters to reconcile the competing considerations of banking, tax, housing, and accounting policies. As a purely tax policy matter, the Bill represents another step toward financial modernization of the tax law--a goal that is very important to the Treasury. Our comments today are of a technical nature.

I. REPEAL OF BAD DEBT RESERVE METHOD

Our support of the repeal of the bad debt reserve method is consistent with long-standing Treasury policy. The tax policy position of the Treasury Department has not changed. We continue to believe that the bad debt reserve method distorts the timing of taxable income, and we continue to support the repeal of the bad debt reserve method. In addition, an important tax policy objective to this Treasury Department is that we move toward uniform tax rules for financial institutions wherever possible. The repeal of the bad debt reserve method for thrifts ensures that banks and thrifts will account for bad debts in a similar manner.

Historically, Congress has accepted Treasury's recommendation only in part. The Tax Reform Act of 1986 repealed the bad debt reserve method for most taxpayers, including large banks. Small banks were allowed to continue using the reserve method because of concerns that they might be adversely affected by repeal. Thrift institutions were also permitted to continue using the bad debt reserve method, but the special benefit they previously received from using the percentage-of-taxable-income method of computing additions to the reserve was substantially reduced.[1] Congress stated at that time that thrift institutions needed some tax incentive to provide residential mortgage loans, but they should not be given a significant competitive advantage over other financial institutions. H.R. Rep. No. 426, 99th Cong., 1st Sess., 582 (1985).

We believe that on a prospective basis, banks and thrifts should be taxed similarly. This will level the playing field for banks and thrifts, and minimize incentives for thrifts to

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[1] Under section 593, a qualifying thrift institution generally may compute its bad debt reserve under either the "percentage-of-taxable-income" method or the "experience" method. The percentage-of-taxable-income method allows a thrift to deduct 8 percent of its taxable income (determined without regard to the deduction and with certain other adjustments) as an addition to its bad debt reserve. The experience method, which is also available to small banks, allows a thrift to deduct the greater of (1) the percentage of its loans outstanding equal to its average bad debt experience (i.e., bad debt losses as a percentage of loans outstanding) in the current and five preceding years, or (2) the amount necessary to restore its reserve to its balance at the close of the last taxable year beginning before 1988 (adjusted downward to reflect any post-1987 decline in loans outstanding).

maintain a narrow focus in their lending activity. Finally, as a banking policy matter, Treasury supports the repeal of the bad debt reserve method of accounting.

II. EXEMPTION OF SMALL INSTITUTIONS

The Bill repeals the percentage-of-taxable-income method for all thrifts, but allows small thrifts (those with no more than $500 million of adjusted basis in their assets) to continue to use the experience method, conforming their tax treatment to that of small banks.

We support the repeal of the percentage-of-taxable-income method for small thrifts. This method may have been appropriate at one time as an incentive to encourage thrift institutions to specialize in mortgage lending. It should not be retained at a time when our objectives are to remove artificial barriers to diversifying thrift portfolios and move toward uniform tax rules for all financial institutions.

III. RECAPTURE OF THE BAD DEBT RESERVE

Under current law, if a thrift institution ceases to be eligible for section 593, it is required to recapture (i.e., include in its gross income) its reserve. In general, the amount would be included in gross income ratably over a 6-year period. The Bill would require a thrift to recapture only the increase in its section 593 reserve since 1987. The Bill would not require the recapture of the amount of the section 593 reserve that was added in tax years prior to 1988 unless distributions to shareholders exceed post-1951 earnings and profits.[2] In the case of a thrift that qualifies as a small bank, the Bill limits the amount of recapture to the post-1987 increase that could not have been claimed under the experience method.[3]

In general, the amount recaptured with respect to post-1987 reserves would be included in income ratably over the 6-year period beginning with the first taxable year beginning after 1995. However, the Bill suspends recapture for any taxable year in which the taxpayer meets a "residential loan requirement." This requirement is satisfied for a taxable year if the principal amount of residential loans made by the taxpayer during the year is not less than one-sixth of the principal amount of residential loans made by the taxpayer during the six most recent testing years.[4] Testing years would include 1990 through 1995 and any subsequent year in which the taxpayer met the residential loan requirement. Special rules are provided for controlled groups and estimated tax payments.

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[2] Section 593(e) of current law, which requires recapture in these circumstances, would continue to apply to the pre-1988 reserve balance.

[3] We question whether the legislation achieves its purpose of forgiving recapture of pre-1988 bad debt reserves in the case of small thrifts. The technical explanation states that "a thrift institution that would qualify as a small bank generally only would be required to recapture its post-1987 additions to its bad debt reserve that were attributable to the use of the percentage of taxable income method . . . ." The legislative language, however, does not specifically provide such an exclusion, apparently under the assumption that the portion of the reserve attributable to use of the percentage of taxable income method is excluded under section 585(b)(2) of current law. Section 585(b)(2) provides that a small bank's bad debt reserve under the experience method is generally not less than the balance of its reserve at the end of its last taxable year ending before 1988 plus experience method additions since 1987. Proposed regulations under section 593 provide, however, that in applying this rule to a thrift that becomes a small bank, its bad debt reserve at the end of its last taxable year ending before 1988 must be recomputed on the experience method. Thus, pre-1988 reserve additions attributable to use of the percentage of taxable income method would not be exempt from recapture under section 585(b)(2). We will be happy to work with the Committee to fix this problem.

[4] For this purpose, residential loans would include loans secured by residential real property, real property used by churches, and mobile homes.

Treasury supports the Bill's elimination of recapture for pre-1988 reserve amounts. We appreciate that this decision is a difficult one. As a purely tax policy matter, we would require recapture of the pre-1988 reserve to the extent it reflects the experience method of accounting. This would prevent a double deduction for the same losses and is consistent with the Treasury's recommendation during the 1986 tax reform. However, it is our understanding that deferred tax liabilities have not been recorded with respect to pre-1988 additions to thrift bad debt reserves, and further that to require recapture with respect to these amounts, even on a deferred basis, would result in an immediate $3 billion increase in thrift liabilities for financial and regulatory accounting purposes.

We also note that under the pending banking legislation, thrifts will be required to pay a 1996 special assessment of approximately $6 billion to the SAIF fund. This assessment must be paid in full this year, further constraining the resources of the thrifts. Forcing recapture now would have a significant effect on the capital of some institutions. Thus, we support the exemption from recapture for pre-1988 reserves.

By contrast, we understand that deferred tax liabilities have been recorded with respect to post-1987 reserve additions. Thus, recapture will not result in any net increase in thrift liabilities for financial and regulatory accounting purposes.[5]

IV. SUSPENSION OF RESERVE RECAPTURE IF INCREASED RESIDENTIAL LENDING OCCURS

Treasury questions technical aspects of the Bill's suspension of post-1987 reserve recapture if a thrift institution continues to specialize in residential loans to the same extent as in the past.

Our first concern is the Bill's perpetual suspension of recapture. As we understand the Bill,[6] a thrift's post-1987 reserves are not fully recaptured until it fails to meet the residential loan requirement in at least six years. The time frame in which this could occur is unlimited. Even if some incentive for residential lending is currently appropriate, we question whether that incentive should continue indefinitely. If for no reason other than reducing record keeping burdens, we recommend that the suspension period be limited and sunset.

Treasury questions the types of loans included in the definition of residential lending. By including refinancings, thrifts can avoid financing new homes, for example, by offering rate reductions for refinancing. The same is true for home equity loans for current homes. The Committee should consider whether it would prefer a rule that encourages only new lending. Also, modifications to existing mortgages do not count for the test. Why force all of the paperwork to be redone? This will often result in recording fees and other burdens to homeowners.

Treasury questions the methodology by which the standard of qualified investment is determined. We do not believe suspension of recapture should depend on whether an individual thrift institution continues to specialize in residential loans to the same extent as in the past. The Bill requires that a thrift average its residential lending over a 6-year period and equal or exceed this average amount in a given year in order to qualify. By taking into account only years in which the lending equals or exceeds the average, the average amount

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[5] We also note, however, that there are precedents for providing recapture relief. For example, the Deficit Reduction of 1984 that changed the method by which life insurance companies compute their reserves allowed a "fresh start" under which excess reserve deductions for prior taxable years were not recaptured. A similar "fresh start" was allowed when the Tax Reform Act of 1986 changed the reserve rules for property and casualty insurance companies.

[6] We find the draft confusing as written and would be willing to work with the Committee to improve it.

will tend to increase over time. This will mean that thrifts will attempt to concentrate their activities even more toward residential lending. In addition, residential lending is extremely cyclical and the particular base period for testing was a historically high period of refinancing. Treasury questions whether these are appropriate test years.

Treasury recommends basing any rule that suspends recapture on a standard that is the same for all thrifts, rather than one determined by reference to the thrift's own past experience. A common standard would not penalize thrifts that have concentrated more heavily than other thrifts in mortgage lending.

Treasury questions loan origination as the basis of the test. It is not clear to us what is technically meant by loan origination other than the paperwork. In our current financial environment, the securitization of residential loans is relatively easy, and we would expect that thrifts will initiate the paperwork for a loan expecting to immediately sell it off. Using loan origination as the basis of the test amounts to nothing more than encouragement for debt-financed origination. Also, loan origination activity has little relationship to bad debt reserves and it is hard to justify on tax policy grounds. Residential loan holdings, on which a thrift has credit risk as well, may be a better measure.

Treasury would encourage the Committee to consider a portfolio-based standard similar to the 60 percent qualified asset test of current law, but preferably with a reduced percentage, instead of a loan origination test. Compliance with a portfolio-based test for this purpose would not be as dependent on cyclical fluctuations--national or regional--in the mortgage market.

Treasury notes that, if the residential loan requirement is retained, it is appropriate for regulations to provide rules for applying the requirement in the case of mergers, spinoffs, and other reorganizations.

Treasury supports the Bill's recapture of pre-1988 reserve balances if a thrift makes distributions in excess of its post-1951 earnings and profits to shareholders.

V. DEDUCTIBILITY OF SPECIAL ASSESSMENT

Treasury has no objection to the Bill establishing that the special 1996 assessment amount imposed by the Thrift Charter Conversion Act of 1995 (the Thrift Act, which comprises subtitle II.B of H.R. 2491) is deductible as an ordinary and necessary business expense. The Thrift Act would address the current underfunding of SAIF by imposing a one-time special assessment on insured depositary institutions. The assessment rate would be sufficient to increase SAIF reserves to a level of $1.25 per $100 of insured deposits. This special assessment would be due in January of 1996 and would be based on March 31, 1995 deposit levels.

The purpose of the special assessment is to increase the capitalization of the SAIF so that it has adequate reserves for 1996. To address long-term weaknesses of SAIF, including excessive concentrations of risk because SAIF insures a specialized industry concentrated on the West Coast, the Thrift Act would separately cause SAIF to be merged with the Bank Insurance Fund (BIF) in 1998, and thereafter eliminate a separate system of Federal thrift regulation. Federal thrifts would be permitted to continue in business only if they convert to a Federal bank charter or a State depositary institution charter.

We understand that the special 1996 assessment will be due independent of whether the insurance funds merge. If immediately prior to any merger the SAIF reserve ratio exceeds the required level of $1.25 per $100 of insured deposits, the excess will be placed in a special reserve of the merged fund and will not be available for any assessment credit, refund, or other payment (except as additional insurance if the insurance fund is severely weakened).

We also understand that the special 1996 assessment has been designed to provide SAIF coverage for 1996, and that it is not a prepayment of future liabilities, but relates solely to the adequacy of SAIF funding and reserve levels in 1996. The intended beneficiaries are only the depositors whose deposits are insured by SAIF. We further understand that the assessed institutions have no ownership interest in SAIF and will not be receiving a separate and distinct asset as a result of the assessment, and that the special premium will not be rebatable, refundable, or otherwise recoverable by assessed institutions.

The Bill provides that the special 1996 assessment on SAIF-insured deposits will be deductible when paid, and Treasury has no objection to this provision. Treasury believes that the special 1996 assessment would be deductible under current law, so that this provision of the Bill would simply codify that current-law treatment. Our conclusions regarding deductibility under current law are limited to the basic special 1996 assessment and should not be construed as applying to other fees that may be imposed by the Thrift Act by other provisions or for other purposes.

This concludes my prepared remarks. We look forward to working with the Committee to resolve our concerns and enact this important and necessary legislation. I would be happy to answer any questions that you may have.

Chairman ARCHER. Thank you, Ms. Beerbower. Thank you also for a detailed explanation of the bill to make the Members here more aware of the details of it and for your position, policywise, on the various elements of the bill.

Let me say in the offing that we look forward to working with the Treasury and perhaps improving this bill as to its details. But let me also say that it is the Chair's position that if there is no recapture over 60 years of existing reserves accumulated after 1986, there should be some standard for continuation of residential mortgage lending.

I know that generally you expressed some concern about that and that there ought to be a level playingfield and that we should perhaps have no such provisions in the bill. But I think the position of the Chair is shared by a majority of the Members of Congress from a public policy standpoint, and the question really is: How are we going to design the basis by which we waive recapture for tax purposes and what will the standards be? And we will be delighted to work with you on that.

Are there any other Members who wish to question? Congressman Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Mr. Chairman, I want to commend you for introducing this very, very important legislation. I just have one question for the Deputy Assistant Secretary.

Ms. Beerbower, you stated in your testimony that under the Archer bill it is clear that the special assessment paid by the thrifts will be deductible as a business expense. In your opinion, will the entrance fee paid by the Oakar banks, that is, banks which acquire thrift deposits, be similarly deductible?

Ms. BEERBOWER. When we were examining the Thrift Charter Conversion Act, we did not see that fee as part of the Banking Committee's legislation, so I am not absolutely sure of the facts associated with this fee.

When you refer to it as a fee the way that you just did, that would suggest that it is not deductible. Fees that are deductible are payments that are made in a current year with respect to business expenses in that current year. Things that are not deductible would be entrance or exit fees or fees that relate to conduct that would occur over a period of time.

Mr. RAMSTAD. So unlike the former, you don't see it as being in the ordinary course of business and, therefore, not deductible?

Ms. BEERBOWER. Well, I prefaced the remarks by saying I haven't seen what is contemplated. It is not in the act that is referenced in H.R. 2494. We would be happy to look at it, but, in general, the standard for deductibility is whether a payment relates to the current year. If it does, it is normally deductible. If it relates to a future period of time, it is normally not deductible.

Mr. RAMSTAD. I appreciate the response.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Kleczka.

Mr. KLECZKA. Mr. Chairman, in your remarks you did address the mortgage origination test, and Ms. Beerbower also talked about it. The criticism that I have heard on this portion of the bill is that it would be too tough for some S&Ls to comply with, even though, you know, they think that that is a worthwhile goal, and it seems to me that we should have a test that can be complied with.

What is your reaction to those comments?

Ms. BEERBOWER. Well, as I mentioned in the oral statement, we do question the loan origination standard as well. It is a vague standard. It is a standard that could be nothing more than simply paperwork. Increased paperwork and securitization of loans may not be the objectives that the Committee wants to achieve.

The difficulty in meeting a loan origination test may very well be triggered not so much by the loan origination test, but by the particular years that are used in computing the average amount that a thrift must equal or exceed. If those years, historically speaking, were years filled with lots of real estate lending activity and lots of refinancing, which is what we believe they were, that will set an artificially high standard for thrifts to meet in the future. And as I said, they must equal or exceed the standard so that, as a mathematical matter, the standard, which may already be too high, will tend to increase in the future.

Mr. KLECZKA. Thank you.

Mr. Chairman, could I inquire of the Chairman what the future holds for this legislation as far as the Ways and Means Committee goes? Specifically, are we going to enter into a markup at some future time so that some of the problems that we are talking about today can be addressed before it is moved up?

Chairman ARCHER. Yes, I will be happy to reply to the gentleman. We believe this is very important conjunctively with banking reform in the Banking Committee and that we must proceed with it, and we hope at the earliest possible time to have a markup. And preceding that, we want to have further interface with the Treasury and, of course, take into account the testimony of the other witnesses today as to what the Chairman's mark might actually be at the time that we mark it up. And the gentleman's input will also be welcome.

Mr. KLECZKA. So there will be an opportunity to possibly make adjustments if, in fact, they are in order?

Chairman ARCHER. Yes.

Mr. KLECZKA. A further inquiry, Mr. Chairman. Once the markup has been completed, I am assuming that it is essential that we put this in the reconciliation bill so that the banking change can be whole at that point. Is that your intention after some type of a markup on the Committee?

Chairman ARCHER. It might possibly be dealt with in the conference on reconciliation.

Mr. KLECZKA. Thank you very much.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Chairman, I have some questions that have been submitted to me by some of the thrifts back home, and I would like to have unanimous consent to just put those in writing to Ms. Beerbower and to you, too, Mr. Chairman, for answers.

Chairman ARCHER. Without objection, so ordered.

Mr. COLLINS. Thank you, sir.

My concern and the concern of my constituency is that in many rural towns where we do have savings banks, they are considered the same as a community bank, which has a far different track record in history than major banks in larger cities.

In your opinion, Ms. Beerbower, will this in any way jeopardize the savings as they appear to be, that is, community banking?

Ms. BEERBOWER. It should not have any effect on this. If a bank serves a particular community, it is going to serve them before and after this legislation. It should not have any effect on serving the community.

Mr. COLLINS. Well, many of the savings, though, do finance heavily in first-time home buying or home mortgage.

Ms. BEERBOWER. We looked at some of the statistics in preparation for the hearing. One of the things that was interesting to me is that the thrifts account for a smaller and smaller percentage of family home mortgage lending. Currently, thrifts account for about 19.5 percent of family home mortgages, with the balance of home mortgages being provided by commercial banks and nonthrift institutions. That part of the industry has been increasing its home mortgage lending.

I do not know why that has occurred, but it may be in your community that home mortgage lending is less dependent on these banks than on commercial banks.

Mr. COLLINS. Well, it is kind of the opposite. A lot of the home mortgages are dependent upon the savings banks rather than the commercial banks. That is one of the reasons they are considered more or less a community-type bank, and we don't want in any way to jeopardize that standing.

Thank you, and thank you, Mr. Chairman.

Mr. PAYNE. Mr. Chairman.

Chairman ARCHER. Yes, Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman, and thank you very much for writing this bill and conducting this hearing this morning.

I would ask unanimous consent to put an opening statement in the record.

Chairman ARCHER. Without objection, so ordered. That will be granted to every Member of the Committee to insert any comments or questions in the record, without objection.

Mr. PAYNE. Thank you, Mr. Chairman.

[The opening statements follow:]

STATEMENT OF REP. L. F. PAYNE
OCTOBER 26, 1995

Mr. Chairman, thank you for holding this hearing today on H.R. 2494, the Thrift Charter Conversion Tax Act. H.R. 2494 is a very important part of the solution to the problems facing our savings and loan institutions.

As you know, the reconciliation bill contains provisions that will merge the Savings Association Insurance Fund with the Bank Insurance Fund and abolish the thrift charter. These steps, along with a special assessment on all SAIF deposits and a redistribution of the burden of payments for FICO bonds, will help us close the books on the savings and loan crisis of the 1980s. And Mr. Chairman, it will do so without costing taxpayers another penny.

However, these provisions will trigger an unintended consequence: the forced recapture and subsequent taxation of the bad debt reserves accumulated by thrifts. This is because thrifts currently enjoy a tax deduction for certain contributions to their bad debt reserves. The deduction is intended to encourage home lending on the part of the thrifts and was subject to several qualifications, one of which is that institutions maintain a thrift charter. The taxation of the bad debt reserves would not only be an enormous and unfair tax, it could also force many of them into insolvency.

And so, Mr. Chairman, I commend you for introducing H.R. 2494 which generally provides a safe harbor from the forced recapture and taxation of thrift bad debt reserves.

I understand that our witnesses here today will propose several technical changes to the bill that I hope you can support. The first would modify the residential loan requirement to prevent the refinancing wave of the early 1990s from forcing the recapture of post-1987 reserves at thrifts that are making substantial numbers of home loans. The second would simply ensure that the sale of a thrift after the 1998 abolition of the thrift charter does not trigger recapture and taxation of bad debt reserves. Lastly, Mr. Chairman, the industry is seeking assurances that it is your intention that the safe harbor provided in H.R. 2494 apply to all institutions with SAIF deposits, regardless of the method ultimately used to bring all financial institutions under one charter and one insurance fund.

Again, Mr. Chairman, thank you for holding this hearing and I look forward to the testimony of our witnesses.

STATEMENT OF U.S. REP. JIM RAMSTAD
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
October 26, 1995

I want to commend Chairman Archer for introducing the Thrift Charter Conversion Tax Act of 1995 along with members of the Banking Committee.

The historic Reconciliation legislation the House will be considering today calls for the merger of thrift and bank deposit insurance funds, and ultimately the merger of thrift and bank charters. The conversion of thrifts to banks will have major tax consequences.

I am looking forward to the testimony that will be presented today regarding the two major issues raised by the Banking Committee's charter conversion proposal -- the tax treatment of bad debt reserve as thrifts convert their charters, and the deductibility of the special assessment thrifts will pay to recapitalize their deposit insurance fund before it is merged with the bank insurance fund.

I look forward to passing legislation that is fair and equitable and will contribute to the long-term solvency of our financial institutions.

Mr. PAYNE. I would simply like to follow up Mr. Ramstad's comments concerning the Oakar banks, those banks who had purchased deposits from SAIF-insured institutions. It is my understanding that the Financial Institutions Subcommittee has already passed a bill dealing with the special assessment and moving these funds from SAIF to the BIF Fund. And it would seem to me that one of the considerations that we need to look at on this Committee would be what is the appropriate tax treatment of the special assessment that would have to be paid by these institutions.

So I would like, as we move forward on this, to continue, both with the Treasury and on this Committee, to look at that because I think that is an issue that needs attention.

One other issue that we need to address is that with the residential loan requirement provision and the 6-year average that we have discussed, apparently in this 6 years there was an unusual period of time when there was a significant amount of refinancing. I think it is also very important as we move forward that we either exclude that kind of activity from an average or we have some sort of a factor that is applied that would have the effect of excluding that sort of activity.

So I would simply mention these things, Ms. Beerbower. Thank you very much for your testimony. I thank the Chairman, and I yield back the balance of my time.

Chairman ARCHER. Mr. Portman, do you wish to be recognized?

Mr. PORTMAN. Mr. Chairman, I just want to commend you for bringing up this issue. I also have met with many of our thrifts back home which have raised some questions. If it is appropriate, I would like the option to submit those in writing to Treasury and to the Chairman.

Chairman ARCHER. The Committee Members are given general leave to do that.

Mr. PORTMAN. Thank you, Mr. Chairman.

I also would say I support the entrance-fee clarification and, again, would commend the Chairman for acting swiftly and promptly on this issue.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Ms. Beerbower, would you clarify your position on the definition of origination as to the point of refinancing of home mortgages, taking advantage of lower interest rates, how you would treat that? Also, would you comment on including the prevalence of relationship as loan brokers in your definition of origination?

Ms. BEERBOWER. Well, our testimony suggests that it is unclear what it means to originate a loan. This type of definitional problem comes up in many different areas of the Tax Code.

For example, if I bring you a customer who wants a home mortgage, have I originated it by reason of finding the customer for you and bringing him to the bank? Or when you take the mortgage application and put the fellow's name on it, have you originated it? These are not clear legal matters.

Mr. LAUGHLIN. I was asking you to comment also on the refinancing of an existing home mortgage.

Ms. BEERBOWER. On refinancing and home equity loans, refinancing is a term of art which generally suggests that the legal documentation underlying the mortgage is canceled and new documentation is provided.

Another way of adjusting a mortgage is simply to make a modification on the existing legal documentation. It is my understanding that modifications would not count toward the amount of residential loans that a particular institution has made, but that refinancings would count. As a result, there is an incentive for thrifts that are dealing with customers who are modifying mortgage documentation to refinance the loan.

The other question I had for the Committee is whether you want to encourage new-home residential lending or whether you want to encourage refinancing of existing residential lending or existing home equity loans that are secured by residential properties. I think that the Committee needs to decide what it wants to encourage, because whatever is included in the definition of a qualified loan will be what is encouraged by the legislation.

Mr. LAUGHLIN. Are you treating a new home any differently whether it is a newly constructed structure or one that has existed and there is——

Ms. BEERBOWER. No, I did not mean to make that distinction. New home means that it is a new sale as opposed to a refinancing.

Mr. LAUGHLIN. And in your definition of origination, would you in any way define the relationship among brokers?

Ms. BEERBOWER. Well, I find origination is a bad test, and I think we would recommend the Committee move away from that as a test and use something much more like what is in current law. It is very difficult to determine whether a broker originates the loan when he brings it to the bank and the bank fills out the paperwork, or whether the bank originates it when the borrower is brought in and the paperwork is transferred.

Mr. LAUGHLIN. Thank you very much. Thank you, Mr. Chairman. I yield back.

Chairman ARCHER. Are there further questions for Ms. Beerbower?

[No response.]

Chairman ARCHER. Ms. Beerbower, thank you very much. You are excused.

[Follow up answers for the record from Ms. Beerbower to Congressman Neal were subsequently received:]

RESPONSES TO MR. NEAL'S QUESTIONS

Question: Will this proposal require thrifts such as state chartered BIF insured saving banks to convert to "Banks"?

Response: No. The proposal addresses only the repeal of the special bad debt reserve rules applicable to thrift institutions and the deductibility of the special assessment for SAIF.

Question: Also, will the changes in the legislation relating to the amount of adjustment to be taken into account as a result of the required change in an institution's method of accounting for bad debts apply to institutions likely requiring taxable recapture of significant amounts of bad debt reserves, if the legislation is not amended?

Response: Yes. Unless the tax rules are changed, a Federally chartered thrift institution that becomes a commercial bank under the Thrift Charter Conversion Act would be required to recapture its entire bad debt reserve (or, in the case of a small thrift, the part of the reserve that could not have been claimed under the experience method). Under the tax rules proposed in the bill, these institutions would not be required to recapture pre-1988 reserve amounts and could suspend recapture of post-1987 reserve amounts for any taxable year in which a residential loan requirement is met.

Question: The legislation requires the inclusion of excluded debts for bad debts into gross income in certain limited circumstances. Do you think the legislation should forgive the excluded amounts for all purposes? Without this exclusion institutions will never be free from the taint of the excluded amounts.

Response: We support the provision requiring recapture of pre-1988 bad debt reserves when thrifts make distributions to shareholders in excess of post-1951 earnings and profits. We think the bill should not eliminate recapture of windfalls to shareholders by reason of excess distributions.

Question: Robert Sheridan, President Savings Bank Life Insurance Company of Massachusetts has submitted testimony for the record about the tax treatment of consolidations of life insurance department of mutual savings banks. I believe we need to legislatively clarify that the payment of the additional annual dividend based on the combined surplus should be deductible, reflective of earnings, mortality and expenses like any other dividend. Could you comment on this?

Response: This issue was addressed in one of the miscellaneous tax proposals on which the Ways and Means Committee held public hearings in July. In the written statement we submitted in connection with the hearings, we said that the Administration would not oppose that proposal as long as it is limited to consolidation of life insurance departments of mutual savings banks under section 594 under requirement of State law, and applies only if (1) policyholders have no rights to surplus and no voting rights prior to the consolidation, and (2) their approval is not required in order for the consolidation to occur.

Chairman ARCHER. Our next panel is James Montgomery, Thomas M. O'Brien, and Stephen Kinnier.

Welcome, gentlemen. Mr. Montgomery, would you lead off and would you identify yourself for the record?

STATEMENT OF JAMES F. MONTGOMERY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GREAT WESTERN FINANCIAL CORP., CHATSWORTH, CALIFORNIA, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. MONTGOMERY. Thank you, Mr. Chairman. I am James F. Montgomery. I am chairman of Great Western Financial Corp. and Great Western Bank, headquartered in California. At $42 billion in assets, we are the second largest thrift in America. We are the third or fourth banking-type organization in California, depending on this or that merger, but we have always been the leading lender in the inner cities of California and to minorities with respect to residential lending, and we are very proud of that.

I am here today representing our national trade association, America's Community Bankers, of which I am vice chairman. I really wish to commend the Chairman for working with Chairman Leach of the Banking Committee to fashion this legislation, H.R. 2494. This is a very important component in the BIF/SAIF deposit insurance resolution which will fully recapitalize the SAIF Insurance Fund, insure it, and assure everyone that there will never again be a thrift crisis in America.

There are two principal elements of your bill: First, we appreciate that this assures the deductibility of the $6 billion special assessment which thrifts will pay to recapitalize SAIF; second, the bill addresses in an important way the recapture of the so-called thrift bad debt reserve.

My own views on the bad debt reserve issue closely parallel the views expressed by Federal Reserve Board Chairman Alan Greenspan in testimony delivered to the Financial Institutions Subcommittee of the House Banking Committee in September of this year. To quote Chairman Greenspan,

> The special bad debt reserve treatment that provides tax benefits—and, hence, a subsidy—to mortgage lending by thrifts no longer serves a perceivable public policy function and, hence, should be removed going forward.

The proposed legislation eliminates this subsidy prospectively by treating thrifts the same as commercial banks. We think that is appropriate for the future, and this also enhances revenues to the treasury.

Chairman Greenspan continues,

> Moreover, the tax recovery of the reserve buildup from this past tax subsidy should be eliminated. In reality, this reserve was always a subsidy and never really a true bad debt reserve.

I certainly agree with that. I have felt for many years that calling this subsidy a bad debt reserve was not an appropriate thing, and I am glad we are dealing with this at this time.

Chairman Greenspan continues,

> The possibility of any significant recapture of lost tax revenue to the U.S. Treasury has been hypothetical at best because of the tax-induced high marginal cost to thrifts of reducing their mortgage portfolios and, as a result, triggering the so-called bad debt recapture.

Certainly I agree with that. That is true for Great Western. We would never do anything voluntarily to trigger this reserve recapture. Obviously, if we are going to be required to convert to a commercial bank charter, we don't think it is appropriate to have that trigger recapture as well.

The legislation does permanently remove bad debt reserves accumulated before 1988 from threat of recapture and conditionally suspends bad debt recapture on post-1987 additions, provided that we meet a new mortgage origination test. We certainly have no objection to this basic approach. We at Great Western and most thrifts that I have talked with intend to continue what we have done for a living for many years, and that is make mortgage loans. However, we do believe that the details of the mortgage test should be clarified and adjusted in ways that we have suggested in our written testimony.

We have also recommended revisions to the legislation with respect to small thrifts under recapture, the duration of the testing period, and the advisability of the continuation of 593(e). But we consider these details. We think the legislation itself is very appropriate, very timely, and we thank the Chairman for being proactive on this important subject.

I will be happy to answer any questions at the conclusion of the testimony. Thank you.

[The prepared statement and attachments follow:]

Statement
of
James F. Montgomery
Chairman & Chief Executive Officer
of
Great Western Financial Corporation
Chatsworth, California

on behalf of
America's Community Bankers

before the
Committee on Ways and Means
of the
United States House of Representatives

October 26, 1995

Introduction

Good morning, I am James F. Montgomery, Chairman and Chief Executive Officer of Great Western Financial Corporation. With assets of $42 billion, Great Western is America's second largest thrift institution. We are the third largest banking institution in California, and we have historically been the leading lender to minorities in California by a wide margin. I am appearing here today in my capacity as First Vice Chairman of America's Community Bankers, a national trade organization representing an industry with 2,200 institutions holding $1 trillion of assets. Our members provide real estate finance and community financial services, and are insured by both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). ACB is the only broad-based banking trade group representing Bank Insurance Fund (BIF), as well as SAIF insured institutions.

Proposed Banking Legislation

Mr. Chairman, ACB deeply appreciates your introduction of HR. 2494, the Thrift Charter Conversion Tax Act of 1995. Its provisions attempt to resolve two tax issues that stand as impediments to the efforts of the House Banking Committee to safeguard the depository insurance system. ACB members have been fully supportive of this effort. We are very grateful to you, Mr. Chairman, for your willingness to assist in moving the process forward. ACB is also very grateful to the staffs of the Ways and Means Committee and the Joint Committee on Taxation for their responsiveness, their unfailing courtesy, and their generous commitment of time to the efforts of the Banking Committee despite the extraordinary demands on their time during the budget reconciliation process.

As part of this process of banking reform, the savings and loan industry has voluntarily agreed to immediately bring the SAIF up to its statutorily-required reserve level via a one-time assessment of approximately $6.2 billion on all SAIF-insured deposits. The Banking Committee has also recognized the necessity of spreading, proportionally, the responsibility for paying the interest on Financing Corporation (FICO) bonds originally issued to provide capital to the FSLIC insurance fund. The fixed interest cost of the FICO bonds has been consuming a larger portion of each premium dollar as the SAIF deposit base against which the premiums are assessed has declined. Currently, 45 cents of each SAIF premium dollar is diverted to pay the interest on the FICO bonds. This diversion was the reason that the SAIF had not reached and could not reach its required reserve level of 1.25 percent to insured deposits in tandem with the BIF. The debt service on FICO bonds was a burden imposed on the surviving savings and loans to resolve a problem for which they bore no more responsibility than commercial banks.

With the recapitalization of the SAIF to its target level and the spreading of the FICO debt service across all deposits insured by the Federal Deposit Insurance Corporation, the destabilizing disparity in premiums for identical deposit insurance coverage will be avoided. The way will then be cleared for a merger of the separate BIF and SAIF funds into a larger, more diversified, and therefore sounder structure.

As the legislative solution to the SAIF/FICO problem has evolved, it has become apparent that two significant tax issues are involved, and that a significant dimension of the solution would actually fall within the jurisdiction of the tax-writing committees in the Congress. With the major elements of that plan now adopted by the banking committees in each chamber, these tax issues now come before this distinguished committee.

Deductibility of Special Premium Payment

The first tax issue arises with the very large payment that will be assessed on SAIF-insured deposits.

The need for full deductibility of this payment, just as for the regular risk-based premiums charged by both BIF and SAIF, has been of vital importance to ACB as a fundamental component of the legislative package. ACB has been gratified by the assurances given by the Treasury domestic finance and tax policy staffs that structuring the solution to ensure this result was of equal priority to the Administration and that the structures under consideration in both House and Senate banking committees passed muster in that regard.

ACB therefore also appreciates the clarification within Section 3 of the bill before this committee to make explicit the result that the Administration had indicated would be provided by the regulatory process. In matters of this significance, the more assurance the better.

Before moving to the more complex issues that arise from the interplay of tax and banking law provisions as regards the treatment of bad debt reserves, it may be useful to note that even a provision as straightforward and well-intentioned as the one-paragraph Section 3 does have its nuances. These are discussed more fully in Appendix B. The issues relate to the treatment of payments by so-called Oakar banks under some versions of the legislation being considered by the banking committees, the exact point at which a deduction can or must be recognized for book versus tax purposes, and the limitations on deferred tax assets (tax deductibility benefits to be obtained in future proceeds) within capital adequacy calculations prescribed under banking law and regulation.

Of course, the driving force bringing these concerns before this committee is the desire for a truly comprehensive resolution of the structural issues within deposit insurance and depository institution charter authorities. ACB has been supportive of the efforts to address these issues provided that they do not delay the legislative response to the threatened FDIC premium disparity and provided that the second tax issue ACB identified at the outset can be addressed.

This is the treatment of the tax bad debt reserves accumulated by thrifts under their special provision, Section 593 of the Internal Revenue Code. The House Banking Committee as part of its reform legislation has passed legislation that will require federally chartered savings and loans to change to either a national bank charter or to a state thrift charter. This mandatory charter change will require federally chartered savings and loans to give up important powers, including broader affiliation and branching authority than is permitted under a national bank charter. There is, however, a far more serious and immediate tax problem created by the forced changed to a national bank charter.

Current Law on Bad Debt Reserve Recapture

Under current law, where a thrift changes to commercial bank charter, it could be required to recapture the full amount of its loan loss reserves. The recapture would be huge because under the percentage-of-taxable-income method thrifts were permitted to take generous deductible additions to their loan loss reserves. This method was permitted as a subsidy to thrifts in their former role as the main source of residential mortgage lending. (See the detailed explanation of the thrift reserve method in Appendix A of my testimony.) Under the tax law, when the thrift charter disappears, an institution faces the recapture of these previously accumulated reserves. The exact procedures and the exact amount of recapture under current law are not completely clear. The actual payment of the tax can, presumably, be spread under section 585(c)(3) and (4) of the Code, though proposed regulations from the Internal Revenue Service challenge this interpretation. It is also conceivable that the amount of currently payable tax will be diminished by net operating losses enhanced by the payment of the special SAIF assessment.

An even more immediate problem is presented, however, by the accounting treatment of recapture of the loan loss reserves. Under GAAP accounting, a distinction was made between the taxable years beginning before and after 1988 owing to the expiration of the "base year rule" of section 585(b)(2)(B). The base year rule, which was an alternative computation available under the experience method, would prevent a recapture of the bad debt reserve where the reserve was larger than permitted under the experience method. For taxable years beginning after 1987, any charges against the reserve henceforth could not automatically be followed by deductions to restore the reserve to its previous level. An automatic deduction would be allowed only to restore the tax reserve to its base year level. A decline in the reserve, to the extent of the difference between the base year, reserve and the reserve at the beginning of a later year, could therefore occur in the event of charge-offs. The reserve could have increased from the base year level of 1987 by deductions claimed under the percentage-of-taxable-income method but if a subsequent significant charge-off occurred in, say, 1991, that dug down well into the reserve the reserve could be automatically restored only to its 1987 dollar value, <u>not</u> the higher level that it had reached prior to the charge-off.

For this reason GAAP accounting has made a distinction as regards the need to provide deferred tax liability on reserves built up before the 1988 tax year and those built up subsequently. The deferral of liability for tax on the post-1987 reserves has been treated as merely a temporary difference and its effect has been included in the financial statements as a deferred tax liability. This has therefore already indirectly reduced capital for each year's accrual of the tax liability since capital is computed as assets less liabilities. The liability for recapture tax on the pre-1988 reserve, however, is treated as a permanently deferrable difference between book and tax income for which no tax provision has been made in the financial statements. Under current GAAP, no tax provision within the financial statements has been required on the base-year amount since that level <u>could</u> be indefinitely retained by automatic "base-year fill-up" tax deductions.

As a result of the GAAP characterization of the pre-1988 recapture tax liability, if a savings and loan is required to change to a commercial bank charter, its capital will be reduced by the full amount of the recapture tax on the pre-1988 reserve. Although the actual payment of the tax will be spread, the full effect on capital will be immediate in the year that the requirement of a mandatory charter change is enacted. It also will not make any difference whether the actual charter change is deferred for some time after enactment. The GAAP standard is that the liability must be booked at the point where "it becomes apparent that those temporary differences will reverse in the foreseeable future."

By itself, the effect of reserve recapture on capital would be devastating for many institutions, but, following the payment of the special SAIF assessment, a truly dangerous situation across the industry will be created. The special assessment will reduce the capital of savings and loan on average by a year's earnings. The loss of capital from booking the pre-1988 recapture tax liability will be on average twice as bad, and, for many institutions, the loss of capital would be significantly greater.

Provisions of H.R. 2494

The bill repeals the percentage-of-taxable-income reserve method for taxable years beginning after 1995. All institutions subject to the legislation, whether or not they actually change to commercial bank charters, will, after the effective date, treat loan losses under the rules applicable to commercial banks. "Large" ($500 million or more in total assets) former thrifts will be ineligible for the reserve method and be permitted to deduct loan losses only as they are actually charged off against income. "Small" former thrifts will be permitted to continue on the reserve method, but using only the moving-average experience computation of section 585(b)(2) of the Code.

The maximum amount of the reserve adjustment recaptured into income under section 481(a) upon the change from the section 593 method to the commercial bank methods will be limited to the reserves accumulated after the 1987 tax year. Any recapture will occur over six years on a straight line basis, commencing with the first taxable year after 1995.

ACB has completed a survey of its members (savings and loans, BIF-insured savings banks, and cooperative banks) to determine their tax liability upon recapture of their bad debt reserves. A separate analysis was also conducted using publicly-available Form 10-Ks filed by stock thrifts with at least a billion dollars in assets. The consistency of the two data sets, in all areas where they can be benchmarked, produces some confidence that the results from the more detailed survey response can be reliably extrapolated to the entire industry. Based on these survey results, it appears that the recapture tax liability of the industry on its post-1987 reserve accumulation is approximately 20 percent of the total estimated liability. Based on the survey responses, the recapture tax would have been approximately 25 percent of the total liability had institutions been limited to the bank moving average experience method. Approximately 70 percent of the responding institutions reported using the percentage-of-taxable-income method for their most recent taxable year and approximately 74 percent stated that they expected to be able to use that method in the current or the coming tax year. Thus, the repeal of the thrift reserve method on a go-forward basis will represent a significant revenue pick-up for the Treasury.

In the case of a large former thrift, all reserves accumulated after 1987 will be recaptured unless the institution satisfies the loan origination test outlined below. In the case of a small former thrift, the recapture is also, according to the explanation of the statutory language, to be limited to the post-1987 accumulations under the percentage-of-taxable-income method. When a small former thrift subsequently crosses the $500 million threshold, it will be required to recapture under the bank recapture timing rules of section 585(c)(3) and (4) only any amount of its experience, "bank-type" reserve in excess of the pre-1988 thrift, base-year reserve.

For both large and small thrifts, the recapture of the post-1987 portion of the reserve may be suspended, even once begun, if the former thrift meets the mortgage origination test. In order to qualify, the former thrift must continue to originate mortgages annually at the average annual level of the most recent six years. To avoid ultimate recapture under this rule, the former thrift will apparently be required to meet 100% of this annual mortgage origination target in perpetuity.

Finally, the former thrift will remain subject to the rule of section 593(e) to the extent of the amount of the pre-1988 reserve. It is as if the pre-1988 base year reserve remains in existence (and subject to current law) solely for purposes of this rule. Section 593(e) was enacted in 1962 when thrifts were beginning to undergo conversions to stock form. Section 593(e) provides that, where a thrift makes a distribution of capital, repurchases stock, or liquidates, the Treasury will recapture prior reserve deductions. Tax-free reorganizations, however, are currently excepted from this recapture rule. (See the description of the origin of this rule in Appendix A.)

Requested Modifications

ACB appreciates the care with which the proposed language addresses the industry's concerns over adverse financial statement impact. We have identified a number of issues that we would like the Committee to consider in its speedy processing of this legislation. The issues arise in five areas:

i) the details of the mortgage origination test;
ii) the treatment of small thrifts under recapture;
iii) the period over which any recapture would occur;
iv) the continued application of Section 593(e);
v) the availability of the special carryback rule of Section 172(f).

I address these issues below.

Mortgage Origination Test

The provision that has generated the most concern is the mortgage origination test. The test is intended to encourage a continued commitment to the residential mortgage market that our members have traditionally served. As discussed below, most institutions affected by this legislation will continue to focus on mortgage lending. But even those institutions that fully intend to do so indicate that they will have difficulty complying with the test because of its inflexibility.

If the test is to be effective, it must permit a prudent focus on mortgage activities that is adaptable enough to conform to evolving market conditions. The proposed origination test may actually be unwise as a matter of policy because it creates a significant financial inducement to attempt to meet a high and rigid concentration in mortgage originations. In fact, thrift executives feel that they could be penalized by the test if they do not maintain a level of mortgage lending that their business judgment tells them may well be risky in some years and may well open them to criticism from their regulator.

Mortgage cohorts, the groups of loans originated in specific time periods, can show very different default and foreclosure rates. Recently published data from the private research organization, the Mortgage Information Corporation, show that the immediate post-closing delinquency rate for 1995 loans is six times that for 1993 loans. Forcing institutions to lend at a constant rate, regardless of likely borrower repayment capacity is clearly unwise.

The goal of the test should be to achieve the optimum level of participation in the mortgage market for an appropriate transition period by taking into account the risks of over-concentration and recognizing the variety of roles that thrifts currently play in an efficient market.

ACB deeply appreciates the cooperation between this committee and the House Banking Committee. ACB feels, however, that the structure of the origination test could be more consistent with the basic thrust of the banking legislation that these tax law amendments would perfect. The basic idea is to allow institutions to select their lines of business by choice rather than charter. Most thrift institutions will continue to focus on mortgage lending because they do it very well and very safely. Some, however, will seek to diversify into broader-based consumer banks and some will move towards greater involvement in small business and corporate lending.

Because of the changes in the mortgage market stemming from the greater role of mortgage banking entities, themselves often owned by banks or thrifts, and the ongoing rapid growth in the market share of Fannie Mae and Freddie Mac as government-sponsored loan packagers and investors, in many real estate markets specialization and economies of scale have sharply changed operating margins. Thrift institutions have been adapting to these changes and have focused more on market segments at the opposite ends of the socioeconomic spectrum not well-served by standardized secondary-market-driven loan terms. There is clearly no shortage of mortgage money for the conforming market below the $203,150 loan limit.

These market realities are irreversible. What is needed is a transition mechanism to protect borrowers from any sudden shift from the new charter changes being designed by the Congress. But the extent of the potential market shock should not be overestimated. Most thrift institutions will maintain mortgage lending as their prime or at least one of their major lines of business. The Congress cannot turn back the clock nor can the industry turn on a dime in response to those forces. The structure of the origination test should reflect those realities.

The most obvious problem with the proposed test is that, for its first three years of operation, the test will include 1993. This will skew the test upward because of the artificially high number of originations due to the refinancing boom of that period. At a minimum, ACB requests that the highest year of any testing period should be excludable, consistent with precedent under the tax code. Averaging alone will not solve the problem of the refinancing surge. From 1993 to 1994, total origination volume dropped almost 40%. The five other years in the testing period will not smooth that out. It would make equal or more sense, however, to simply exclude refinancings from the test, though this would cause some administrative burdens.

Another obvious problem with the test is that it does not take into account changes in the size of the institution from year to year. An important technique adopted by many institutions over the last five years to achieve capital compliance was increasing the capital ratio by simply shrinking the institution. Branches were sold and loans no longer originated in previously served market areas. Because the test makes no allowance for increases and decreases in size, it punishes the institution that shrinks and rewards, at least temporarily, one that grows. This aspect of the test is not only unfair, but potentially dangerous to the extent that it discourages prudent behavior.

The term "origination" should be defined flexibly to recognize the evolving role of thrifts in the mortgage process. Many thrifts have found that they can participate most efficiently in the market by working with brokers in formal or casual relationships. Lenders have formed a wide variety of relationships with loan brokers. To survive by providing the best deal to borrowers, brokers typically do not have exclusive relationships with a single lender. Thus, it is not always the case that the broker will arrange to close the loan in the lender's name with the lender's funds on the lender's forms. Even so, under "table funding" arrangements the "wholesale" lender is often immediately substituted for the "retail" lender/broker so that the wholesale lender, economically, is the originator as a matter of substance, if not form.

The prevalence of the lender/broker relationships that have quietly revolutionized the origination process over the last five years must be recognized within the origination test. The drafter of that test, the IRS under the bill, must confront some difficult decisions on how quickly the loan must be transferred to the ultimate servicer/investor in order to qualify as an origination under the test. One way to accommodate the more complex origination process today would be to allow a "wholesale" origination credit for any loan acquired on the first sale from a loan conduit or broker. Obviously, no double counting should be allowed for any given loan.

One of the most important roles that thrifts play in the current mortgage market is the holding of nonconforming loans that for a variety of reasons, e.g., borrower profile, loan amount, or characteristics of the property, are unacceptable to the government-sponsored enterprises and difficult to match with other secondary market investors. ACB believes that there should be an alternative asset test that recognizes the important role thrifts play as portfolio lenders.

In fact, the tax code already contains such a test under Section 7701(a)(19)(C). Since as outlined above, there is no shortage of mortgage funds for conforming Fannie/Freddie secondary market quality loans, the area where public policy might seek to support housing credit in order to smooth a transition period is in the non-conforming product that must appear on the lender's balance sheet anyway since it cannot be sold. ACB appreciates concerns about "slippage" between actual mortgage lending and the 60% asset composition standard under the existing code, but it may be a simpler technical task to make fine-tuning adjustments to a long familiar test than to erect a whole new system.

This is all the more significant in that ACB would suggest that the basic logic of the test with which an institution must comply to suspend the Section 481(a) recapture argues for application for a limited period. The total amount of tax liability involved is approximately $1 billion, which can be suspended by meeting the test.

Some readers of the text of the bill initially formed the apparently erroneous impression that the test would be in force only for the six year period from 1996 onwards. Such a limited time period actually makes great sense. Institutions should not be permanently in thrall to a test structured to a fixed dollar amount. Eventually, organic growth will dilute the importance of the test to irrelevance.

In the meantime, however, market fluctuations may make the test impossible to meet, especially for smaller institutions with limited geographic scope. It is certainly conceivable, indeed inevitable, that, for some local market, supply and demand conditions will simply prevent any lender operating only within that market from maintaining the average origination volume of recent years. An entire local market's mortgage business can collapse from loss of a major employer or some other exogenous force.

The above mentioned balance sheet approach can accommodate such a phenomenon. If the basic origination approach is maintained, some alternative is necessary. One way to handle this contingency would be to allow institutions to be deemed to satisfy the loan origination test if, say, 50% of its loan volume were of the required type and if its Community Reinvestment Act rating is at least "Satisfactory". This would handle cases where the failure to meet the origination standard is the simple absence of any demand that the institution could prudently meet at other than give-away rates. The institution <u>is</u> making all the loans that the market needs, as demonstrated by its CRA passing performance.

If the originations test is to be maintained indefinitely, the institution, in addition to the above alternative, should also have the option of meeting the **lesser** of the **initial** testing period dollar target and the most **recent**. The institution earned the fixed amount of post-1987 bad debt accumulation via its performance over the 1987 to 1995 period. It should not have to do any more than that to hold on to those amounts in the future. If satisfying the test is obviously impossible over the long run, institutions will simply consider the best time to fail and desired effort on credit availability will not persist anyway.

<u>Small Thrift Recapture</u>

The percentage-of-taxable-income method provided a subsidy to thrifts in recognition of the vital role that the industry performed as, until recently, the sole providers of residential mortgage finance. This subsidy provided a means to build up capital in implicit recognition of the risks created by the industry's high degree of specialization. Nevertheless, a true reserve component (deductions taken for anticipated losses) can be imputed to the thrift reserves on the basis that had the thrifts not had their subsidy method available they would have used another method that more accurately anticipates losses in the current portfolio.

The ACB survey data indicates that the aggregate dollar value of the hypothetical experience reserve and the aggregate dollar value of the post-1987 accumulation of reserves are roughly equal. The distribution across institutions, however, is quite different.

Recapture of one amount or the other would produce comparable revenue to the Government. A substitution of the post-1987 accumulation for the hypothetical experience reserve as the amount subject to recapture, however, has a very practical attraction. Recapture of the post-1987 reserve will have no impact on the industry's capital because, as mentioned, GAAP requires that the addition of each layer of post-1987 reserves reflect the effect on retained earnings of the future reversal of the current tax deduction. The tax bill from recapture of the post-1987 reserve would be borne, for the most part, by the most profitable institutions. Recapture of the hypothetical experience reserve would require the highest payments from the institutions with the most losses and it is very likely that none of their reserves would have been "tax effected" because none of them have been built up since 1987.

ACB believes that, based on this analysis, the recapture being imposed on thrifts is comparable to what was imposed on the banks in 1986. A portion of the industry's reserves that, as a percentage of total reserves, approximates the portion of the total reserves that could have been held under the experience method would be recaptured if thrifts adopt the diversified asset allocation strategies typical of commercial banks. There is an argument that, even under existing law, a converting small institution is not subject to any recapture and can simply grow into its thrift reserve, as long as the institution stays below the $500 million dividing line. This analysis is contrary to the views of the Internal Revenue Service, though the issue would be moot on enactment of this proposal.

ACB requests that, as with the treatment afforded commercial banks, no recapture be imposed on small thrifts under the legislation. If and when a small former thrift becomes "large," its experience reserve, plus its post-1987 reserve built up under the subsidy method can be recaptured -- with a credit for the pre-1988 reserve. Such treatment would be a fairer way to treat small thrifts and would be consistent with the policy underlying the legislation.

The mechanics of the recapture rules that apply to small former thrifts that are required to recapture their post-1987 reserves under the legislation and, subsequently become subject to the large bank rules are not entirely clear in the statutory language. Based on the language in the Description it appears that so much of the total thrift reserve as qualifies as a hypothetical experience reserve, even if it were accumulated after 1987, will be treated as if it were the opening small bank reserve. Thus, the post-1987 experience reserve will not be subject to recapture. Where the small bank then becomes a large bank, to avoid the loss of the benefit of the proposed treatment of recapture of the pre-1988 reserve, recapture of the experience reserve will be limited to the excess over the pre-1988 reserve. Nevertheless, although it seems apparent that the small thrift recapture rules operate this way, more detail is needed.

<u>Recapture Timing Rules: Section 585(c)(3) - (4)</u>

ACB requests that, consistent with the analogy to the recapture of the bank reserves, the recapture timing rules of section 585(c)(3) and (4) of the Code should be applicable to the recapture of the thrift reserves under the bill. The Committee has the power, of course, to decide the appropriate spread period for the new set of recapture rules created by the legislation. Specifically, Revenue Procedure 92-20, 1992-1 C.B. 685, provides that in certain situations the Commissioner may permit a section 481(a) adjustment to be taken into income using a cut-off method. ACB believes that the use of a cut-off method would be particularly appropriate because it was made available under section 585(c)(4) to large banks required to change from reserve method. ACB is concerned that the use of the six-year spread typically provided in the case of voluntary changes from a "class B" method, as that term is used in Rev. Proc. 92-20, may have been influenced by the proposed reserve recapture regulations issued by the IRS in 1991.

These regulations, insofar as they applied to non-acquisitive charter changes, were criticized by every comment letter received by the IRS at the time of their publication. The theory of the proposed regulations is that a thrift that loses eligibility for the section 593 method is required to change to the section 585 method. Congress was unaware in 1985, when the section 585 recapture timing rules were created, of the IRS position that the thrift and bank methods are separate methods of accounting. This lack of awareness is apparent because the imposition of the proposed regulations creates an absurd result with respect to large thrifts.

The IRS position is that large thrifts losing eligibility for the section 593 reserve method undergo **two** accounting method changes. The first change is from the section 593 method to the section 585 method. This change has not been provided for under the Code so the IRS is free to use its administrative procedures to impose a six-year spread period for taking the section 481(a) adjustment into income. The amount of the section 481(a) adjustment is the difference between the large former thrift's actual reserves and the reserves it would have computed under the experience method. The problem with this first change is that the former large thrift has changed to an impermissible method -- large banks are not permitted to use the reserve method. It is as if the large former thrift has changed to a method to which it was not permitted to change, and then, upon discovering its mistake, changes to the permissible specific charge-off method.

Given the theoretical problems with the IRS proposed regulations, ACB hopes that the Committee would not be reluctant to take a fresh look at how best to time the recapture of the thrift reserves under the legislation. The cut-off method was created as an alternative for institutions with a portfolio of long-term loans. It is ACB's view that, in fact, it was intended to be available for the full amount of thrift reserve recapture under current law. To be consistent with the bank recapture analogy, ACB requests consideration of making the cut-off method available as a recapture timing alternative under the legislation.

Section 593(e)

ACB requests that the Committee consider at some point the continued application of Section 593(e). Appendix A to this testimony provides the historical context for this provision, but, currently, it functions as little more than a trap for the unwary. Capital distributions to shareholders, whether in the form of stock buy-backs or capital dividends, from the thrift and its holding company are strictly controlled by the regulators. When they are permitted to occur, section 593(e) is usually avoided by the interposition of a holding company.

When recapture occurs upon the acquisition of a thrift by a commercial bank, it is the result, in the typical case, of conforming the thrift's methods of accounting to the acquiring bank's methods. Section 593(e) does not trigger recapture. When the thrift and bank methods are conformed, section 593(e) by its terms should only trigger recapture in a taxable asset acquisition. Under current law when a thrift is acquired by a commercial bank in a stock swap or a stock purchase by the acquirer and the thrift becomes a member of the bank holding company, section 593(e) is not an issue. Section 593(e) clearly provides that it does not apply in carryover basis asset acquisitions and certain liquidations.

ACB believes that, with respect to the issue of whether or not section 593(e) should remain in place to trigger recapture, the testimony of Chairman Alan Greenspan of the Federal Reserve before the Financial Institutions Subcommittee of the House Banking Committee on September 21, 1995 is relevant:

> The special bad debt reserve treatment that provides tax benefits -- and, hence, subsidy -- to mortgage lending by thrifts no longer serves a perceivable public policy function and, hence, should be removed going forward. Moreover, the tax recovery of the reserve buildup from this past tax subsidy should be eliminated. In reality, this reserve was always a subsidy and never really a true bad debt reserve. The possibility of any significant recapture of lost tax revenue to the U.S. Treasury has been hypothetical at best because of the tax-induced high marginal cost to thrifts of reducing their mortgage portfolios and, as a result, triggering the so-called bad debt recapture. Indeed, without a fresh start, the current bad debt recapture provisions would be a significant barrier for entities that wish to diversify. A penalty should not be charged institutions striving to respond rationally to market realities, and to legislation designed to induce portfolio diversification.

ACB believes that the continued existence of section 593(e) as a matter of policy is fundamentally inconsistent with the views expressed by Chairman Greenspan, apart from its practical irrelevance with sufficient attention to balance sheet and acquisition details. If subsection 593(e) is not repealed with the rest of the section, however, ACB strongly urges that the legislative history provide as much guidance as possible on its application. It is far preferable to ACB, based on our experiences with the IRS in the interpretation of the reserve recapture provisions, that guidance on the meaning of a tax provision be provided by the Congress.

Carryback of Special Assessment Deduction

As a final matter, ACB requests your help, Mr. Chairman, with an issue, which, while is it is not included in H.R. 2494, is consistent with the intent of the legislation. Moreover, this issue arises from your willingness to assist us in clarifying that the special assessment is currently deductible.

It is ACB's view that the special assessment qualifies for the special 10-year net operating loss carryback provisions under section 172(f), to the extent an institution suffers an overall loss for the tax year. In general, section 172(f) allows a 10-year carryback rather than a 3-year carryback for the portion of a net operating loss that is attributable to certain liabilities that arise under a federal or state law. We believe that section 172(f) clearly covers this special assessment because the purpose of this federal legislation is to provide a final resolution to the thrift crisis which arose during the 1980s. Consistent with the help provided on current deductibility, we request that the bill also clarify the application of section 172(f), to recognize this fact.

While it is our opinion that section 172(f) clearly applies, there is a heightened regulatory need for clarification on this point. The special assessment will cause a significant reduction in regulatory capital and the need to soften this effect by providing a federal tax benefit is imperative. A failure to have section 172(f) apply to an institution with losses, could restrict or even eliminate the institution's ability to book federal tax benefit currently for financial or regulatory accounting purposes. (See Appendix B). This situation could further aggravate the impact of the special assessment on the thrift's regulatory capital. In addition, given changes in federal tax rates between the carryback and carryforward years, it could be advantageous to the Treasury to allow the carryback, even allowing for the interest cost of providing the benefit more quickly.

Conclusion

ACB deeply appreciates the opportunity to raise such a wide array of complex issues before a committee that has been processing such a major share of the entire budget reconciliation work load. We are grateful as well for the case with which the proposed - language was drafted under these difficult circumstances. We stand ready to address any issues that arise from this submission of our views and await your questions.

APPENDIX A

History of the Thrift Bad-Debt Reserve Method

Revenue Act of 1951

Mutual savings banks, savings and loan associations, and cooperative banks were first made taxable in 1952. They were permitted, however, to take a deduction for additions to reserves for whatever amount they deemed appropriate, so long as the addition did not exceed the lesser of taxable income or the addition needed to increase reserves and surplus to 12 percent of deposits. The addition to reserves, based on the legislative history, was intended to maintain the safety and soundness of the institutions. At the time, thrift institutions were typically mutual in form, not stock corporations. While commercial banks, which were stockholder-owned institutions, could sell new shares to obtain additional capital, thrifts could accumulate needed protective reserves only through the retention of earnings.

The limitation to 12 percent of deposits seems to have been based on the level of reserves and surplus that the institutions maintained before they were made taxable. Mutual savings banks in 1951, on average, maintained reserves and surplus equal to about 11 percent of deposits. Savings and loan associations, often because of their shorter existence, maintained surplus and reserves on average equal to about 7.5 percent of deposits (See Revenue Act of 1951, Senate Report to accompany H.R. 4473, Report No. 781, pp. 1992 and 1995). In addition, estimated overall losses of savings banks during the period 1931-1944 amounted to 12.2 percent of deposits as of the end of 1930. (See statement of Edward P. Clark, Chairman of Taxation Committee, National Association of Mutual Savings Banks, on the Taxation of Mutual Savings Banks, Hearings before the Committee on Ways and Means, House of Representatives, 87th Congress, 1st Session, August 9, 1961, pp. 149-50.)

Assuring the safety and soundness of thrifts was viewed as important because of their traditional specialized functions. Mutual savings banks were established to encourage thrift and to provide safe and convenient facilities to care for savings. Mutual savings banks were originally organized for the purpose of serving factory workers and other wage earners of moderate means who, at the time these banks were started, had no other place where they could deposit their savings. At the end of 1950, U.S. Government obligations represented nearly 51 percent, and loans (primarily mortgages) represented 38 percent of the total investments of these institutions. The primary function of savings and loan associations was to provide facilities for savings and a means for financing the purchase of homes. Mortgage loans represented 80 percent of all assets held at the end of 1950. (See Revenue Act of 1951, Senate Report to accompany H.R. 4473, Report No. 781, pp. 1991 and 1995). State and federally chartered savings and loan associations were defined as institutions substantially all of whose business was confined to making loans to members.

Revenue Act of 1962

The 1962 Act made significant changes in the tax treatment of mutual savings banks, savings and loan associations, and cooperative banks. The definition of state and federally chartered savings and loan associations eligible to use the liberal thrift reserve method was tightened: (1) they were required to be supervised and examined by the authority having supervision over such institutions, or to be insured by FSLIC; (2) substantially all of their business had to consist of receiving deposits and making loans; and (3) the qualifying asset test was introduced to the Code for the first time. Under the qualifying asset test enacted in 1962, 90 percent of the savings and loan association's assets had to be cash, government securities, obligations of state corporations that insure deposits, real estate loans, foreclosure property, loans secured by deposits, and assets used in the business. At least 60 percent of this 90 percent had to be cash, government obligations, loans to purchase or improve one- to four-family residential properties or church property, and such property acquired through foreclosure. The changes in the definition of a savings and loan association were intended to bring it into conformity with actual practice and to restrict the availability of the special deductions for additions to reserves to those institutions making residential real estate loans, with emphasis on one- to four-family units.

The 1962 Act changes, in general, indicate a congressional intent that the liberal thrift reserve method was to be available to the extent that a thrift was engaged in home mortgage lending. The reserves maintained by thrift institutions were divided into three separate reserves. First was a reserve for qualifying real property loans. Second was a reserve for nonqualifying loans. Third was a reserve, the supplemental reserve, representing the pre-1963 reserves. Qualifying real property loans were those loans secured by an interest in improved real estate or real estate to be improved out of the loan proceeds, but excluding certain loans that were considered to be virtually risk-free. The nonqualifying loan reserve was maintained for all other loans. The qualifying and nonqualifying loan reserves were established out of the thrift's post-1951 reserve, the remainder of which became the supplemental reserve. The nonqualifying reserve was established first in whatever amount was reasonable based on experience. The qualifying reserve was then established in the amount of 3 percent of qualifying loans. The pre-1952 reserve could be added to the qualifying reserve if the post-1952 reserve was insufficient to bring it up to 3 percent, but the pre-1952 amount would be considered a reserve only for purposes of making the 3 percent level and would not be a reserve for any other purpose under the Code. The remainder of the post-1951 reserve was the supplemental reserve. The opening balance of the qualifying reserve was limited to 3 percent of qualifying loans because otherwise, if the entire remaining post-1951 reserve at that date had been allocated to the qualifying reserve, thrifts with large reserves would have been denied deductions under the 3 percent method until significant growth in their qualifying loans had occurred.

Deductions for additions to the reserve for nonqualifying loans were to be based on actual bad-debt experience. Additions to the qualifying reserve were limited to the largest of: 60 percent of taxable income computed before the bad-debt deduction (reduced by the addition to the nonqualifying reserve); an amount sufficient to bring the balance of the qualifying reserve to 3 percent of the qualifying real property loans outstanding at the close of the taxable year; or an amount based on actual experience. Under the percentage-of-taxable-income method, the addition to the qualifying loan reserve could not exceed 6 percent of qualifying loans. Under the 3 percent method, new thrifts were permitted an additional 2 percent deduction on the first $4 million of qualifying loans. The overall limit on the additions to total reserves at 12 percent of deposits was carried over from prior law. (The 3 percent method was analogous to the percentage-of-eligible-loans method that was then available to commercial banks under the administrative practice of the Internal Revenue Service.)

In adopting the 3 percent and 60 percent reserve provisions for thrifts, the Committee on Ways and Means stated that: "The bill provides reserves consistent with the proper protection of the institution and its [depositors] in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions." (Revenue Act of 1962, Report of the Committee on Ways and Means, House of Representatives, to accompany H.R. 10650, House Report No. 1447, p. 33). Implicit in this statement and explicit in the adoption of the 3 percent method, which provided, in effect, a deduction equal to 3 percent of mortgage growth, is recognition of the desirability of encouraging thrifts to expand their mortgage lending activities. The 3 percent method afforded savings banks that had a relatively small proportion of their assets in home mortgages a reason to expand their holdings of these riskier investments faster than would otherwise be prudent. The intent of Congress has been widely recognized as being directed toward increasing mortgage lending by thrifts. For example, the Joint Committee on Taxation has stated: "The present percentage of taxable income method for savings and loan associations, cooperative banks, and mutual savings banks was designed to serve a non-tax purpose — encouraging these institutions to specialize in residential mortgage lending and certain other specified types of lending." (Joint Committee Print JCS-5-83, Taxation of Banks and Thrift Institutions, p. 32, prepared for the use of the Committee on Finance, March 9, 1983).

As mentioned, the generous reserve additions under the 1951 Act were permitted, in part, because thrifts at the time were typically not stock institutions and, unlike commercial banks, could not raise capital through stock sales to increase their reserves. During the 1950's, savings and loan associations began converting to stock ownership and by 1961 there were approximately 500 stockholder-owned savings and loan associations. (See Treasury Department Report on the Taxation of Mutual Savings Banks and Savings and Loan Associations, submitted to the Committee on Ways and Means, August 8, 1961.) The special thrift reserve methods continued to be available, however, regardless of whether the thrift was mutually or stockholder-owned. This fact helps to make clear that the special thrift reserve methods were intended as a subsidy to encourage home mortgage lending. Nevertheless, Congress recognized that stockholders can realize income from a thrift's undistributed reserves. Income retained by a stockholder-owned thrift will enhance the value of its stock, and this appreciation could be realized by its stockholders at capital gains rates. For this reason, Section 593(e) of current law was enacted in 1962.

Section 593(e), in the version finally enacted in 1962, provides that any distribution with respect to stock in excess of earnings and profits for any distribution in exchange for stock, that is, redemptions and liquidations, will be treated as made out of the portion of the qualifying loan reserve in excess of the amount allowed under the experience method (i.e., the thrift "subsidy" reserve component but not out of the pre-1952 addition, if any) and then out of the supplemental reserve. The amount of the qualifying reserve in excess of the experience portion (subsidy portion) and the amount of the supplemental reserve to be recaptured is the amount that, when reduced by the tax on such reserve amounts, equals the amount of the distribution. In other words, the amount of the reserves to be recaptured is equal to the amount of the distribution divided by the reciprocal of the current tax rate. For example, if an S&L were to repurchase a share of stock this year for $100, the amount of the recapture can be determined by dividing $100 by one minus 34 percent or 66 percent. Thus, rounding for the sake of convenience, the amount of the subsidy portion of the qualifying reserve and the amount of the supplemental reserve to be recaptured is $150, and the tax owed is $50. This treatment under Section 593(e) ignores any stacking order in the creation of those capital amounts. For example, a redemption of stock issued in an offering after the last year making use of the thrift method is still deemed to come from the thrift reserve accumulation.

Tax Reform Act of 1969

The 1969 Act made changes to the reserve methods of both banks and thrifts. For both banks and thrifts, additions to reserves were no longer to be made under the experience method of Section 166, but under two new methods. The first new statutory method created by the 1969 Act was the percentage-of-eligible-loans method of Section 585(b)(4). Banks had actually been using this method for several years under rulings issued by the Internal Revenue Service (See Rev. Rul. 65-92, 1965-1 C.B. 112, as supplemented by Rev. Rul. 68-630, 1968-2 C.B. 84.) Under this method, the deduction for the addition to reserves for a bank was the amount needed to increase the reserve to the allowable percentage of eligible loans at the close of the tax year, plus the amount determined under the experience method for other loans. Eligible loans were those made in the course of normal customer loan activities on which there was more than an insubstantial risk of loss. Under the 1968 Act, the maximum percentage of eligible loans was reduced from 2.4 percent to 1.8 percent through 1975, 1.2 percent through 1981, and 0.6 percent through 1987 and eliminated thereafter.

The 1969 Act also codified an experience method computation in Section 585(b)(3). The deduction for the addition to reserves under the experience method of Section 585(b)(3) is the amount needed to increase the reserve at the close of the tax year to the amount which bears the same ratio to outstanding loans at the close of the year, as the bad debts during the current and past five years bear to the outstanding loans during those six years, or as an alternative, if a larger deduction results, the amount of the addition needed to increase the reserve to the reserve balance at the close of the base year. The base year is the last taxable year before the most recent adoption of the experience method, except that the most recent base year permitted to be used is a tax year that began in 1987. The base year rule was intended to prevent institutions that changed from a more generous reserve method to the experience method from having to draw down their reserves until they were at the level permitted by the experience method computation. Although the base-year rule is still available to thrifts changing from the percentage-of-taxable-income method, it is no longer fully effective because it references the percentage-of-eligible-loans method, which was last available for tax years that began before 1988.

When using the experience method, an institution may be permitted by the Commissioner to use a shorter period than six years where losses increase due to a change in the loan portfolio, as for example, where a bank issues a substantial number of credit cards for the first time. Permission to use a shorter period, however, must be granted by the Commissioner.

Under the 1969 Act, the qualifying assets test, within the definition of a savings and loan association, was changed to the current 60 percent qualifying asset test. The legislative history indicates that this change was intended as a liberalization of the composition of the qualifying assets test. Under the qualifying assets test, at least 60 percent of total assets at the close of the taxable year must consist of: cash; obligations of the United States or non-tax-exempt state obligations; certificates of deposits in or obligations of a state deposit insurance corporation; loans secured by deposits; loans used to purchase or improve residential real property or property used for church purposes; certain institutional loans; foreclosure property acquired from qualifying loans; and property used by the institution in the conduct of its business. (The Tax Reform Act of 1986 added certain interests in a Remic.) The 60 percent of assets tests is computed as of the close of the taxable year or, at the option of the institution, on the basis of average assets outstanding during the taxable year.

The 1969 Act eliminated the reserve method under which a deduction was permitted of 3 percent of the growth in qualifying loans. The reason given in a legislative history for the elimination of this method was that savings banks had used it to pay almost no taxes during the period from 1962 to 1969. This statement in the legislative history is, however, potentially misleading. The 3 percent method had, in one way, achieved its purpose in that savings banks during this period had substantially moved out of government obligations and other security investments into mortgage loans in order to take full advantage of the method. In the period from 1962 to 1969, savings banks utilizing the 3 percent method had expanded their total mortgage holdings by $21 billion, compared with $13 billion in the preceding six-year period, and they had increased their overall ratio of mortgage loans to total assets from 69.5 to 74.9 percent. Savings and loan associations, by contrast, started off 1962 with mortgage holdings near their practical limits. Their overall mortgage-asset ratio had remained stable from 1962 in the 84-85 percent range: thus, they did not find the 3 percent method useful. (See statement of Edward P. Clark, Chairman of Taxation Committee, National Association of Mutual Savings Banks, on the Taxation of Mutual Savings Banks, Hearings before the Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session, March 24, 1969, p. 3488.)

After the 1969 Act, additions to the qualifying loan reserve could be made under whichever of the experience method, percentage-of-eligible-loans method, or percentage-of-taxable-income method, gave the largest deduction. Under the percentage-of-taxable-income method, the 1969 Act phased the allowable percentage deduction down from 60 percent in 1969 to 40 percent for taxable years beginning in 1979 and thereafter. The full percentage deduction under the percentage-of-taxable-income method was available to savings and loans (and stock savings banks after 1981) only if 82 percent of their assets were qualifying assets. The deduction was phased down by 3/4 of 1 percent for each 1 percent decrease in qualifying assets from 82 percent to 60 percent. The full percentage-deduction was available for mutual savings qualifying loan reserve under the percentage-of-taxable-income method were limited to 6 percent of the qualifying loans outstanding, and the total limit on additions to both the qualifying and nonqualifying reserves was 12 percent of deposits. In computing taxable income for purposes of the percentage-of-taxable-income deduction, only income earned from assets that give rise to the special deduction can be used to compute taxable income. The following items of income are excluded: reserve recapture under Section 593(e); gains from the sale of corporate stock or tax-exempt securities; the benefit from the rate differential, if any, for net long-term capital gains; and dividend income qualifying for the dividends-received deduction.

The Tax Equity and Fiscal Responsibility Act of 1982 later provided a 15 percent "cutback" in many corporate preferences including the reserve addition tax deduction for thrifts. The cutback reduced the deduction for the addition to thrift reserves by 15 percent of the excess over the deduction that would have been permitted under the experience method. The Deficit Reduction Act of 1984 increased the tax preference cutback to 20 percent of the reserve deduction for the taxable year in excess of the amount permitted under the experience method. The 20 percent cutback reduced the 40 percent deduction under the percentage-of-taxable-income method by 8 percent (20 percent of 40 percent). The 32 percent deduction under the percentage-of-taxable-income method after the cut back resulted in a 31.28 percent effective tax rate for thrifts (the 68 percent of income that was taxable times the 46 percent tax rate).

Tax Reform Act of 1986

The 1986 Act changed the percentage-of-taxable-income method to a flat 8 percent deduction so long as the thrift satisfied the 60 percent qualifying asset test. The percentage of taxable income was changed to 8 percent because it also resulted in a 31.28 percent effective tax rate after repeal of the tax preference cutback (92 percent, the percentage of income that was taxable, multiplied by the 34 percent tax rate of the 1986 Act). The 1986 Act also confirmed the repeal of the percentage-of-eligible-loans method for tax years beginning after 1987. Additions to the reserve for qualifying loans can now only be made under the percentage-of-taxable-income method or the experience method. Under the experience method, however, additions may be made under either the six-year rolling average or the "fill-up" permitted by the base-year rule.

Reducing to 8% the percentage of taxable income method deduction was the final step in a progression that had decreased the attractiveness of the thrift subsidy since 1962. (Obviously if the statutory tax rate was reduced from 46% to 34%, the relative benefit of a 31.28% effective rate was diminished.) In addition, thrifts were now facing stiffer competition from a host of mortgage originators that immediately sold off their mortgage loans to packagers such as Ginnie Mae, Fannie Mae, and Freddie Mac. Originating and servicing mortgages are still profitable activities, and thrifts, based on their experience and market knowledge, are particularly well-suited to perform them. Many thrifts, however, can simply no longer afford to continue holding the mortgages they originate in portfolio simply to satisfy the qualifying assets test. Another change of far greater impact to thrifts, however, was made by the 1986 Tax Reform Act. Without warning, the reserve subsidy, which in the case of savings banks had caused a dramatic shift into mortgage lending, became a sword hanging over all thrifts. This occurred because of the interaction of the amendments made by the 1986 Tax Reform Act to Sections 585 and 593 of the Code.

Section 593 was amended to provide that satisfaction of the 60 percent test was a condition of the availability of Section 593. Under prior law, if a savings bank or cooperative bank had less than 60 percent qualifying assets, it would not be permitted to use the percentage-of-taxable-income method, but it would still be under Section 593. For a savings and loan association, however, because the 60 percent test was definitional, if it flunked the 60 percent test, it was no longer a savings and loan association. If a substantial part of its business was taking deposits and making loans, however, it would still be a bank under Section 581. It was generally believed that before 1986, flunking the 60 percent asset test would not be a disadvantage for a savings and loan association other than the loss of the percentage-of-taxable-income method. It would simply compute its reserves as a commercial bank under Section 585. (There was, in fact, a small benefit in that it could then use the percentage-of-eligible-loans method for its nonqualifying loans.) If it requalified in a subsequent year as a savings and loan association by satisfying the 60 percent asset test, it would simply go back to using Section 593 and the percentage-of-taxable-income method. It could switch back and forth between Section 593 and Section 585 and was not considered to have made a change in accounting method.

In 1985, however, the Internal Revenue Service issued Revenue Ruling 85-171, which involved the merger of a savings and loan association into a larger bank. The Service held that under Section 381(c)(4), the method of accounting used by the larger commercial bank must be used for the items acquired from the savings and loan association. That is, the reserves acquired from the savings and loan association had now to be accounted for under Section 585 instead of Section 593. The IRS held that this involved a change in accounting method because the reserve methods under Section 585 and Section 593 were separate methods of accounting. There was, thus, a change in accounting method requiring a Section 481(a) adjustment to prevent the omission or duplication of income. It was not clear under the revenue ruling what the Section 481 adjustment would be. It was left open whether the difference between the experience method and the total amount of the reserve should be taken into income as an adjustment under Section 481.

Under the 1986 Tax Reform Act, Section 585 was amended to provide that banks with over $500 million in total assets could no longer use the reserve method, but must account for their bad debts by charging them off only as they become partially or totally uncollectible. Because deductions had already been taken in anticipation of non-collectibility by additions to reserves, it was necessary to prevent a duplication of these deductions under the charge-off method. This was accomplished by requiring that the previously taken reserve deductions be recaptured into income. Two recapture methods were provided: The bank could choose to recapture its reserves under the direct-inclusion method of Section 585(c)(3), which provided for recapture of the reserves over four years. The bank was required, in the disqualification year, to recapture a minimum of 10 percent of the total reserve. If it recaptured only the minimum 10 percent, it must recapture 20 percent, 30 percent, and 40 percent in the subsequent three years. A bank could choose to recapture more than 10 percent in the disqualification year, and, if it did so, it would be required to recapture 2/9, 1/3, and 4/9 of any remaining reserve over the succeeding three years.

In the alternative, the bank could elect to recapture its reserves under the cutoff method of Section 585(c)(4) in the year it became disqualified to use the reserve method. Under the cutoff method, losses on all loans made after the first day of the disqualification year are accounted for on the specific-charge-off method. The loans outstanding as of the first day of the disqualification year are accounted for separately. The existing reserve as of the first day of the disqualification year is maintained for pre-disqualification year loans, but no further additions to the reserve are permitted. No deductions are permitted for pre-disqualification year loans until the reserve balance is reduced to zero, then subsequent loan losses on the pre-disqualification year loans give rise to deductions under the specific-charge-off method. If, on the other hand, the reserve balance exceeds, for any year, the amount of the pre-disqualification year loans, dollar-for-dollar recapture is required of the excess of the reserve balance over the balance of the outstanding loans.

A thrift that changes its charter to a commercial bank charter would, of course, then come under Section 585. In addition, because of the amendment to Section 593, a savings bank or cooperative bank that fails to maintain 60 percent of its assets as qualifying assets would also come under Section 585, assuming that it otherwise satisfies the definition of a bank under Section 581 of the Code. Thus, if a thrift that changes its charter or fails the 60 percent asset test has over $500 million in total assets, it will be subject to recapture of the entire amount of its reserves under either the direct-inclusion method or the cutoff method.

This would subject many thrifts to an enormous tax liability and is manifestly unjust. The subsidy portion of a thrift's reserve deductions could never be duplicated under the specific charge-off method and thus no double benefit arises. A thrift that is required to recapture its reserves might be consider not to suffer a significant tax disadvantage because of the nature of its loan portfolio if it elects the cutoff method. Because of the long-term nature of the typical thrift loan portfolio, it would not be required to recapture its reserves under the cutoff method for possibly as long as 15 to 20 years, absent a significant restructuring of its loan portfolio.

Under the rules of financial accounting, however, a thrift that is required to recapture its reserves would be dramatically disadvantaged on its financial statements. Because a thrift controls the events that require recapture generally accepted accounting principles (GAAP) as expressed in FAS #109, FAS #96 and APB #23, have not required the thrift to set up a reserve for the full amount of the taxes owed on recapture. When a thrift is required to recapture its reserve, or it becomes probable that it will be required to do so, it is required to set up immediately a liability for the taxes owed on recapture and charge its earnings and profits, despite the fact that under the cutoff method the actual payment of tax may be deferred for a significant period of time. It is likely that a profitable thrift that is required to recapture its reserves would show such an enormous loss on its financial statements that its ability to raise new capital would be diminished, and it might no longer satisfy regulatory capital requirements.

If a thrift whose total assets are $500 million or less changes its charter or fails the 60 percent test, there should be no recapture. This is not entirely clear under the statute, but the General Explanation of the Tax Reform Act of 1986 (Blue Book), prepared by the Joint Committee on Taxation, supports this result: the thrift would simply no longer be able to use the percentage-of-taxable-income method. (See the Blue Book, at page 556.) Based on the rationale of Rev. Rul. 85-17, 1985-2 C.B. 148, however, it became possible that the IRS could say that the entire excess of the reserves over the experience portion should be taken into income as a Section 481(a) adjustment intended to prevent an omission or duplication of taxable income as a result of the change from the Section 593 method of accounting to the Section 585 method of accounting for reserves. Such an adjustment would significantly disadvantage small thrifts as compared to the small banks, which suffered no recapture as a result of the 1986 Act change. In addition, the rules of financial accounting would then likely be interpreted to require that the taxes that would be owed on recapture be recognized immediately in the financial statements on the basis that the institution is no longer a thrift and permitted to treat the difference between book and tax reserves as a permanent accounting difference.

<u>Proposed IRS Reserve Recapture Regulations for Thrifts</u>

The worst fears of the thrift industry were confirmed when, on January 13, 1992, proposed regulations were published by the IRS applying to thrifts that fail the 60 percent asset test or change to commercial bank charters. A failure of the 60 percent test or a charter change is treated as a change in accounting method creating a positive adjustment under section 481(a) in the amount of the excess of the total thrift reserve over a hypothetical bank experience reserve. This adjustment is required to be taken into income over six years on a straight line basis. Large "former thrifts" will be permitted to recapture only the remainder of their bad debt reserves using the large bank recapture timing rules under sections 585(c) or (4). A large former thrift may elect to recapture the entire reserve as a section 481(a) outside the large thrift recapture timing rules.

Small thrifts that fail the 60 percent test or change charter are permitted to remain on the reserve method, but they must recapture the "excess" or thrift portion of their reserves as a section 481(a) adjustment over six years, like the large "former thrifts." The small former thrift that is now treated under the tax code as a small bank is permitted to continue on the reserve method using the bank experience method. Its opening reserve balance is the hypothetical bank reserve computed to determine the excess thrift reserve subject to recapture amount to be recaptured.

A "foot fault" rule is provided that permits former thrifts, both large and small, to re-qualify as thrifts -- where they have lost thrift status for only a year, presumably through inadvertence. If a former thrift regains its thrift status, it must still receive IRS permission to use the thrift reserve method again. The reinstated thrift is not permitted to set up the entire thrift reserve that it had before recapture. Its thrift reserve is limited to a new amount that is 8 percent of taxable income for the requalification year.

Appendix B

Special Assessment Deductibility and Related Issues

Section 3 of the proposed legislation puts beyond doubt the full deductibility of the special premium payment of SAIF. The exact timing of that full deductibility is a matter of some concern despite the valuable reinforcement of previous Treasury assurance.

ACB requests, however, that the language of Section 3 be amended to delete the words "during 1996." Section 7(b)(6)(B) of the Federal Deposit Insurance Act, as proposed to be amended by H.R. 2491, provides for the premium to be spread in some cases via retention of a higher premium schedule and removal of the reference to 1996 payments will avoid any possible controversy. In addition, although the issue is not certain, it is possible that under, section 446 of the Code, the year in which the special assessment may be deemed paid or incurred could be earlier or later than 1996.

Most institutions are on a calendar fiscal year. It is ACB's understanding that, under GAAP, institutions will recognize their liability for the special SAIF payment as soon as the legislation is enacted and they are notified by the FDIC as to the amount of the required payment. It is probable that this will occur in December 1995 and the liability will be posted and expense booked for the fourth quarter. Under Section 446 of the Code, accrual for book purposes would normally be followed by recognition for tax purposes. Thrifts were moved to an accrual basis by the 1986 Tax Reform Act and should therefore be allowed the deduction in 1995.

If the deduction is deferred to 1996, the deferred tax asset of that subsequent year's deduction recognized under GAAP (according to FAS #109) could be subject to the special, more stringent standard imposed by bank regulators for regulatory capital purposes. Only the amount that can be recouped by a carryback or no more than one year's carryforward will be allowed in regulatory capital despite the availability of a 15 year carryforward under the Code. Leaving open the possibility of a 1995 deduction would eliminate or reduce this concern.

A related issue here is the treatment of the special payment to be made to SAIF on "Oakar" deposits. Though the language in the bill referenced by the proposed tax law amendments would most likely not be interpreted as an entry fee to the BIF, other variants might be so classified. Any relief to Oakar deposits should be weighed carefully against the transfer of burdens to other institutions, both BIF and SAIF insured. Again this is an area where the language of the banking and tax law amendments must be coordinated to achieve whatever treatment the Congress deems is appropriate for this subset of the payment to the SAIF.

Chairman ARCHER. Thank you, Mr. Montgomery.

Mr. O'Brien, you may proceed.

STATEMENT OF THOMAS M. O'BRIEN, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, NORTH SIDE SAVINGS BANK, FLORAL PARK, NEW YORK

Mr. O'BRIEN. Thank you, Mr. Chairman.

My name is Thomas M. O'Brien. I am chairman, president, and chief executive of North Side Savings Bank in Floral Park, New York. North Side Savings Bank is a New York State-chartered stock savings bank with total assets in excess of $1.5 billion. My institution is a full-service community lender. We make residential mortgage loans, home equity loans, commercial real estate loans, and small business and personal loans to meet the demands of our customers. In addition, I serve as chairman of the legislative committee for the Community Bankers Association of New York State.

North Side is a savings bank, as I mentioned. We are insured by BIF, the Bank Insurance Fund. North Side is not only insured like a commercial bank; it is regulated by the same agency that regulates many commercial banks, the FDIC.

The traditional savings bank grew up primarily in the Northeastern and Northwestern United States. Savings and loans were created to make residential mortgage loans, but savings banks generally had a more diversified function. Despite these historical differences, savings and loans and savings banks have been given similar tax treatment under the law.

I would like to thank you, Mr. Chairman, and the Committee and its staff, together with the staff of the Joint Tax Committee, for taking up this bad debt reserve issue at a time when we know you are so busy with all the provisions within the budget reconciliation that fall within this Committee's jurisdiction.

Institutions such as my own appreciate your willingness to hear about these often unnoticed details of our charter type as you consider how to coordinate with the House Banking Committee.

Savings banks early on agreed to the sharing of the debt service on FICO bonds via an increase in premiums charged by BIF to ensure that the weakness in the financing structure did not produce a default. Against this public policy background, relief from adverse impact of related tax law changes is justifiable.

As noted, my institution is somewhat more diversified in its asset allocation than the typical savings and loans.

I appreciate the substantial relief that the proposed legislation offers from the removal of the base-year reserve amounts from recapture. Furthermore, there is some opportunity to suspend the potential recapture of the post-1988 reserve accumulations from recapture, and that is most welcome, though I would like to echo what has been said previously about the mechanical complexity of the proposed formula. I do see some attraction to the origination rather than the asset approach that is proposed. However, the details of the test make long-term compliance very difficult.

As proposed, I would seriously consider letting my institution fail the test and get on with the transformation to a broader-based community and consumer lender. That will generate some recapture tax, but it will not promote mortgage originations.

I believe that thrifts fully earn the benefits of the bad debt reserve by past focus on the mandated types of lending and asset holdings. We are currently surrendering a very valuable deduction. Section 593(e) should be repealed along with the rest of that section of the Code.

I understand that there is precedent for that in the financial services sector in the case of insurance company policyholder reserves. If, however, 593(e) is not repealed, we would appreciate some changes in its mechanics.

First, it would be helpful and logical to change the stacking order that currently requires that recapture under this section occurs on any stock repurchase by an institution. This can be avoided in the case of a holding company, but the formation of a holding company should be driven exclusively by business rather than tax considerations.

Second, the application of 593(e) in merger situations should be clarified in statutory language or in legislative history. It really does not make good tax policy, as I see it, to generate revenue from inadvertent failure to comply with an arcane tax law.

The long-term maintenance of these suspense tax accounts maintains a level of complexity and differential recordkeeping that is at odds with the goal of tax simplicity and uniform bank taxation. However, it is excellent tax policy to show the openness and care that this Committee has shown in crafting this language to address the very pressing tax problems that are arising from actions elsewhere in Congress.

We deeply appreciate your responsiveness to our concerns, and I would be pleased to take your questions.

[The prepared statement follows:]

Statement
of
Thomas M. O'Brien
Chairman, President, & Chief Executive Officer
of
North Side Savings Bank
Floral Park, New York

before the
Committee on Ways and Means
of the
United States House of Representatives

On

H.R. 2494

Thrift Charter Conversion Tax Act of 1995

October 26, 1995

Mr. Chairman, thank you very much for giving me the opportunity to appear before your committee today. My name is Thomas M. O'Brien. I am Chairman, President, & Chief Executive Officer of North Side Savings Bank, Floral Park, New York. North Side Savings Bank is a stock savings bank with total assets in excess of $1.5 billion. My institution is a full-service community lender. We make residential mortgage loans, home equity loans, commercial real estate loans, small business, and personal loans to meet the demands of our customers in the intensely competitive banking environment of New York City and its Long Island suburbs.

North Side is insured by the Bank Insurance Fund (BIF). This is the same insurance fund that insures commercial banks and it is to be distinguished from the Savings Association Insurance Fund (SAIF), which insures mostly savings and loans, though these lines are blurring with hybrid entities like so-called "Oakar" and "Sasser" institutions. North Side is not only insured like a commercial bank, it is regulated by the same agency that regulates many commercial banks. the Federal Deposit Insurance Corporation. Savings and Loan Associations are regulated by the Office of Thrift Supervision (OTS).

The traditional savings bank was a form of bank that grew up primarily in the Northeastern and Northwestern United States. Savings Banks, or "mutual savings banks," as they are called in the Internal Revenue Code, were created as depositories for the savings of working men and women. Their historical function and purpose was always somewhat different than that of savings and loans, or building and loans, as they were often called. Jimmy Stewart's institution in the movie It's a Wonderful Life, you may recall, was a building and loan. Savings and loans were created to make residential mortgage loans, but savings banks always had a more diversified function. Although they always allocated a significant part of their deposits to investments in U.S. Treasury securities, they historically functioned as fairly broad-based community lenders, as opposed to savings and loans, which historically had a narrower function. The names of many savings banks indicate their historical link with the small saver and the notion of thrift, for example, Five Cent Savings Bank, Dime Savings Bank, Peoples Savings Bank. Over their long history of community service, many of our institutions have grown into large full service banks. Washington

Mutual Savings Bank of Seattle, Washington, for example, has almost $20 billion of assets and an active business in securities and mutual fund brokerage.

Despite these historical differences, savings and loans and savings banks have been given similar treatment under the tax law, although there are still some distinctions. Savings and loans must satisfy a definition in the tax code, while there is no definition of mutual savings bank. More important, although the basic principles of their taxation were always the same, the details of their tax treatment differed. Different percentages were at one time provided for savings and loans and savings banks under the percentage-of-eligible-loans method, the subsidy reserve method provided for thrift institutions. Most of these historical differences have now been eliminated. Both savings and loans and savings banks are equally eligible to use the "subsidy", percentage-of-income method of reserving for bad debts under section 593 of the Code.

I would like to thank you, Mr. Chairman, and the committee and its staff, together with the staff of the Joint Tax Committee, for taking up this bad debt reserve issue at a time when you are so busy with all the provisions within budget reconciliation that fall under this committee's jurisdiction. Institutions such as my own appreciate your willingness to hear about the details of these often unnoticed details of charter type as you consider how to coordinate with the changes that the House Banking Committee is proposing in banking law.

Clearly the impetus for taking on these issues is the urgency of the need to address the problems of the SAIF insurance fund and the potential for default on the FICO bonds. That is an event no one wishes to risk.

For that reason, savings banks early on agreed to the sharing of the debt service on the FICO bonds via an increase in the premiums charged by BIF to ensure that the weaknesses in the financing structure do not produce this result. Obviously, this is not something that any BIF- insured entity is eager to do, and some commercial banks have not fully reconciled themselves to this approach, but it was the right thing to do if no better way could be found. Again, though FICO debt service is an item for the Banking Committee, the impact of FICO problems on the credit status of overall U. S. government and agency debt is a matter at the heart of the jurisdiction of this distinguished committee.

Thus it is appropriate, against this public policy background, for this committee to consider the best way to handle the treatment of institutions that fall under the same tax code provisions as SAIF-insured institutions but otherwise would not have been affected by the banking law changes, other than their willingness to help resolve a difficult and urgent policy issue. Relief from adverse impact from the related tax law changes is certainly justifiable.

As noted, my institution is somewhat more diversified in its asset allocation than the typical savings and loan. Though North Side Savings Bank still easily meets the thrift definition in the Internal Revenue Code, changes in market conditions have caused us to rethink how our institution can best evolve to serve our customers and our stockholders.

I appreciate the substantial relief that the proposed legislation offers from the removal of the base-year reserve amounts from recapture. Furthermore, there is some opportunity to suspend the potential recapture of even the post-1989 reserve accumulations from recapture, which is also most welcome, though I would like to indicate some problems with how that mechanism works. Also, the treatment for small institutions could be adjusted to forestall recapture and allow them to grow into their reserve, provided that they do not cross the $500 million threshold. This is obviously not an issue for my institution, given our asset size, but it would be helpful to the smaller, less sophisticated entity that could have real problems with the origination test. I would like to discuss that test briefly.

Reliance on mortgage lending and portfolio holding as the major source of income for my institution is increasingly precarious. The changes in the mortgage market caused by the growth of the secondary market government-sponsored enterprises, especially Fannie Mae and Freddie Mac, have narrowed margins substantially. Making and holding the fixed rate loans that consumers often prefer is difficult to do on any reasonable risk-reward basis.

Consequently, I do see some attraction to the origination, rather than an asset approach, that is proposed. Institutions would theoretically have the opportunity to originate loans for the secondary market, rather than hold them in portfolio. But the defects in the details of the test make long term compliance very difficult.

The six-year moving-average approach simply will not accommodate a sharp decline in market demand. If the market volume ever drops off by more than the variation within the previous six-year testing period, the institution cannot be protected sufficiently by the smoothing process.

Nor do institutions have the option of going out and capturing additional origination market share to compensate for that market decline. Some institutions already have such a large share in their market that they cannot offset that decline. Expansion merely triggers diminishing returns and safety and soundness concerns. Remember that the test puts them on a treadmill whose speed is always ratcheted upward.

Also, the origination market is highly competitive with low barriers to entry and enormous excess capacity. Origination margins are paper thin. In fact, it is very difficult to sell origination (as opposed to servicing) systems. Much of this excess capacity was developed in the extraordinary refinancing boom of 1993. This type of loan business adds a great deal of "noise" and excess volatility to market volumes, driven as it is by interest rate gyrations. Excluding refinances, at least as an option to the institution, is vital.

Unless that test is revised to allow some lower percentage of the moving-average period (say 75%) or contains some other safeguard to allow for market fall-offs, I would seriously consider letting my institution fail the test quickly and get on with my transformation into a broad-based consumer and community bank. That may generate a modest amount of recapture tax but it will certainly not promote mortgage originations.

Balancing the goals of revenue generation and credit availability is a delicate matter. The need for revenue should not be paramount as I see it since the pick-up from the loss of future availability of the percentage-of-taxable income method should be significant.

I believe that my institution fully earned the benefits of its bad debt reserve by its past focus on the mandated types of lending and asset holdings. So I would like to address the retention of Section 593(e) as applied to the base-year amounts that can be set aside from recapture. Since my institution is being forced off the method we have long used, by public policy changes that are not of our doing, ideally Section 593(e) would be repealed along with the rest of that code section. I understand that there is precedent for that in the financial services sector in the case of insurance company policy-holder reserves. If, however, Section 593(e) is not repealed either as part of this welcome legislative initiative or in the foreseeable future, we would appreciate some changes in its mechanics.

First, it would be both helpful and logical to change the "stacking order" that currently requires that recapture under this section occurs on any stock repurchase by an institution. This can be avoided in the case of a holding company but the formation of a holding company should be driven exclusively by business considerations rather than its tax dimension.

Secondly, the application of Section 593(e) in merger situations should be clarified in the statutory language or in its legislative history. It is one thing to carry over the apparatus of recapture and whether distributions come out of earnings and profits or tax bad debt reserves (but only to the extent that they exceed the experience reserve) to acquirers of thrift institutions that themselves come from within the traditional thrift sector. It is quite another to apply these complexities to acquirers that do not have the familiarity or database that can produce compliance with these rules. It really does not make good tax policy, as I see it, to generate revenue from inadvertent failure to comply with arcane tax law provisions.

It is, however, excellent tax policy to show the openness and care that this committee has shown in crafting this language to address the very pressing tax problems that are arising from actions elsewhere in Congress. We deeply appreciate your responsiveness to our concerns and would be pleased to respond to any questions that my testimony may produce.

Chairman ARCHER. Thank you, Mr. O'Brien.

Finally, Mr. Kinnier.

STATEMENT OF STEPHEN R. KINNIER, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, VIRGINIA FIRST SAVINGS BANK, F.S.B., PETERSBURG, VIRGINIA

Mr. KINNIER. Thank you, Mr. Chairman and Members of the Committee. My name is Stephen R. Kinnier, and I am the senior vice president and chief financial officer of Virginia First Savings Bank. We are based in Petersburg, Virginia, and we have assets of approximately $700 million. We are a full-service community bank. We have 23 retail branches in Virginia, and we provide mortgage loan financing in the States of Virginia and Maryland.

I am here to voice my support for H.R. 2494. In our view, it is absolutely critical that in order to accommodate banking and thrift policy as we go forward, it is important that this year the treatment of the accumulated thrift bad debt reserves be addressed.

Mr. Chairman, I am very grateful that you have taken a step forward on this because there was some concern earlier in the year that the banking legislation was going to go forward without addressing this, and I do thank you for holding this hearing today.

The bill addresses rules regarding the treatment of the accumulated reserves on thrift bad debts if the thrift institutions either convert on their own or are required to convert to banks. Under the bill, the maximum amount of reserve recapture would generally be limited to the reserves accumulated after the 1987 base year.

I must state that not having to recapture the pre-1988 reserves is really important to us. If we had to take it into income, there would be a substantial reduction in our capital. As you know, nowadays for thrift institutions as well as banks, capital is very, very important. They say capital is king these days, and the last thing we need is to have a substantial hit to our capital by having to take into income, into taxable income, the pre-1988 reserves. This is especially more important now that the proposed legislation to satisfy the BIF/SAIF legislation would hit our industry with approximately $6.2 billion of the special assessment.

The amount that is being proposed for the one-time special assessment is huge for our industry. In the case of my institution, it will represent approximately 40 percent of this year's pretax earnings. So this is going to hit us hard, but we are willing to make that contribution as part of our industry's contribution to clean up this mess, which is why not having to recapture the pre-1988 reserves is so important to us.

We are also very sympathetic to the Chairman's desire that thrifts and former thrifts, once they become former thrifts, remain active players in the mortgage loan origination business. That is our business. More than 80 percent of the assets in my institution are loans. We are a mortgage lender.

I do think there are some modifications that can be made to the proposed mortgage loan requirement that would make it a little bit easier for thrifts like mine to meet. One that was mentioned earlier was to find a way to exclude refinancings from the test. Volumes of refinancing of mortgage loans can create enormous swings in the total volume of mortgage originations from year to year.

By including refinancings in the test, it could make it almost impossible for some thrifts to meet the test. In the case of our institution, we had massive refinancing activity in 1993 and 1994. I have already run the numbers for my institution using your test, and I would fail it in the first year of the test, even though that is our primary business, Mr. Chairman. But this could be fixed, we think, by somehow eliminating refinancings or somehow taking them out.

Also, in recognizing the changes in the business practices, we would like the term origination to include activities with mortgage loan brokers, because an institution such as ours, we will deal with local brokers to help provide financing in our areas.

Finally, I would like to make a point that I think Congress should consider sunsetting the section 593(e) rules. I personally believe that it serves no useful purpose other than to be a trap for the unwary.

Again, I would like to thank the Committee for the opportunity to testify and thank the Chairman for taking the lead on this issue.

[The prepared statement follows:]

Statement of
Stephen R. Kinnier
Chief Financial Officer
of
Virginia First Savings Bank, F.S.B.
Petersburg, Virginia

Before the
Committee on Ways and Means
of the
U.S. House of Representatives

October 26, 1995

My name is Stephen R. Kinnier and I am Senior Vice President and Chief Financial Officer of Virginia First Savings Bank, F.S.B. Virginia First is based in Petersburg, Va., and has assets of $700 million. We have 23 retail branches in Virginia and originate residential mortgage and construction loans in Virginia and Maryland.

I am testifying today to express my general support for H.R. 2494, legislation introduced last week by Chairman Archer, and to address certain technical aspects of the bill. In the view of Virginia First, it is absolutely critical, in order to accommodate banking and thrift policy for the future, that Congress, this year, address the treatment of accumulated bad debt reserves as they pertain to thrift institutions.

Most importantly, the Chairman's bill addresses these issues in a manner that would eliminate many of the hurdles standing in the way of the continued financial safety and modernization of depository institutions.

I would like to make some general comments about thrift bad debt reserves and their treatment under the bill. In addition, I would like to discuss several technical issues that I hope can be addressed as the Committee considers this important legislation.

The conversion of thrift institutions into bank-chartered institutions is viewed by many policy makers as inevitable in light of the ongoing transformation of the banking and financial services industries. The thrift industry is supportive of provisions included in the current budget reconciliation legislation that would bring the Savings Association Insurance Fund, or SAIF, up to its statutorily required reserve level through a one-time assessment of approximately $6.2 billion on all SAIF-insured deposits. In addition, the thrift industry generally agrees with banking policy makers that the SAIF and the Bank Insurance Fund, or BIF, should be combined. The conversion of thrift institutions into bank-chartered institutions is viewed by many as inevitable as this restructuring progresses.

I am particularly pleased that Chairman Archer has introduced H.R. 2494 because it indicates there is an understanding of the important role tax policy must play as banking policy is formulated.

Under current law, banks and thrift institutions generally are treated under the same tax rules that apply to other corporations. The primary difference between the taxation of thrifts and other corporations, including banks, involves the treatment of bad debts. Thrifts meeting certain requirements are allowed to maintain reserves for bad debts in lieu of claiming bad debt losses when specific debts become wholly or partially worthless. Generally, banks (and banks in controlled groups) with total assets greater than $500 million are not permitted bad debt reserves.

Historically, Congress has provided more generous bad debt treatment to thrifts as an incentive for them to hold residential mortgage loans. Thrifts lose this special incentive when they fail to meet certain qualifying tests. Under proposed IRS regulations, failure to meet the qualifying tests or conversion to a bank charter will result in the recapture -- or the taking into taxable income -- of the excess of a thrift's tax reserves over its allowable bank tax reserve.

Under generally accepted accounting principles (GAAP), thrifts are not required to record for financial statement purposes a liability against the tax bad debt reserves accumulated in years prior to and including 1987 -- the so-called base year. After 1987, deferred taxes must be provided for any increases above the base-year reserves.

H.R. 2494 would repeal the special bad debt deduction for thrifts for taxable years beginning after 1995. Thus, institutions that had been allowed to take advantage of the special deduction would, on a going forward basis, be subject to the rules that currently apply to commercial banks for purposes of treating loan losses.

Most importantly, the bill includes rules relating to the treatment of accumulated reserves that are critical if thrift institutions convert on their own, or are forced to convert to banks. Under the bill, the maximum amount of reserve recapture generally would be limited to the reserves accumulated after the 1987 base year.

This so-called fresh start for pre-1988 reserves is vitally important.

If a thrift is required to take the pre-1988 bad debt reserves into income, the associated income tax will have an immediate and adverse effect on capital. This would be the case even if the reserves were taken into taxable income over several years. This reduction in an institution's capital as a result of having to record for GAAP and regulatory purposes the liability for deferred taxes may cause many institutions to fall below acceptable capital levels.

The potential damage to the capital position of these institutions is particularly significant given the capital requirements established by the banking legislation of the late 1980s. Moreover, the BIF/SAIF legislation now before the Congress would address the severe shortfall in the SAIF, and the competitive imbalance of the two insurance funds resulting from sharply differing premiums. The current proposal would require thrifts to pay a $6.2 billion special assessment to ensure the full funding of the combined insurance fund. Requiring thrifts to pay tax on accumulated reserves in addition to making a large contribution to the insurance fund would clearly jeopardize the capital position of many institutions.

The fresh start also is appropriate in that it properly recognizes that the preferential bad debt deduction methods allowed thrift institutions effectively acted as a permanent incentive for thrift institutions to actively participate in the residential mortgage business.

A second important feature of the bill generally would require thrift institutions to take into income the post-1987 accumulated reserves over a 6-taxable year period, beginning with the first taxable year beginning after 1985. However, institutions meeting a special test, called a residential loan requirement, for any year would have this recapture treatment suspended for that year. This test runs in perpetuity and requires that the principal amount of residential loans made by the taxpayer during the year not be less than the average of the principal amount of such loans made during the six most recent years.

We are sympathetic to the Chairman's desire to encourage thrifts and former thrifts to remain active players in the mortgage loan business in return for deferring the recapture of post-1987 reserves. However, we believe the test as currently drafted will pose problems for institutions of all sizes and may not accomplish what I perceive to be the intended goal of encouraging institutions to make credit available to home buyers.

I suggest two modifications to this test:

The first modification relates to the inclusion of refinancings in the test. The volume of refinancings of mortgage loans can create enormous swings in the total volume of mortgage originations from year to year. Including refinancings as part of the test will make it virtually impossible for thrifts to meet the mortgage origination test for any extended period of time. Thus, any incentive element of the proposal would be lost.

To illustrate, in the fiscal year that ended June 30, 1995, my institution originated more loans to finance home purchases than ever before. However, if the residential loan test as drafted applied in the current year, we would likely fail to meet the target because mortgage loan refinancings in the 1993 and 1994 time period greatly distort the average originations over the testing period.

In my view, this problem could be fixed by eliminating refinancings from the test to moderate the skewing effects caused by refinancings. There may be other workable alternatives.

The second modification relates to the term "loan made." In recognition of changing business practices, the term should be clarified to include mortgage loans originated by mortgage loan brokers and either closed in the name of the lender or funded by the lender within a short period of time after the loan is made.

Finally, I urge the committee to be mindful of how the rules will operate as the banking industry continues to undergo significant changes. Institutions are consolidating at an ever increasing pace both through mergers with other institutions, but also from realignments of their existing corporate structures. As a result, there can be no ambiguity in the legislation regarding the effect tax-free reorganizations will have on thrifts that are involved in these transactions. Additionally, taxpayers will not have the luxury of waiting on the Treasury Department to issue regulations instructing them how the test will operate following an acquisition.

Therefore, I encourage the tax-writing committees to provide as much guidance as possible on the effect tax-free mergers and consolidations will have on thrift bad debt reserves that are either forgiven or have been suspended under this bill. I believe the legislative history should state specifically that tax-free mergers, acquisitions, or consolidations do not result in either the pre-1988 or post-1987 reserves being included in income even if the acquiring or resulting institution is not a thrift. Additionally, specific rules should be provided to guide an acquiring institution, if it was not a thrift, on how to meet the residential loan requirement following an acquisition or merger.

Again, I would like to thank the Committee for the opportunity to testify and express my appreciation to the Chairman for taking the lead on an issue of such importance to my institution and the thrift industry. I would be happy to take any questions you may have.

Chairman ARCHER. Thank you, Mr. Kinnier.

Gentlemen, let me see if you are together on a couple of items here. Do all three of you agree that refinancing should be taken out of the formula?

Mr. MONTGOMERY. Yes, I do.

Mr. O'BRIEN. Yes, I do, too.

Mr. KINNIER. Yes, sir.

Chairman ARCHER. As between the origination test and an asset test, which do you prefer? Which do you think is the most appropriate?

Mr. O'BRIEN. I like the origination test.

Mr. MONTGOMERY. I think without the refinance element, the origination test works fine.

Mr. KINNIER. I agree, sir.

Chairman ARCHER. And can you briefly tell us what your definition of origination would be?

Mr. O'BRIEN. If I can start, the origination would be the inhouse origination purchased from a broker at the closing or other acquisition of the loan in its first year.

Mr. MONTGOMERY. I do think it is important to have the origination test include loans purchased from brokers, because that is an increasing trend in mortgage finance around the country, and it needs to be recognized, yes.

Mr. KINNIER. And you may consider including the home equity line type of financing, and I would also ignore the fact that once the loan is originated, however defined, the loan might be sold on the secondary market to be able to provide us with more funds to make more loans. So I don't think the fact that loans might be sold should be a consideration.

Chairman ARCHER. You would not have any holding period requirement test?

Mr. KINNIER. No, sir. We are the frontline loan originator. We are the people who deal with the community. The fact that we may turn around and sell the loan almost immediately to get more money to make more loans, I don't think there should be any holding period at all.

Mr. O'BRIEN. We tend to be a portfolio lender, Mr. Chairman, but that kind of recordkeeping is awfully complex and, again, would certainly deter from the value of the formula.

Chairman ARCHER. Thank you very much.

Any Members of the Committee wish to inquire?

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Montgomery, I would like to hear your views on section 593(e) specifically as it relates to the possibility of it being a recordkeeping problem for your institutions.

Mr. MONTGOMERY. I think 593(e) to me no longer serves a useful purpose if we are dealing with the recapture problem of the pre-1988 reserves. It does represent a bookkeeping problem. A lot of things could happen in the future with respect to mergers and this sort of thing. I think it was described here it could end up to be a trap for the unwary, and in order to avoid that, there is an awful lot of recordkeeping that will be needed.

I don't believe that there has ever been significant revenue generated under 593(e) to the Treasury, and I would think that would be the case in the future, except through inadvertent noncompliance. And it just doesn't seem to me to be worth keeping under those circumstances.

Mr. COYNE. So, in your view, it is not a revenue generator?

Mr. MONTGOMERY. Oh, I don't believe so, no.

Mr. COYNE. Thank you.

Chairman ARCHER. Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

I think the common thread here is problems in the origination test. Clearly, in 593(e), if I heard the panel correctly, they think that the origination test can be fixed by excluding the refinancing from the test. As far as 593, I am told by Joint Tax that they have no objection to excluding stock purchase from earnings and profits.

I know Mr. O'Brien indicated that we should repeal the entire section, but, Mr. Montgomery, would 593(e) be workable if we would exclude the stock purchase from earnings and profits? At that point, would the balance be workable?

Mr. MONTGOMERY. I think my colleague on my right is more of an expert on 593(e), so——

Mr. KLECZKA. I was going to call on him, but I can't pronounce his name. [Laughter.]

Mr. KINNIER. My personal belief is that 593 in its entirety is not a revenue raiser at all; that it is truly the trap for the unwary; that if a party has informed tax advice, they will find a way to get around it.

As you may know, many institutions these days have put in place holding companies, and by using the holding company device and with informed tax advice, you can get around 593 anyway. In my opinion, it would be better just to let it go, especially if it is not scored as a revenue loser.

Mr. KLECZKA. OK. I won't ask this panel about the Oakar banks, because I don't know if you would have a comment on that, but I think the Committee is aware of that problem.

The last question I have is regarding the small thrifts. It has been raised that the small commercial banks were exempted in, I think, 1986 and there is a feeling here that we should do the same to small thrifts today. Do you folks have any opinion on that?

Mr. MONTGOMERY. As a very large thrift, I would support exempting small thrifts. I think it does make sense.

Mr. KLECZKA. Just to be nice to your small brethren, or what?

Mr. MONTGOMERY. Well, I just think that there are certain situations where the small thrifts should be relieved from the burdens that some of us have to bear.

Mr. KLECZKA. You are talking about equity here, the same as was provided 10 years ago for the small commercials?

Mr. MONTGOMERY. I think that is correct, yes.

Mr. KLECZKA. Any other comments, gentlemen?

Mr. O'BRIEN. I would agree. Comparable treatment I think is appropriate for the small thrifts.

Mr. KINNIER. I would agree.

Mr. KLECZKA. Fine. Thank you, Mr. Chairman.

Mr. LAUGHLIN. Mr. Chairman.

Chairman ARCHER. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Kinnier, as a representative of a large rural area, I have only small institutions, so I picked up on your comment about 593(e). As I take from your comment, the large institutions and the institutions that are part of the sophisticated holding companies are not going to have a problem with this. It is the small savings and loans, and savings banks in my district that are going to have the problem.

Mr. KINNIER. Yes, sir. That is my belief, because in many cases they may not have either the resources or the availability of the tax advice. They may not have holding companies in place.

What I would be afraid of, sir, would be if, say, an institution like you have described might be about to be acquired or merged with some other institution, and I would hate to think that a potential buyer would say, you know, we would sure like to pay market value for your stock but you have this 593(e) problem here, so we are going to discount your stock.

Now, that may not occur under the rules, but I would hate to think that some local owners of a stock institution would get hurt because this is there. And like I said, and as you said, the only people who are really going to be hurt by this are the smaller institutions, perhaps less sophisticated on this kind of matter.

Mr. LAUGHLIN. Mr. Montgomery, some people told me that the mortgage origination test in this bill may be too tough for many savings and loans to comply with. I would like your opinion on that. It seems to me that we ought to—if that is the case, I would like for you to tell us what a test should be, because it seems to me that it makes sense in terms of the Chairman's goal to provide an incentive for at least some savings and loans to remain dedicated to residential mortgage lending.

Mr. MONTGOMERY. Yes, we agree with the thrust and the intent of the test. We do disagree with the makeup, and I think as we have said earlier, removing refinance would help in a number of ways. It helps do what you are trying to do, which is to continue to have us originate loans. But we had such a surge of refinancing activity all over the country in 1993 and 1994 that that distorts the numbers and would make the test very difficult for most all of us to comply with. So taking that out will help a great deal.

Mr. KINNIER. I would like to add to that.

Mr. LAUGHLIN. Yes.

Mr. KINNIER. As you know, institutions such as ours are already gathering a lot of this data for a number of the reporting requirements that we have outside the grounds of this Committee. And so if the data is already there, it should not be that much of an incremental burden to meet this test. It is not like we would be gathering data that we are not already gathering.

Mr. LAUGHLIN. Thank you very much.

Thank you, Mr. Chairman. I yield back.

Chairman ARCHER. Mr. Neal.

Mr NEAL. Thank you, Mr. Chairman. I think Mr. Laughlin raised a proper question, and I thought the panelists addressed it accurately.

Mr. Kleczka and I were on the Banking Committee at the same time in the middle of the S&L issue. There is one model that sticks in my mind; and that was the rush at the time to correct the situation and to point fingers at everybody who might have even been remotely involved. But I remember one particular amendment during that period of time, and it was to raise capital standards. At the time that is what everybody said, we had better raise those capital standards, and the end result of that was to drive some good S&Ls over the deep end. So I think the question that Mr. Laughlin raised is an entirely accurate one. I appreciated the candid responses.

Mr. KLECZKA. Would the gentleman yield?

Mr. NEAL. Yes.

Mr. KLECZKA. Mr. Neal and I and I think other Members of the Committee left the Banking Committee because for years and years we were steeped in the S&L crisis, and so we escaped to come over here. And, lo and behold, in 1995 you folks are back. So I don't know if you are following us or what, but it is good to see you all.

Mr. MONTGOMERY. We don't intend to be back again. [Laughter.]

Chairman ARCHER. Does the gentleman yield back his time?

Mr. NEAL. Yes.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

I just would like for you to comment generally on the recapture provisions. Are you generally satisfied with what is in this bill? Can you live with it? Can your industry live with it like it is written, or is there something that is critical that you need changed?

Mr. O'BRIEN. It would be very helpful, sir, to clarify the 593(e) section or just eliminate it. As I said, it is complex and it does go against the whole concept of a unified bank tax structure. It is another set of records, and as has been said, it is a potential trap or a problem for years going forward, and I think elimination at this point would just solve a lot of problems.

Mr. MONTGOMERY. Just to clarify, I think what we have proposed right here and in our written testimony represents what I would consider fine tuning of what really is an excellent bill. We think that a very good job has been done here in addressing an important issue. We can make some changes on the margin to make it better such as we have discussed, but on the whole I think it does quite a good job.

Mr. MCCRERY. Thank you.

Chairman ARCHER. Any other member wish to inquire?

[No response.]

Chairman ARCHER. Gentlemen, thank you very much. You have been very helpful to us, and we appreciate having the opportunity to hear from you.

Mr. MONTGOMERY. Thank you.

Mr. O'BRIEN. Thank you.

Mr. KINNIER. Thank you, Mr. Chairman.

Chairman ARCHER. We will also include in the record the statement of Robert Sheridan, president, Savings Bank Life Insurance Co. of Massachusetts, and the statement from the staff of the Joint Committee on Taxation.

The Committee will be adjourned.

[Whereupon, at 10:11 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

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ASSOCIATION

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EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS
Edward L. Yingling
202-663-5328

October 25, 1995

The Honorable Bill Archer
Chairman, House Ways & Means Committee
1236 Longworth House Office Building
Washington, DC 20515

Dear Chairman Archer:

The American Bankers Association (ABA) is pleased to submit written comments for the record regarding the topic of your October 26, 1995 hearing on the "Thrift Charter Conversion Act of 1995" (H.R. 2494). The ABA is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90% of the commercial banking industry's total assets, and about 94% of ABA members are community banks with assets less than $500 million.

We want to commend you for introducing this important bill, which we believe is a very positive step on an issue that needs to be addressed by Congress. While we may have a few suggestions for improvements, we support your bill and will be pleased to work for its enactment.

The ABA appreciates your acknowledgement, and that of your co-sponsors, Chairman Leach and Representative Roukema, that a comprehensive solution for the thrift industry SAIF issue must include a charter conversion requirement along with a certain level of forgiveness of the bad debt reserve recapture. We recognize that such forgiveness should be part of a requirement that thrifts convert to banks in order to make the comprehensive solution workable from a capital standpoint. Furthermore, we agree with the basic concept that the bad debt reserve was essentially a subsidy for mortgage loans, and therefore, not really subject to the usual arguments for recapture. We agree with your statement that the bad debt recapture issue should accompany the charter conversion requirement.

It is important that the bad debt forgiveness issue related to the base year amount be coordinated with any plan to merge the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF). The simultaneous imposition of the special assessment and the recapture of the base year amount would clearly result in significantly reduced capital levels for a number of thrifts. If those thrifts then become part of the BIF, they would enter the bank insurance fund at much lower levels of capital than is acceptable from a regulatory standpoint.

We may have some further suggestions with respect to the provisions on post-1987 reserves. Our general concern is that we believe the concept of requiring that a specified percentage of originations be housing related is outdated in today's marketplace. Federal Reserve Board Chairman Alan Greenspan clearly laid out the problems with such a concept in testimony before the House Banking Committee, and we agree completely with his analysis.

The intent of the co-sponsors with respect to transition, acquisition, and other issues are important components of this legislation and future regulations. We believe that it is extremely important that these issues be resolved in a fair and equitable manner as they pertain to banks. For example, the beneficial effects of this legislation should also apply to banks that have already begun recapturing bad debt reserves for thrifts they have recently purchased. Further, the legislative history and provisions of H.R. 2494 should confirm that the 1987 base year is not required to be recaptured upon merger of a thrift with a bank; that is, the provisions should apply to any thrift or its successor(s).

Another extremely important issue that is addressed in your bill is the deductibility of the special assessment. We agree with your provision, and we encourage you to specifically include in the language of Section 3 a provision specifying that the deduction be allowed for "the amount paid or incurred as a special assessment", replacing the existing language, "the amount paid during 1996 as a special assessment".

The ABA stands ready to work with Congress on this issue. Please feel free to contact us if we can be helpful.

Sincerely,

Edward L. Yingling

Edward L. Yingling
Executive Director, Government Relations
American Bankers Association

cc: The Honorable Sam M. Gibbons

TAX TREATMENT OF THRIFT INSTITUTIONS UNDER H.R. 2494, THE "THRIFT CHARTER CONVERSION TAX ACT OF 1995"

Scheduled for a Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

On October 26, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

October 25, 1995

JCX-46-95

INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on October 26, 1995, on H.R. 2494 (the "Thrift Charter Conversion Tax Act of 1995"), which was introduced by Chairman Archer, Mr. Leach, and Mrs. Roukema on October 11, 1995. H.R. 2494 addresses certain Federal income tax issues relating to the treatment of thrift institutions raised by proposed banking legislation (H.R. 2363, the "Thrift Charter Conversion Act of 1995," the principal provisions of which are contained in Title II of H.R. 2491, the 1995 budget reconciliation bill as reported by the House Committee on the Budget.[1]) This document,[2] prepared by the staff of the Joint Committee on Taxation, describes present law and background with respect to the treatment of thrift institutions and the provisions contained in H.R. 2494.

Part I of the document provides an overview. Part II provides a description of the treatment of bad debt reserves of thrift institutions under present law, prior law, and the bill, and a discussion of the issues raised by H.R. 2491 and H.R. 2494. Part III provides a description of the tax treatment under present law and under H.R. 2494 of certain special assessments proposed to be levied upon thrift institutions by H.R. 2491.

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[1] See Title II of H.R. 2491 ("Seven-Year Balanced Budget Reconciliation Act of 1995"), as reported (H. Rept. 104-280, October 17, 1995.)

[2] This document may be cited as follows: Joint Committee on Taxation, <u>Tax Treatment of Thrift Institutions Under H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995"</u> (JCX-46-95), October 25, 1995.

I. OVERVIEW

Thrift institutions (i.e., building and loan associations, mutual savings banks, or cooperative banks) historically have been allowed Federal income tax deductions for bad debts under reserve methods that were more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions, including banks). The thrift bad debt method of present law, contained in section 593 of the Internal Revenue Code, allows a qualified thrift institution to deduct as an addition to its reserve for bad debts an amount equal to the larger of: (1) 8 percent of its taxable income, or (2) the amount determined under the experience method generally applicable to small banks. Under proposed Treasury regulations, the conversion of a thrift institution to a bank requires the institution to recapture all or a portion of its bad debt reserve.

H.R. 2363 (the "Thrift Charter Conversion Act of 1995," the principal provisions of which are contained in Title II of H.R. 2491, the 1995 budget reconciliation bill), contains a provision that would require a Federally-chartered savings and loan institution to become a Federally-chartered bank or State-chartered savings and loan institution. It is understood that the recapture for Federal income tax purposes of a portion of the bad debt reserve of a thrift institution upon the conversion to a Federally-chartered bank would require the institution to record a tax liability for financial accounting purposes that would reduce the regulatory capital of the institution.

H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995," would (1) repeal the special bad debt reserve method of section 593 for all thrift institutions, (2) not require the recapture of a certain portion of the institutions' bad debt reserves, and (3) suspend recapture of the remaining portion of the reserve for each taxable year an institution met a residential loan requirement. The residential loan requirement would be met for a taxable year if the institution made a principal amount of loans secured by certain residential real or church property equal to the average amount of such loans made by that institution during a preceding 6-year period.

In addition, H.R. 2491 would require thrift institutions to pay a special assessment to the Saving Association Insurance Fund ("SAIF"), the insurance fund for deposits in thrift institutions. Effective January 1, 1998, the SAIF would be merged with the Bank Insurance Fund ("BIF") (the insurance fund for deposits in banks). Thrift institutions and banks currently are required to pay annual premiums to the SAIF and BIF, respectively, based on the amount of their insured deposits, but the premium rate for the SAIF deposits is substantially higher than the premium rate for BIF deposits. After the merger of the SAIF and BIF in 1998, thrift institutions and banks would be subject to the same lower deposit insurance rates generally applicable to banks.

It may be unclear under present law whether the payment of the special assessment under H.R. 2491 would be deductible for the Federal income tax purposes. H.R. 2494 would provide that the special assessment would be deductible when paid.

II. ACCOUNTING FOR BAD DEBTS BY THRIFT INSTITUTIONS

A. Present Law

Tax treatment of bad debt deductions of savings institutions

Reserve methods of accounting for bad debts of thrift institutions

A taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions are eligible to compute deductions for bad debts using either the specific charge-off method or the reserve method of section 593 of the Internal Revenue Code. To qualify for this reserve method, a thrift institution must meet an asset test, requiring that 60 percent of its assets consist of "qualifying assets" (generally cash, government obligations, and loans secured by residential real property). This percentage must be computed at the close of the taxable year, or at the option of the taxpayer, as the annual average of monthly, quarterly, or semiannual computations of similar percentages.

If a thrift institution uses the reserve method of accounting for bad debts, it must establish and maintain a reserve for bad debts and charge actual losses against the reserve, and is allowed a deduction for annual additions to restore the reserve to its proper balance. Under section 593, a thrift institution annually may elect to calculate its addition to its bad debt reserve under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method that is also available to small banks.

Under the "percentage of taxable income" method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). Pursuant to a provision contained in the Tax Reform Act of 1986, for taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. The base year amount is reduced to the extent that the taxpayer's loan portfolio decreases. Prior to 1988, computing bad debts under a "base year" concept allowed a thrift institution to claim a deduction for bad debts for an amount at least equal to the institution's actual losses that were incurred during the taxable year.

Bad debt methods of commercial banks

A small commercial bank (i.e., one with an adjusted basis of assets of $500 million or less) only may use the experience method or the specific charge-off method for purposes of computing its deduction for bad debts. A large commercial bank must use the specific charge-off method. If a small bank becomes a large bank, it must recapture its existing bad debt reserve (i.e., include the amount of the reserve in income) through one of two elective methods. Under the 4-year recapture method, the bank generally includes 10 percent of the reserve in income in the first taxable year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the cut-off method, the bank generally neither restores its bad debt reserve to income nor may it deduct actual losses relating to loans held by the bank as of the date of the required change in the method of accounting. Rather, the amount of such losses are charged against and reduce the existing bad debt reserve; any losses in excess of the reserve are deductible. Any reserve amount in excess of actual losses is includible in income.

Recapture of bad debt reserves by thrift institutions

If a thrift institution becomes a commercial bank, or if the institution fails to satisfy the 60-percent qualified asset test, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations,[3] is required to recapture its bad debt reserve.[4] The percentage of taxable income portion of the reserve generally is included in income ratably over a 6-taxable year period. The experience method portion of the reserve is not restored to income if the former thrift institution qualifies as a small bank. If the former thrift institution is treated as a large bank, the experience method portion of the reserve is restored to income either ratably over a 6-taxable year period, or under the 4-year recapture method described above.

In addition, a thrift institution may be subject to a form of reserve recapture even if the institution continues to qualify for the percentage of taxable income method. Specifically, if a thrift institution distributes to its shareholders an amount in excess of its post-1951 earnings and profits, such excess will be deemed to be distributed from the institution's bad debt reserve and must be restored to income (sec. 593(e)).

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[3] Prop. Treas. reg. sec. 1.593-13.

[4] The requirement of the proposed regulations that a thrift institution recapture its bad debt reserves upon a change in the method of its accounting for bad debts is based on Nash v. U.S., 398 U.S. 1 (1970), where the U.S. Supreme Court held that a taxpayer essentially was required to recapture its bad debt reserve when the related accounts receivable were transferred by the taxpayer .

B. Prior Law

Savings and loan associations, cooperative banks and mutual savings banks were tax exempt until the Revenue Act of 1951. While thrift institutions were made taxable as part of that Act, they also were given generous bad debt deductions that effectively kept thrift institutions exempt from income tax. In the Revenue Act of 1962, Congress attempted to end this virtual tax exemption by modifying the bad debt reserve deductions.

The system set up in 1962 allowed thrift institutions to choose among two alternative formulas: (1) an annual addition to reserves of 60 percent of taxable income (limited to a loss reserve of 6 percent of qualifying real property loans), or (2) a loss reserve of 3 percent of qualifying real property loans plus a percentage of other loans based on experience. Savings and loan associations and cooperative banks were allowed to use these methods only if 82 percent of their assets were invested in residential real estate, liquid assets and certain other assets, but no similar restrictions were applied to mutual savings banks.

The Tax Reform Act of 1969 eliminated the 3-percent method, phased down the percent of taxable income from 60 to 40 percent over 10 years, applied limits on the use of the percentage of taxable income method to mutual savings banks similar to those applicable to savings and loan associations (but with a 72-percent qualifying asset requirement in place of 82 percent), provided that the taxable income percentage was to be phased down gradually if an institution's proportion of qualifying assets fell short of 82 or 72 percent (instead of causing that institution to lose all benefit from the percentage of taxable income method), and made a series of other modifications to the bad debt provisions.

The Economic Recovery Tax Act of 1981 expanded the organizations eligible for these special rules to include stock savings banks. The rules applicable to stock savings banks are the same as those applicable to savings and loan associations.

The Tax Equity and Fiscal Responsibility Act of 1982 enacted Code section 291 which required that deductions for bad debts by a thrift institution must be reduced by 15 percent of the amount that the institution's bad debt deduction exceeded the amount that would have been allowed under the experience method. The section 291 cut-back percentage was increased to 20 percent by the Deficit Reduction Act of 1984.

The Tax Reform Act of 1986 ("1986 Act") created the present system for accounting for bad debts by limiting the percentage of taxable income method to 8 percent of taxable income for those thrift institutions that met the 60-percent qualifying asset test of present law and repealing the section 291 cutback provision.[5] The 1986 Act also repealed the percentage-of-

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[5] The 1986 Act changes did not change the effective tax rate applicable to thrift institutions. Before the 1986 Act, the effective tax rate was 31.28 percent, computed as:

(1) 46-percent corporate tax rate times,

(2) 68 percent (100 percent minus 32-percent deduction allowed under 40-percent

eligible loans method for taxable years beginning after 1987. The 1986 Act significantly changed the treatment of accounting for bad debts for other taxpayers by requiring the use of the specific charge-off method for all taxpayers, except thrift institutions and "small banks" (i.e., those with assets of $500 million or less). Small banks were allowed to continue to use the experience method of section 585. The experience method was amended to establish 1987 as a permanent base year for all taxpayers eligible to use the experience method, including thrift institutions.

C. Proposed Banking Legislation (H.R. 2491)

Treatment of thrift institutions under H.R. 2491

H.R. 2363 (the "Thrift Charter Conversion Act of 1995," introduced by Mrs. Roukema, and Messrs. Leach, McCollum, Roth, Baker of Louisiana, Bachus, Vento, Flake, Royce, Lucas, Weller, Metcalf, and Watts of Oklahoma on September 10, 1995, the major provisions of which are contained in H.R. 2491, the 1995 budget reconciliation bill) would require savings and loan institutions to forego their Federal thrift charters and become either State-chartered savings and loan institutions or Federally-chartered banks. Under proposed Treasury regulations, if a thrift institution becomes a bank, the institution would be subject to recapture of all or a portion of its bad debt reserve . As described in detail below, it is understood that such recapture would require the institution to immediately record, for financial accounting purposes, a current or deferred tax liability for the amount of recapture taxes for which liabilities previously had not been recorded (generally, with respect to the pre-1988 reserves) regardless of when such recapture taxes are actually paid to the Treasury. It is further understood that the recording of this liability generally would decrease the regulatory capital of the new bank.

Financial accounting treatment of tax reserves of bad debts of thrift institutions

In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deductible for tax purposes in a period earlier than they are expensed for book purposes. The deferred tax liability signifies that, although a corporation may be reducing its current tax expense because of the accelerated tax deduction, the corporation will become liable for tax in a future period when the timing item "reverses" (i.e., when the item is expensed for book purposes but for which the tax deduction had already been allowed). Under the applicable accounting standard (Accounting Principles Board Opinion 23), deferred tax liabilities generally were not required for pre-1988 tax deductions attributable to the bad debt reserve method of thrift institutions because the potential reversal of the bad debt reserve was

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of taxable income method, adjusted for the 20-percent cutback of sec. 291).

After the 1986 Act, the effective tax rate also was 31.28 percent, computed as:
(1) 34-percent corporate tax rate times,
(2) 92 percent (100 percent minus 8-percent deduction allowed under percentage of taxable income method).

indefinite (i.e., generally, a reversal would only occur by operation of sec. 593(e), a condition within the control of a thrift institution). However, the establishment of 1987 as a base year by the 1986 Act increased the likelihood of bad debt reserve reversals with respect to post-1987 additions to the reserve and it is understood that thrift institutions generally have recorded deferred tax liabilities for these additions.

D. Description of H.R. 2494

H.R. 2494 (the "Thrift Charter Conversion Tax Act of 1995," introduced by Chairman Archer, Mr. Leach, and Ms. Roukema on October 11, 1995), would repeal the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Under the bill, thrift institutions that qualify as small banks would be allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks would be required to use the specific charge-off method. Thus, the percentage of taxable income method of accounting for bad debts would no longer be available for any institution.

A thrift institution required to change its method of computing reserves for bad debts would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995. For purposes of determining the section 481(a) adjustment of a taxpayer, the balance of the reserve for bad debts with respect to the taxpayer's base year (generally, the balance of the reserve as of the close of the last taxable year beginning before January 1, 1988, adjusted for decreases in the taxpayer's loan portfolio) would not be taken into account. However, the balance of these pre-1988 reserves would continue to be subject to the provisions of present-law section 593(e) (requiring recapture in the case of certain excess distributions to shareholders).

Thus, under the bill, subject to the special rule described below, a thrift institution that would be treated as a large bank generally would be required to recapture its post-1987 additions to its bad debt reserve, whether such additions are made pursuant to the percentage of taxable income method or the experience method. In addition, subject to the special rule described below, a thrift institution that would qualify as a small bank generally only would be required to recapture its post-1987 additions to its bad debt reserve that were attributable to the use of the percentage of taxable income method during such period. If such small bank would later become a large bank, any amount required to be recaptured under present law would be reduced by the amount of the pre-1988 reserve.

Under a special rule, if the taxpayer meets the "residential loan requirement" for any taxable year, the amount of the section 481(a) adjustment otherwise required to be restored to income would be suspended. A taxpayer would meet the residential loan requirement if for any taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than the average of the principal amount of such loans made during the six most recent testing years. A "testing year" means (1) each taxable year ending on or after December 31, 1990, and before January 1, 1996, and (2) each taxable year ending after December 31, 1995, for which the taxpayer met the residential loan requirement. For this purpose, a residential loan would be a loan described in section 7701(a)(19)(C)(v) (generally, loans secured by residential real and church property and mobile homes). The special rule would continue to apply until the taxpayer recaptured its entire section 481(a) adjustment. The determination of whether a member of a controlled group of corporations meets the residential loan requirement would be made on a controlled group basis. A special rule would provide that a taxpayer that calculates its estimated tax installments on an annualized basis would determine whether it meets the residential loan requirement with respect to each such installment. Treasury regulations are expected to provide rules for the application of the residential loan requirement rules in the case of mergers, acquisitions, and other reorganizations of thrift and other institutions.

Effective date.--The bill would be effective for taxable years beginning after December 31, 1995.

E. Issues Raised by H.R. 2491 and H.R. 2494

Title II of H.R. 2491 (the proposed banking legislation) and H.R. 2494 (the proposed tax legislation) raise and address certain accounting, banking, and tax policy issues. First, H.R. 2491 would require a Federally-chartered savings and loan institution to become either a Federally-chartered bank or a State-chartered savings and loan. If an institution became a bank, absent any accompanying tax legislation, the converting institution would be denied the future benefit of the bad debt reserve method of section 593 and, pursuant to proposed Treasury regulations, would recapture all or a portion (depending on whether the institution would be treated as a small or a large bank) of its bad debt reserve. Thus, H.R. 2491, without any legislative tax relief, would impose a financial burden upon those institutions selecting Federal bank charters rather than State thrift charters. Further, as described in Part C. above, requiring the recapture of all or a portion of an institution's bad debt reserve may require the institution to record a deferred tax liability for such amounts, thereby reducing the regulatory capital of the institution. Taken together, the financial and capital requirements burdens imposed by bad debt reserve recapture may provide an incentive for thrift institutions to become State-chartered savings and loans rather than Federally-chartered banks, thus potentially frustrating Federal banking policy.

H.R. 2494 resolves this issue by forgiving, subject to certain restrictions, recapture with respect to that the portion of the bad debt reserve for which it is understood that deferred tax liabilities have not been recorded for financial accounting purposes. Such forgiveness raises certain tax policy concerns. In general, whenever a taxpayer changes from one method of accounting to another, such change is implemented by way of a section 481(a) adjustment that reflects the cumulative difference between the old and new accounting methods. This adjustment generally is restored to income over a specified period of time so that a taxpayer does not receive a "double deduction" with respect to an item of expense--once under the old method and again under the new method. Restoring the section 481(a) adjustment to income with respect to a repeal of a reserve method of accounting for bad debts ensures that the taxpayer does not receive a double deduction with respect to the same expense--once when the reserve is established and again when the bad debt is actually realized. The opposite of implementing an accounting method change under section 481 of the Internal Revenue Code is the "fresh start" approach, wherein the taxpayer is allowed deductions under both its old and new methods of accounting with no adjustment to reconcile the two methods.

H.R. 2494 effectively allows "fresh start" with respect to the pre-1988 reserves of a thrift institution (subject to the sec. 593(e) limitation) and requires a section 481(a) adjustment with respect to the post-1987 additions to the reserves of the institution (subject to the residential loan requirement). Some would argue that allowing "fresh start" is appropriate with respect to bad debts computed under the percentage of taxable income method of section 593 because such method effectively acted as a permanent incentive for thrift institutions in the residential mortgage business. Conversely, others would argue that fresh start is not appropriate because the benefits of the percentage of taxable income method were never intended to be permanent benefits--pointing to the recapture potential under section 593(e) (relating to certain excess distributions to shareholders). Finally, a third argument could be made that it is appropriate to allow "fresh start" with respect to the pre-1988 portion of the reserve and require recapture for the post-1987 additions to the reserve because the change made by the 1986 Act establishing 1987 as a permanent base year changed the nature of the bad debt deductions of thrift institutions from one of permanency to one of timing.[6] Indeed, the 1986 Act change appears to be the

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[6] As discussed in Parts A. and B. above, the 1986 Act changed the base year balance to the reserve balance at the close of 1987 taxable year. Prior to the 1986 Act, the base year balance of a thrift institution was the reserve balance whenever the institution changed from one bad debt method to another (e.g., from the percentage of taxable income method to the experience method). How the establishment of 1987 as a permanent base year changed the nature of bad debt deductions between pre-1988 years to post-1987 years can be illustrated by the following example:

Assume that a thrift institution ("T") always used the percentage of taxable income ("PTI") method to deduct bad debts through 1986 when its reserve balance was $10,000. Further assume that in 1987, T: (1) has insufficient taxable income to use the PTI method, (2) has actual bad debt losses of $1,000, and (3) under the six-year average formula of the experience method, would be allowed a deduction of $900. Under pre-1986 Act law, T would be allowed a bad debt deduction of $1,000 (rather than $900) in 1987 because $1,000 is the amount necessary to restore the reserve to its base year (PTI) level. Specifically, in 1987, T would charge the year-end 1986 reserve of $10,000 for the $1,000 actual loss and then add (and deduct) $1,000 to the reserve so that the balance of the reserve at year end 1987 is once again $10,000. Thus, T's former PTI deductions, which gave rise to the $10,000 reserve balance, generally would not be restored to income under pre-1986 Act law (subject to sec. 593(e)).

Further assume that in 1988, T has sufficient taxable income to be allowed a PTI deduction of $1,500, increasing the balance of the reserve to $11,500 at year-end 1988. Further assume that in 1989, T: (1) again has insufficient taxable income to use the PTI method, (2) has principal reason that accountants changed the treatment of accounting for income taxes with respect to bad debt deductions of thrift institutions for financial accounting purposes.

H.R. 2494 suspends the recapture of post-1987 additions to the bad debt reserve of a thrift institution so long as the institution continues to originate a certain level of loans secured by residential property. The residential loan requirement test is determined with respect to any loans secured by an interest in residential real or church property (including mobile homes not used on a transient basis). Such loans could include conforming and nonconforming[7], home purchase mortgages, home improvement loans, second trusts, mortgage refinancings and home equity loans. This provision raises and addresses certain tax and banking policy issues. The first issue is whether banking policy should be implemented through the Internal Revenue Code. The second issue is whether the residential loan requirement of the bill is appropriately tailored to meet the perceived banking policy goal of ensuring a source of mortgage financing. Specifically, (1) should this benefit be provided permanently or during a limited transition period; and (2) does the provision encompass the appropriate types of loans for the appropriate types of property?

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actual bad debts of $2,500, and (3) under the six-year average formula of the experience method would be allowed a deduction of $900. Pursuant to the change made by the 1986 Act, T would be allowed a deduction of $1,000 (i.e., the amount necessary to restore the reserve to its base year (year-end 1987) level.) Specifically, T would charge the year-end 1988 reserve balance of $11,500 for the $2,500 actual loss and then add (and deduct) $1,000 to the reserve to restore the balance to the $10,000 base year amount. Thus, T's post-1987 PTI deduction of $1,500 is restored to income under post-1986 Act law (i.e., T had actually losses of $2,500 in 1989, but only was allowed to deduct $1,000).

[7] A loan generally is "conforming" if it readily acceptable on a secondary market. A loan may be "nonconforming" if it exceeds a certain principal amount, provides for certain variable interest rates, is secured by both a personal residence and other (e.g., farm) property, or is made to an individual who fails to meet certain creditworthiness standards.

III. TAX TREATMENT OF SPECIAL ASSESSMENTS

A. Present Law and Background

Title II of H.R. 2491 would require thrift institutions to pay a special assessment to the Saving Association Insurance Fund ("SAIF"). The SAIF generally is the insurance fund for deposits in thrift institutions. The amount of the assessment would be the amount necessary to ensure that the SAIF has reserves of $1.25 for each $100 of insured deposits and the due date of the payment would be the first business day of January 1996. Effective January 1, 1998, the SAIF would be merged with the Bank Insurance Fund ("BIF") (the insurance fund for deposits in banks). Thrift institutions and banks also are required to pay annual premiums to the SAIF and BIF, respectively, based on the amount of their insured deposits. Currently, the premium rate for the SAIF deposits is substantially higher than the premium rate for BIF deposits. After the merger of the SAIF and BIF in 1998, under H.R. 2491, thrift institutions and banks would be subject to the same lower deposit insurance rates generally applicable to banks.

In general, a taxpayer is allowed to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business during the taxable year (sec. 162). However, amounts that give rise to a permanent improvement or betterment must be capitalized rather than deducted currently (sec. 263). Whether an expenditure is deductible under section 162 or must be capitalized under section 263 is often a matter of dispute between the IRS and taxpayers, and has been the subject of significant litigation. Most recently, in INDOPCO v. Commissioner, 503 U.S. 79 (1992), the U.S. Supreme Court noted that the capitalization of expenditures is the norm and that a current "income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."[8] In INDOPCO, the Court distinguished its prior decision in Lincoln Savings v. Commissioner, 403 U.S. 345 (1971), (relating to additional premiums paid by a thrift institution to the Federal Savings and Loan Insurance Corporation) to hold that it is not necessary for an expenditure to give rise to the creation of a separate and distinct asset before such expenditure is capitalized. Rather, the Court held that "although the presence of an incidental future benefit may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is important in determining whether the appropriate tax treatment is immediate deduction or capitalization." In INDOPCO, the Supreme Court found that the record supported the lower courts' findings that the investment banking fees in question produced significant benefits extending beyond the tax year in which they were incurred so as to warrant capitalization.

The scope of the INDOPCO decision and its application to the payments of the special assessments provided in H.R. 2491 is uncertain. On the one hand, if the special assessments are

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[8] INDOPCO, citing Interstate Transit Lines v. Comm., 319 U.S. 590, 593 (1943); Deputy v. DuPont, 308 U.S. 488, 493 (1940); and New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

viewed as payments necessary to raise SAIF funding to a level appropriate for current needs,[9] a current deduction arguably would be allowable. If, on the other hand, the special assessments are viewed as current payments that will facilitate the future BIF/SAIF merger (such merger providing the assessed institutions with significant future benefits such as reduced deposit insurance rates), capitalization arguably would be required.[10]

B. Description of H.R. 2494

The bill would provide that the special assessment paid to the SAIF as required by H.R. 2491 would be deductible when paid.

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[9] See, e.g., the testimony of the Hon. John D. Hawke, Jr., Undersecretary of the Treasury for Domestic Finance on the SAIF, before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services, August 2, 1995, calling for a special assessment at least partially to correct current SAIF weaknesses. The testimony did not discuss the proper Federal income tax accounting treatment for the assessment.

[10] See, e.g., Private Letter Rulings 9348003 (August 30, 1993) and 9402006 (September 24, 1994), where the IRS required capitalization of certain "exit and entry" fees paid by institutions on the transfer of insured deposits from the SAIF to the BIF. However, these rulings are not dispositive of the proper treatment of the special assessments required under H.R. 2491 because private letter rulings are only applicable to the taxpayers to whom issued and the facts underlying the rulings differ from the facts underlying the special assessments.

TESTIMONY OF
ROBERT K. SHERIDAN, PRESIDENT
SAVINGS BANK LIFE INSURANCE COMPANY OF MASSACHUSETTS

BEFORE THE COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
OCTOBER 26, 1995

ON

H.R. 2494
"THRIFT CHARTER CONVERSION ACT OF 1995"

Chairman Archer and Members of the Committee on Ways and Means, my name is Robert K. Sheridan and I am President of the Savings Bank Life Insurance Company of Massachusetts.

I am grateful for the opportunity to explain the relationship between the demutualization of savings bank life insurance (one product line of the very same institutions addressed by H.R.2494) mandated by Massachusetts law in 1990, and what you are here today to consider -- establishing certainty with regard to the Federal tax rules when demutualizing entire thrift institutions should Federal banking law mandate the conversion of mutual thrift institutions into commercial banks.

I am hopeful that the Committee will resolve favorably in this legislation, the question of how the Internal Revenue Code of 1986 should treat the additional policyholder dividends required to be paid by SBLI to individuals over twelve years due to the similar SBLI demutualization legislation enacted in 1990 by Massachusetts. The payment of the additional annual dividend based on the combined surplus should be legislatively clarified as deductible, reflective of earnings, mortality and expenses like any other dividend.

Due to the previous diligent work of Members of the Massachusetts delegation, I am able to provide the Committee with current revenue estimates from the Joint Committee on Taxation based on appropriate policy considerations and proposed legislative language known to the Committee and Administration.

ADDITIONAL BACKGROUND

The Savings Bank Life Insurance Company of Massachusetts (SBLI) provides low-cost life insurance consistent with absolute safety to the citizens of Massachusetts. Legislative language is being sought which would clarify the tax consequences of the consolidation of the SBLI into a stock life insurance company pursuant to state legislation. The issue comes down to whether or not an additional policyholder dividend that is to be paid over a twelve year period is treated the same as any other policyholder dividend as was the intention of the state legislation.

The sole reason there is any question is because of the unique nature of SBLI. In truth, it is unlike any other company in the country. Massachusetts SBLI was created by an act of the Massachusetts Legislature in 1907 as the brainchild of Justice Louis D. Brandeis. The enabling legislation represented one of the earliest efforts at progressive, consumer reform. Justice Brandeis felt that there was much waste in the prevailing system of selling life insurance, in response, he devised a plan whereby life insurance could be purchased at a cost much lower than that generally available. The vision for SBLI was a system of over the counter sales with reduced costs by eliminating sales commissions and other ancillary expenses. Justice Brandeis' selection of mutual savings banks can be traced to history as at that time savings banks were the banking institutions of low income and immigrant consumers. Experience has shown that the Brandeis experiment has even exceeded the greatest of expectations. Consumer's Report made a study of insurance company costs in the United Sates and concluded that before any Massachusetts citizen purchases life insurance, they consider SBLI, noting that "Massachusetts Savings Bank Life Insurance in particular is a model for what all life insurance ought to be". Consumer's Report, in a three-part series on life insurance, consistently rated SBLI in the top tier of low cost, high quality life insurance companies, including number one in whole life coverage, and other categories. Many other consumer-oriented publications have similarly endorsed SBLI.

Presently, SBLI has over 500,000 policies and $12 billion in in-force insurance. While we have the full range of life insurance products our yearly renewal term insurance has grown in popularity and does represent about 80% of current issues. An example of our rates for a 30 year old non-smoker should show why the product is so popular -- $99 for $100,000; $180 for $250,000; and $315 for $500,000. This policy, as virtually all of our policies is participating, meaning that dividends can be expected at some point in time.

The deregulation of the banking industry posed a significant challenge to the prior SBLI system. During the 1980's, many savings banks converted to stock ownership which produced a natural conflict between a stock bank and a non-stock life insurance department. Moreover, as a stock entity, such banks were subject to acquisition and if a non-savings bank were involved, SBLI outlets would have diminished. Desirous of preserving and protecting SBLI for future generations of Massachusetts consumers and wanting to make available low-cost life insurance through a banking network, legislative and consumer leaders overhauled the SBLI governing statute in 1990.

The plan consolidated the fifty separate life insurance departments into a closely held stock company. All conceivable so-called home office functions, including the underwriting and servicing of policies and the investment of premiums, were transferred to the consolidated entity. Almost immediately, the efficiencies of consolidation manifested themselves as after the first year of operation in 1992, the restructured SBLI realized a 34.1% reduction in general insurance expenses. Further aspects of the plan included the repeal of artificially capped policy size limits and the creation of a public watchdog group whose mandate was to see that SBLI remained faithful to safe, low-cost life insurance.

In effecting consolidation, the SBLI banks received stock in the new company roughly in proportion to the size of the surplus in the life insurance department. The size of the stock distribution sought to equitably recognize the degree of subsidy and support that was provided by any host savings bank. To buttress the provision of low-cost insurance, an additional dividend was prescribed to be paid out to policyholders over a twelve-year period. This dividend roughly equated to the present value of 60% of the total combined surplus and constituted mounts made excess by operating one consolidated entity as opposed to fifty small life insurance departments.

The issue was raised as to whether such dividend is the same as the payout of surplus to policyholders for their ownership interest in a conventional demutualization. In a typical demutualization, policyholders receive a payment for their legal ownership interest as it is considered a redemption.

Unfortunately given the sui generis nature of SBLI, conversion models cannot be followed. If ownership is the controlling factor, then the normal attributes of ownership were not held by a SBLI policyholder: 1) there was no right to vote; 2) the right to participate to earning was qualified; and 3) there was no right to participate in the distribution of assets.

The prior regulatory body, the State Division of Savings Bank Life Insurance, and the Massachusetts Legislature carefully analyzed the status of policyholders and concluded that SBLI policyholders did not have an equity interest in the surplus of their life insurance department.

For the reasons cited above, the payment of the additional annual dividend based on the combined surplus should not be construed as payment for the redemption of any ownership interest, but rather represents a dividend payment as it would be reflective of earnings, mortality and expenses like any other dividend. Moreover, the legislation made clear that a policyholder must keep his policy in force so in the case of a lapse or surrender such individual would cease to be eligible for the dividend.

While it is crystal clear in our opinion that the additional dividend is the same as any other dividend pursuant to SBLI operations, our unique fact pattern did not permit Internal Revenue Service guidance through a private letter ruling. Among developments considered was the pending regular demutualization of the Equitable Life Assurance Society in New York so the IRS was disinclined to create any exceptions to standard practice, however meritorious the facts or arguments.

Legislative clarification was decided upon as the best route to give meaning to the intent of Massachusetts law.

The Joint Tax Committee has estimated a revenue loss of $25 million over five years if the additional dividend was legally found to be a non-deductible redemption of a propriety interest as opposed to a deductible repayment of a creditor interest. This estimate must be placed in perspective. In 1992, the federal government realized more than $5 million more in federal income taxes from SBLI since the small business deduction ended due to corporate reorganization. Ongoing, SBLI will pay more in federal income taxes as one large taxpayer in contrast to multiple smaller ones. This permanent revenue windfall to the federal government should more than mitigate the impact of clarifying the additional dividend. We understand that the Joint Tax Committee's methodology prevents taking into account any revenue enhancements. For purposes of revenue estimates, we do, however, understand that a revenue offset has been identified.

In summation, I believe that the amendment merely clarifies the state of the law and effectuates the intended meaning of the Massachusetts legislation. In so doing, the legitimate interests of SBLI policyholders and stockholders are acknowledged. It is crucial that this matter be resolved soon so we can continue to provide consumers with the most cost-efficient life insurance coverage. If the tax clarification is not made, SBLI will be subject to a tax inequity which would regrettably be passed on to the consumer. Accordingly, we urge approval of this important amendment.

I appreciate your consideration and attention.

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