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MEMORANDUM

December 17, 2007

TO: Honorable Steven Kaplan
Secretary of Banking
PENNSYLVANIA DEPARTMENT OF BANKING

Paul H. Wentzel, Jr.
Executive Assistant to Secretary of Banking
PENNSYLVANIA DEPARTMENT OF BANKING

FROM: Reginald S. Evans, Esq.

RE: Our File No. 07-510

SUBJ: PACB Request for Exemption for All Affiliates of Community Banking Institutions from Proposed Mortgage Regulations

CC: Interested Legislators

PACB Board of Directors

Frank A. Pinto
President/CEO
PENNSYLVANIA ASSOCIATION OF COMMUNITY BANKERS

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This memo is written on behalf of the Pennsylvania Association of Community Bankers ("PACB"). The PACB requests that the Pennsylvania Department of Banking (the "Department") expand the exemption from the Department's proposed mortgage regulations beyond the exemption for mortgage subsidiaries to include as exempt from the proposed regulations all affiliates of community banks. This memo provides information and legal analysis to support the PACB's request. Paul Wentzel indicated in a recent telephone discussion that we had that PACB may provide such a memo to you for your consideration. **It is my understanding that PACB will be following receipt of this memo with a request for a meeting with the Secretary and staff and the PACB Executive Committee to discuss this issue further.**

BACKGROUND

As originally proposed in summer 2007, the Department's proposed mortgage regulations exempted banking institutions (banks, savings banks, savings associations) from being subject to the proposed regulation. Then, in response to requests from the PACB and member banking institutions for the Department to expand the exemption to all affiliates of all banking institutions, the Department of Banking agreed partially with this request by expanding the exemption to mortgage subsidiaries of banks. PACB appreciates and thanks the Department for agreeing to such an exemption.

The PACB has continued to request an exemption from the proposed mortgage regulations for "all affiliates of banking institutions". In response, the Department has indicated that it is not inclined presently to agree to this request.

PACB continues respectfully and constructively to assert and note to the Department generally that the community banks have NOT been part of this subprime mortgage origination or general mortgage foreclosure problem in Monroe County or elsewhere in Pennsylvania. Therefore, PACB believes that it is not necessary or appropriate for the Department to impose regulatory burden in the form of the proposed mortgage regulations on the community banks or their affiliates. PACB notes that it is the large multibillion dollar asset size banks that have mortgage affiliates in the news and on the regulatory radar screen that have been the major players in the subprime mortgage origination and general mortgage foreclosure problems across the country. Furthermore, these large banks and their affiliates are not necessarily direct subsidiaries of the lead bank in their respective holding company structures, such as Household, CitiFinancial, and American General. PACB does not want any of its member banks that presently have or in the future will have affiliates engage in mortgage banking to be subject to unnecessary and unwarranted regulatory burden.

The community banks have not contributed to the subprime or mortgage foreclosure problem in Pennsylvania and should not be penalized for their good behavior by being made subject to the proposed mortgage regulations.

PACB PROPOSAL

The PACB has considered the Department's position and has a proposal that we request be considered and approved by the Department. **The PACB's proposal is for the Department to allow exemption of all affiliates of banking institutions of a certain size, such as affiliates of banking institutions with asset size of \$5 billion or less.** While most of PACB's members are asset size of \$1 billion or less, our request is relative to the "megabanks" in excess of \$100 billion asset size that have the mortgage affiliates that actually did contribute to the subprime mortgage origination and the general spike in mortgage foreclosures problems.

In regard to this PACB proposal, PACB notes that there is precedent similar to the sliding scale of compliance allowed for “smaller small banks” and “intermediate small banks” pursuant to the federal Community Reinvestment Act regulations adopted by the federal banking agencies in July 2005.

PACB also notes that the U.S House of Representatives bill titled "Mortgage Reform and Anti-Predatory Lending Act" (H.R. 3915 of 2007) which is intended to impose less regulatory burden on community banks than on the other participants in the residential mortgage loan industry in recognition that community banks have not caused or contributed to the subprime mortgage origination and home mortgage foreclosure problem.

Finally, we are not aware of any applicable constitutional basis to overrule an exemption from the Department's mortgage regulations that would exclude affiliates of community banks from being made subject to the proposed mortgage regulations, while remaining applicable to the larger banks.

We will discuss below the precedent and present reality of each of these items (CRA, U.S House Bill H.R. 3915, and the constitutional law issue) in support of PACB's proposal for the Department to allow all affiliates of community banking institutions to be exempt from the Department's proposed mortgage regulations.

BANKING DISTINCTION AREAS BASED ON SIZE OF BANK; CRA REGULATIONS SET INCREASING AMOUNT OF REGULATORY REQUIREMENTS BASED ON INCREASED ASSET SIZE OF BANKING INSTITUTIONS

Banking Area Distinctions Based on Size of Banks. In the banking realm and besides the CRA distinctions between small banks and large banks, there have been other distinctions between banks of different size. Over the years, there have been distinctions between banks of different sizes in subject areas such as the following:

1. Risk-based capital rules pursuant to the BASEL II requirements that are mandatory for large banks but not for small banks. *See* Final Rule on Advanced Capital Adequacy Framework – Basel II Financial Institution Letter 107-2007 dated December 7, 2007.
2. Loans to one borrower rules, in which the OCC pilot program for additional lending authority for smaller banks was adopted for national banks under 12 CFR § 32.7, and through parity state-chartered banks have obtained similar authority.

Another banking distinction area is the Community Reinvestment Act, discussed in detail below as an example of the validity of certain distinctions between small banks and large banks.

Community Reinvestment Act Distinctions between Small Banks and Large Banks. The Community Reinvestment Act (CRA), enacted by Congress in 1977 (12 U.S.C. 2901 et seq.) and implemented by Regulations 12 CFR parts 25, 228, 345, and 563e, is intended to

encourage depository institutions to help meet the credit needs of the communities in which they operate.

The CRA regulations have long distinguished between "small banks" and larger banking institutions by imposing differing CRA compliance requirements on the small banks versus the larger banks. As announced in July 2005 and effective September 1, 2005, regulatory relief under the CRA was provided to community banks by the federal banking regulatory agencies. The regulators expanded the definition of "small bank" from the old definition which was a bank with total assets of less than \$250 million that was independent or an affiliate of a holding company that had total banking and thrift assets of less than \$1 billion. The new definition of "small bank" that remains in effect today is a bank that as of December 31 of either of the prior two calendar years had assets of less than \$1 billion in either of the prior two calendar years, regardless of holding company affiliation.

The CRA regulations also were amended by adding an "intermediate small bank" category, defined as a small bank with assets of at least \$250 million as of December 31 of either of the prior two calendar years, also regardless of holding company affiliation.

The amended CRA compliance and reporting requirements are greatest for large banks, less for intermediate small banks, and least for smaller (less than intermediate) small banks.

Large banks, generally meaning those with assets of \$1 billion or more, will continue to be evaluated by the federal banking agencies for CRA compliance in their geographic assessment areas under the lending, investment, and service tests. Also, large banks will continue to be required to collect and maintain loan information for each small business or small farm loan originated or purchased by the large bank, and to annually report data including regarding small business and small farm loans, community development loans, and home mortgage loans.

"Intermediate small banks", meaning those with assets of \$250 million up to less than \$1 billion, will be examined for CRA compliance under the existing small bank lending test and the new community development test that includes an evaluation of community development loans, investments, and services in light of community needs and the capacity of the bank. Pursuant to the regulatory amendments, intermediate small banks will no longer be required to collect and report CRA loan data for small business, small farm, and community development loans.

Smaller "small banks", meaning those with total assets of less than \$250 million, will be examined for CRA compliance under the existing small bank lending test, but will not be subject to the new community development test that is applicable to intermediate small banks. Smaller small banks continue to not be required to collect and report CRA loan data.

The regulators indicated in the Federal Register that the differing sizes of banks (i.e., smaller small banks with assets less than \$250 million, intermediate small banks with assets of \$250 million to less than \$1 billion, and large banks with assets of \$1 billion

or more) were being made subject to respectively more CRA reporting and compliance requirements as the size of the bank increased by size category because of recognition of regulatory burden and practicality of being able to comply with more requirements as the bank grew in size. See 70 Federal Register No. 147, pages 44256-44270, August 2, 2005.

The July 2005 amendments to the CRA regulations created a new test, the community development test for intermediate small banks. At the same time, intermediate small banks were no longer required to collect and report CRA loan data for small business, small farm, and community development loans. Intermediate small banks were allowed to stop collecting CRA loan data on September 1, 2005. The CRA regulation continued to allow small banks, including intermediate small banks, to opt for examination as a large bank under the lending, investment, and service tests.

Thanks to cooperation from federal banking agencies, and comment letters from banks and their trade associations including the PACB, small bank regulatory relief became a reality. It is this type of regulatory relief, namely small bank regulatory relief, that is sought by the community banks request for an "all affiliates of community banks" exemption from the mortgage regulations being proposed by the Pennsylvania Department of Banking.

U.S HOUSE OF REPRESENTATIVES BILL TITLED "MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT" (H.R. 3915) IS INTENDED TO IMPOSE LESS REGULATORY BURDEN ON COMMUNITY BANKS THAN ON OTHER LENDERS

The Mortgage Reform and Anti-Predatory Lending Act bill, H.R. 3915, is for purposes including to amend the federal Truth in Lending Act to reform consumer mortgage practices and provide accountability for such practices, to establish licensing and registration requirements for residential mortgage originators, and to provide certain minimum standards for consumer mortgage loans. The bill has been passed by the U.S. House of Representatives and awaits action by the U.S. Senate. H.R. 3915 is directed at the subprime mortgage industry, the problems of which are viewed by the legislators as not including community banks.

House Financial Services Committee Chairman Barney Frank (D-Mass.) who was a principal author of H.R. 3915 is reported to have said during floor debate that the legislation was expressly written so as not to deter community banks from originating mortgages. Representative Frank said that "Community banks are very important. ... If only they had made more loans for mortgages we wouldn't have a crisis. ... It is the [House Financial Services] Committee's intent that when the regulators write these new regulations they have flexibility to limit the regulatory burden and compliance costs on community banks."

Community banks and their affiliates will be subjected to enough increased regulatory burden from H.R. 3915 if it becomes law. Thus, PACB appreciates that the Department will allow an exemption from the Department's proposed mortgage regulations for community banks

and their affiliates, and requests that such increased regulatory burden not be placed on other affiliates of community banks.

**CONSTITUTIONAL BASIS FOR EXEMPTION FOR ALL AFFILIATES OF
COMMUNITY BANKING INSTITUTIONS (ASSET SIZE OF \$5 BILLION OR LESS)
IS SUPPORTED BY CASE LAW**

PACB asserts that is constitutional for “all affiliates of community banks of assets of size of \$5 billion dollars or less” to be exempted from compliance with the Department’s proposed mortgage regulations. Provided there is a “rational basis” for the exemption, which there is, the exemption for the affiliates of the community banks versus the large banks should and likely would be upheld as constitutionally valid by a court of law.

The key to the anticipated valid constitutionality of the requested exemption for all affiliates of community banks is that there be a “reasonable classification” or “rational basis” for the exemption, and that therefore the exemption would not be “arbitrary” and/or “capricious”.

There is significant case law to support the argument that a statute or regulation may distinguish between entities covered by such law, based on the size or other factors, provided there is a rational basis for such a distinction between entities of the same kind but with varying attributes. *See the following cases:*

1. *Federal Communications Comm'n v. Beach Communications, Inc.*, 508 U.S. 307, 313, 113 S.Ct. 2096, 2101, 124 L.Ed.2d 211 (1993) (“In areas of social or economic policy, a statutory classification that neither proceeds along suspect lines nor infringes fundamental constitutional rights must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification.”).
2. *Fitzgerald v. Racing Ass'n of Central Iowa*, 539 U.S. 103, 123 S.Ct. 2156 (2003) (Finding a rational basis for disparate tax treatment for slot machine revenues based on the type of business at which they are located).
3. *Hernandez v. City of Hanford*, 41 Cal.4th 279, 159 P.3d 33 (Cal.,2007) (Disparate zoning treatment based on department size of store not unconstitutional because it is rationally related to government’s economic interests).
4. *Bennett v. City of Redfield*, 446 N.W.2d 467 (Iowa,1989) (Statute establishing different termination practices for city employees based on size of the city is not unconstitutional because it rationally related to the burdens imposed by the law).
5. *41 Kew Gardens Road Associates v. Tyburski*, 70 N.Y.2d 325, 514 N.E.2d 1114 (N.Y.,1987) (Statute which distinguishes between taxpayers based on the size or value of

the property is not unconstitutional because it is rationally related to the tax revenue generated by those properties).

6. *Madison Metropolitan Sewerage District v. Committee on Water Pollution*, 260 Wis. 424, 50 N.W. 2nd 424 (1951). (There was a rational basis for statutory “population” classifications in a statute providing that sewage runoff could be handled by static waters regarding small towns but for towns with populations of 45,000 or more, additional regulatory requirements were necessary to eliminate a potential public nuisance factor regarding the sewerage.)

Based on the foregoing, it is constitutionally permissible for a statute or regulation to distinguish between entities of the same type if there is a rational basis to do so. Community banks and all of their affiliates should be exempt from the Department’s proposed mortgage regulations for reasons including the following:

1. It is affiliates of the very large banks that have been cited as part of the subprime mortgage industry and general mortgage foreclosure increase issues, not community banks or their affiliates.
2. The relative cost of additional regulatory requirements can be absorbed more easily by larger banks than the smaller community banks and their affiliates.
3. Community banks and their affiliates have small staffs that are not as far flung geographically or in terms of oversight or as likely to violate already existing mortgage lending requirements.
4. As a general matter, community banks do not make and have not made the “low document” or “no document” loans, or made loans without analyzing and confirming the ability of the borrower to repay, and have performed detailed credit analysis on the loan applicants prior to issuing any loans.
5. Examinations of community banks in Pennsylvania have yielded little to no evidence of improper mortgage lending or mortgage disclosure activities by community banks.
6. Community banks were not part of the mortgage origination and mortgage foreclosure increase in Monroe County or in any other counties in Pennsylvania.
7. Community banks should not be “punished” by additional regulatory burden when the community banks did not perpetrate or cause or

engage in any improper subprime mortgage lending activity forming the reason for the Department's proposed mortgage regulations.

CONCLUSIONS

An exemption for all affiliates of community banks of \$5 billion asset size or less is supported by precedent in the banking realm including CRA, BASEL II, and loans to one borrower areas in which the size of the bank was the distinguishing factor upon which different levels of regulatory requirements were imposed. Such distinctions are constitutionally permissible as evidenced by the case law cited above. Representative Barney Frank in proposing H.R. 3915 specifically stated that community banks were not the cause of the subprime mortgage market and mortgage foreclosure issues that are afflicting the mortgage marketplace. The community banks and their affiliates have not been the cause of the subprime mortgage market meltdown and should not be penalized by being made subject to the Department's proposed regulations. Based on the foregoing, PACB requests that the Department of Banking provide an exemption for all affiliates of community banks up to \$5 billion asset size.

Thank you for taking the time to consider this memo. If you have any questions or comments, please feel free to contact me directly.

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