Testimony

Before the

Pennsylvania Senate Banking & Insurance Committee

Presented by

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Introduction

The Pennsylvania Bankers Association (PA Bankers) deeply appreciates this opportunity to appear before the Committee to discuss the competitiveness of the banking industry from the perspective of the Commonwealth's financial institutions.

My name is Mark Hughes. I am employed by Citizens & Northern Bank (C&N) in Wellsboro, PA where I serve as Executive Vice President, Chief Financial Officer and Treasurer. Prior to joining C&N in 2000, I was Principal and Manager at the accounting firm of Parente Randolph P.C. I appear here today in my capacity as chair of the PA Bankers Association's financial institution tax advisory committee.

Citizens & Northern has been a local, community bank since 1864. Ever since our founding, Citizens & Northern has been instrumental in helping our communities thrive by providing needed funding for growth and contributing to local charities which share our mission to enhance the lives of our neighbors in the communities we serve. We operate in seven counties in northern PA and one in southern NY. We employ 295 people. We now have $631 million in loans outstanding to individuals, businesses and government entities. In 2014, C&N made $180,000 in charitable contributions in the communities we serve. Our staff volunteered countless hours in their communities last year.

Sizes, locations and business models may differ, but banks exist to help make their customers' dreams come true – their first cars, homes, vacations, retirements, investments and educations in the case of individuals' success, and expansion in the case of our business clients, and security and sustainability in the case of our nonprofit and government customers. If our customers do not prosper, our shareholders cannot either. Whether by direct investment or by participation in an employer's benefit plan, many Pennsylvanians invest in one or more financial institutions, so many of your constituents have an interest in the banking industry.

Bank Regulation Impacts Competition

Virtually every task a bank undertakes is controlled by federal and/or state law and regulation. When the regulatory system works well, it insures a safe and sound banking system without disrupting commerce. When it does not, it constricts the natural cycle of credit-granting, job growth and economic expansion.

Banks earn money by accepting deposits from individuals and businesses and lending it to your constituents. Those businesses and individuals in turn create jobs, wealth and capital. Individuals and businesses' financial success causes them to need key financial services such as cash and liquidity management, wealth management and trust and custodial services which banks provide.

Banks are key to the economy of this Commonwealth which cannot succeed without them. We also pay significant taxes, but we will get to that issue and its competitive impacts in a moment.

While too much risk may have been assumed prior to the financial crisis, the effort today seems to be an attempt to remove all risk from the banking system. Recently-imposed federal regulations have fundamentally altered the way banks do business and meet their customers' needs.

The Federal Reserve's Vice Chair Stanley Fischer recently cited[1] the fact that banks are now only about one-third of credit-granting entities. A large and growing "shadow banking" sector consisting of hedge funds, broker-dealers, exchange-traded funds and others is not regulated by banking regulators such as the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and state departments of banking. Those entities face less regulatory scrutiny by agencies which do not have a banking focus. There is some coverage of both banks and non-banks by the Consumer Financial Protection Bureau, but only on consumer issues. My point is that banks are facing much higher levels of regulation and examination at a time when their non-bank competitors are not and as a result are taking-over certain markets.

Each new banking regulation is well-intentioned, but when added together they are prescriptive, complicated and often conflicting. The thousands upon thousands of pages of new regulations promulgated since the financial crisis are making it difficult for the nation's community banks in particular.

Every dollar spent on regulatory compliance is a dollar that cannot be lent. Combine increased regulatory costs with lower earnings that result from them and you reach the tipping point at which smaller banks merge with larger ones. There are 1200 fewer community banks than there were 5 years ago and that downward trend will continue unless rational changes are made at the federal level. The loss of a town's local bank has an impact that extends far beyond the job shifts that often result at the bank.

This Commonwealth made rational changes to Pennsylvania's banking statute over the years designed to keep state-chartered banks like mine competitive with federally-chartered banks and banks chartered by other states. Most recently, Acts 170-172 of 2012 updated, simplified and modernized the banking laws of the Commonwealth and reduced regulatory burden at the state level where possible given the increased regulatory demands of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The Commonwealth has also generally avoided the enactment of new state and local regulatory requirements that unreasonably burden banking operations. It is essential to scrutinize new regulatory and legislative proposals as they arise, however, to ensure that often well-intentioned proposals to protect consumers or other business interests do not impose excessive and unnecessary burdens on banking institutions.

While it is not in your purview to make the changes needed at the federal level, when you speak to our U.S. Senators and Members of the PA Congressional Delegation, please urge them, as we have, to convince the federal banking regulators that one-size-does-not-fit-all and that a better approach would be to tailor regulation to a bank's charter, size and business model. In addition, Congress could insure credit continues to flow to communities by

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[1] http://www.federalreserve.gov/newsevents/speech/fischer20150327a.htm

removing impediments to serving customers, improving access to home loans and ensuring proper oversight of the Consumer Financial Protection Bureau.[2]

State Bank Taxation Impacts Competition

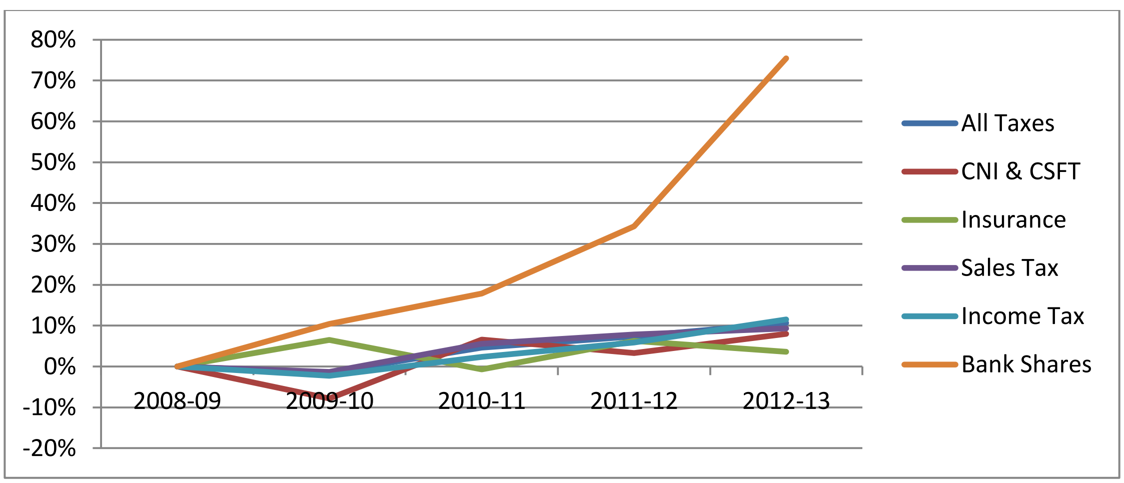
The Governor has proposed an onerous, retroactive increase in the PA Bank Shares Tax which would significantly constrict banks' ability to lend in PA. For the reasons noted above, state bank tax policy clearly has economic and competitive implications beyond our industry, so we urge this Committee and the General Assembly to be very cautious regarding further changes to the Bank Shares Tax.

I'd like to explain how banks are taxed currently in Pennsylvania, the structural changes made to the tax by Act 52 of 2013, and explain our concerns and opposition to Governor Wolf's Proposal[3] to sharply increase the rate of that tax.

Banks are not taxed like other corporations in Pennsylvania. Most PA businesses are taxed on their income. Banks are taxed on their total bank equity capital or stockholders' equity. Stockholders' equity is equal to the excess of the company's assets over its liabilities.[4]

Our federal and state regulators place a great deal of importance on our capital level, a measure of our sustainability. Our capital is reported by our bank and all banks to the federal regulators on a quarterly basis on reports of our condition, known as Bank Call Reports. These reports are accessible online.

Because we are taxed on capital and not income, banks pay the Bank Shares Tax whether they make money or not. In the wake of the financial crisis, when federal regulators required banks to increase their capital, Bank Shares Tax revenue increased exponentially as depicted by the chart below.



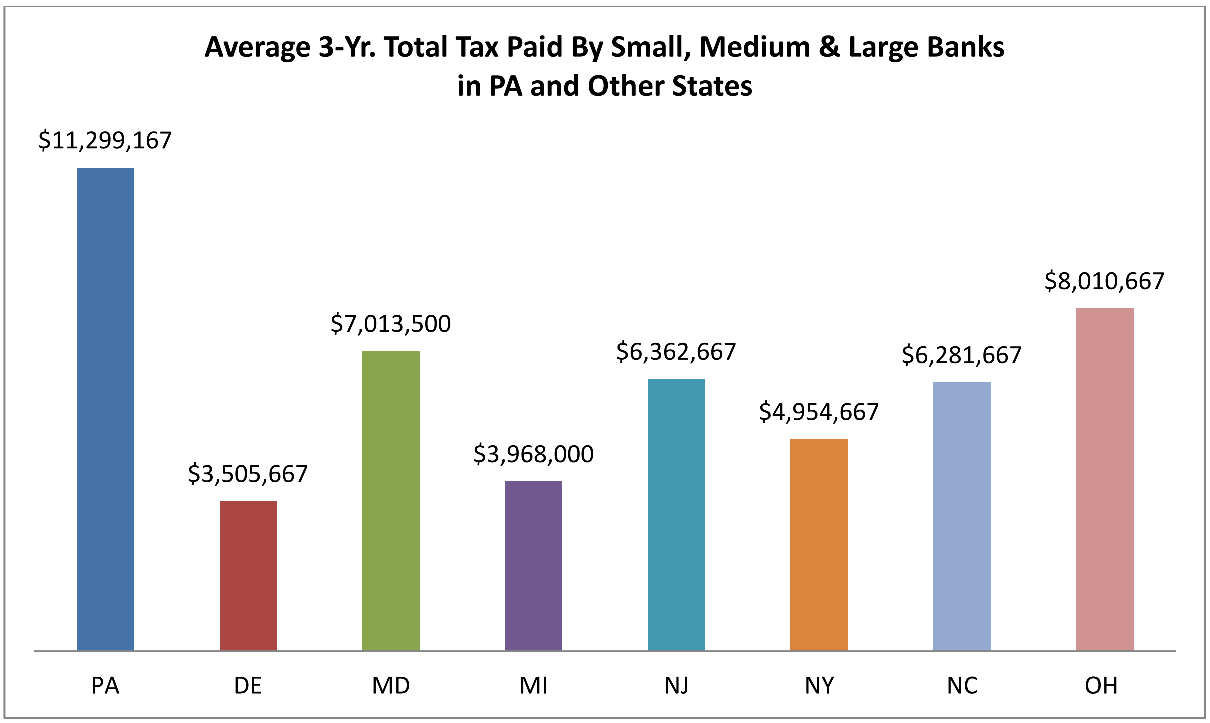
[2] http://www.aba.com/Issues/Index/Documents/2015GRPriorities.pdf

[3] See pages C1-6, C1-12, C1-13, C1-16, & C1-20 for Bank Shares Tax Information.

[4] Stockholders' equity is often referred to as the book value of the company, and it comes from two main sources. The first and original source is the money that was originally invested in the company, along with any additional investments made thereafter. The second comes from retained earnings that the company is able to accumulate over time through its operations. In most cases, especially when dealing with older companies that have been in business for many years, the retained earnings portion is the largest component. *Source:* Investopedia.

This sharp spike in banks' PA tax burden came at a time when revenue from other business taxes grew very slowly or declined.

In addition to growing much more rapidly than other taxes, the Pennsylvania Bank Shares Tax is much higher than taxes imposed on banks by other states. The Pennsylvania Bankers Association engaged the accounting firm of Crowe Horwath represented here today by Chris Hopkins to conduct an evaluation that compared the taxes imposed on typical banks under Pennsylvania law with the taxes that would be imposed if the laws in several other states were substituted for Pennsylvania law, including the taxes imposed by most of our neighboring states. The results of this analysis, which was incorporated by the Department of Revenue into the study of Bank Shares Tax conducted by the Department of Revenue as required by Act 52 of 2013, are illustrated below:



Pennsylvania banks are also disadvantaged by the tax benefits made available to some of their strongest emerging competitors for consumer and business relationships - federally and state chartered credit unions. In contrast to the high rates of tax paid by banks, **credit unions do not pay any federal, state or local taxes**, except for taxes on real property. The Governor's 2015-16 Budget Proposal estimates that these tax exemptions will cost the Commonwealth $26.3M in lost revenue in Fiscal Year 2015-16.[5]

Prior to enactment of Act 52 of 2013, Pennsylvania banks were exposed to unsustainable year-to-year tax increases, and were subject to a tax system in Pennsylvania that was uncompetitive[6] with surrounding states. Moreover, the prior tax did not encourage banks to locate operations in Pennsylvania. In addition the prior tax was the subject of frequent

[5] Governor's 2015-16 Budget, page D45.
[6] As demonstrated by the comparison research performed by the accounting firm of Crowe Horwath provided to the Committee in a separate document.

litigation. Therefore, the PA Bankers Association requested that the Bank Shares Tax be modernized and adjusted to a more sustainable growth rate.

Changes Made by Act 52 of 2013

As a result, the General Assembly in Act 52 of 2013 made the following structural changes to the Bank Shares Tax:

- Eliminated the use of a six-year moving average of equity capital to determine the base of the tax, and instead required banks to calculate Bank Shares Tax liabilities using the most recent year-end value of equity capital. This change eliminated the discrimination that occurred under the prior tax system that did not include equity as a result of mergers for the prior five years when a bank merged with an out-of-state institution not previously subject to the tax, but included equity for the prior five years when two institutions subjected to the tax merged.

- Required the interstate apportionment of tax liabilities be based solely upon receipts, rather than based equally on receipts, deposits and payroll. This change is similar to the move to a single sales factor for the Corporate Net Income Tax that the General Assembly enacted several years ago. Using apportionment based solely on receipts, rather than including payroll and deposits, bases tax liabilities on the extent to which banks serve customers in Pennsylvania regardless of their physical location, thereby eliminating disincentives to locate bank operations in Pennsylvania.

- Excluded non-controlling interests in consolidated subsidiaries from equity capital. Non-controlling interests in subsidiaries represent the portion of the equity of subsidiaries not owned or controlled by a bank or its parent company. Excluding these interests from equity avoids taxing banks on property they do not own or control.

- Provided a clear definition of receipts subject to apportionment in order to eliminate a frequent source of tax assessments and appeals.

- Adopted extensive new rules for the apportionment of receipts based upon the apportionment recommendations of the Multistate Tax Commission, but which rely more heavily on market-based sourcing and eliminate disincentives to maintain headquarter operations in Pennsylvania.

- Expanded nexus requirements for purposes of determining when banks engage in business in Pennsylvania and are subject to the Bank Shares Tax.

- Reduced the rate from 1.25% to 0.89% to prevent the changes in the tax base from resulting in an overall increase or decrease in tax liabilities.

The modernizations the legislature made to the Bank Shares Tax by Act 52 of 2013 encourage banks to locate employees and operations in the Commonwealth. As you know, states may only tax to the degree taxpayers have reasonable contacts with the state known as *nexus*.

The prior Bank Shares Tax discouraged banks from locating employees and operations in PA and did not adequately tax banks located elsewhere which generate receipts from within PA. So, Act 52 expanded the tax's *nexus* to include banks which operate in Pennsylvania (beyond a *de minimis* level) whether they locate employees and operations here in order to do so, or not.

At the time the Bank Shares Tax was revised, we were told that any changes had to be "revenue neutral." The current .89% Bank Shares Tax rate was calculated by the Department of Revenue to be "revenue neutral." The department did not share the bases of their estimate with us, so we could not test its assumptions.

When Bank Shares Tax revenue received in 2014 was less than the $350M in cash the department told us was expected for that fiscal year, we tried to assist the department in determining why. In particular, we asked the department whether, based on more recent data, their June 2013 estimate that revenues for the 2013-14 fiscal year would have been $350M had the law not been changed was accurate. We suspect this base-line "revenue neutral" estimate may have been overly optimistic and that had Act 52 not been enacted revenue collections would have been more consistent with the $307.5M actually collected in the 2013-14 fiscal year.

One indicator that the $350M revenue estimate was too high is that between February of 2013 when the Governor's Budget Proposal for the 2013-14 fiscal year was released, and the time the 2013-14 budget was enacted, the Revenue Department increased the estimate of Bank Shares Tax collections by $42.5M, without in our view any adequate explanation. To date, we have not received enough data from the department to determine whether the $350M revenue estimate was accurate, and if the estimate did accurately reflect what would have been collected had the law not been changed, why cash collections under Act 52 fell below this estimate.

We strongly believe, however, that other factors were responsible for the shortfall. For example, the department's Bank Shares Tax Report issued on January 9, 2015 demonstrates on page 1 of its Appendix A that **banks' shares tax liabilities rose** in 2013-14, so we suspect that prior years' over-payments, use of tax credit programs and other factors resulted in less cash being received. Despite our attempts to reduce litigation about the bank shares tax, disputes occur. These disputes may last several years and may result in assessments or refunds/credits that significantly impact a given year's cash revenue from the bank shares tax. We are also concerned that the estimate included amounts in dispute. Prior to the enactment of Act 52, banks were required to pay their assessments[7] before having the opportunity to appeal them. Act 52 brought banks in line with all other businesses by not requiring them to "pay to appeal". We do not believe that the Department of Revenue accounted for this change in its 2014 estimate.

The Bank Shares Tax Study

As mentioned above, Act 52 required the Department of Revenue, working with representatives of the banking industry, to submit to the legislature a detailed joint report to

[7] Appendix A of the department's Bank Shares Tax Report shows $41.6M of assessments which increased 2012-2013 tax over the amounts reported by banks on their returns. That is a significant amount the impact of which merits a careful analysis as to how it may have impacted the department's Act 52 revenue estimate.

enable the legislature to determine whether the revisions to the Bank Shares Tax statute made by the Act sufficiently addressed the significant changes in the structure and regulatory environment within the banking industry and provided predictable tax revenues for the Commonwealth.

The Association believes that analysis of the growth rate of reported tax liabilities provided in the report illustrates that Act 52 achieved and exceeded the rate of growth of tax liabilities included in the Fiscal Notes that supported enactment of the legislation. Further, data provided in the report demonstrates that shortfalls of cash collections reflect cash-flow timing issues that will be resolved over time, caused by variability in the timing and amounts of assessments, changes in economic conditions not anticipated during the consideration of Act 52, and actions taken in other legislation to increase the availability of tax credits.

The Association disagreed with the Department of Revenue's interpretation, as suggested by the report, that Act 52 limits the use of Method 1 apportionment only to receipts from trading activities and that clarifications to current law are needed to allow continued use of the goodwill deduction. However, in order to eliminate any perceived ambiguity in the Act, PA Bankers does support enactment of legislation, as recommended in the report, to provide clarity to these provisions and allow banks to choose either Method 1 or Method 2 for apportionment of receipts and to continue to be able to deduct goodwill from the tax base.

I wish to highlight the fact that even with the changes made to the Bank Shares Tax by Act 52 of 2013, the Study notes that Pennsylvania's bank tax structure remains uncompetitive with how banks are taxed in our surrounding states. The Crowe Horwath Report cited previously shows that even after enactment of Act 52 of 2013 Pennsylvania imposes substantially higher taxes on banks than other states.

Opposition to Governor's Proposal

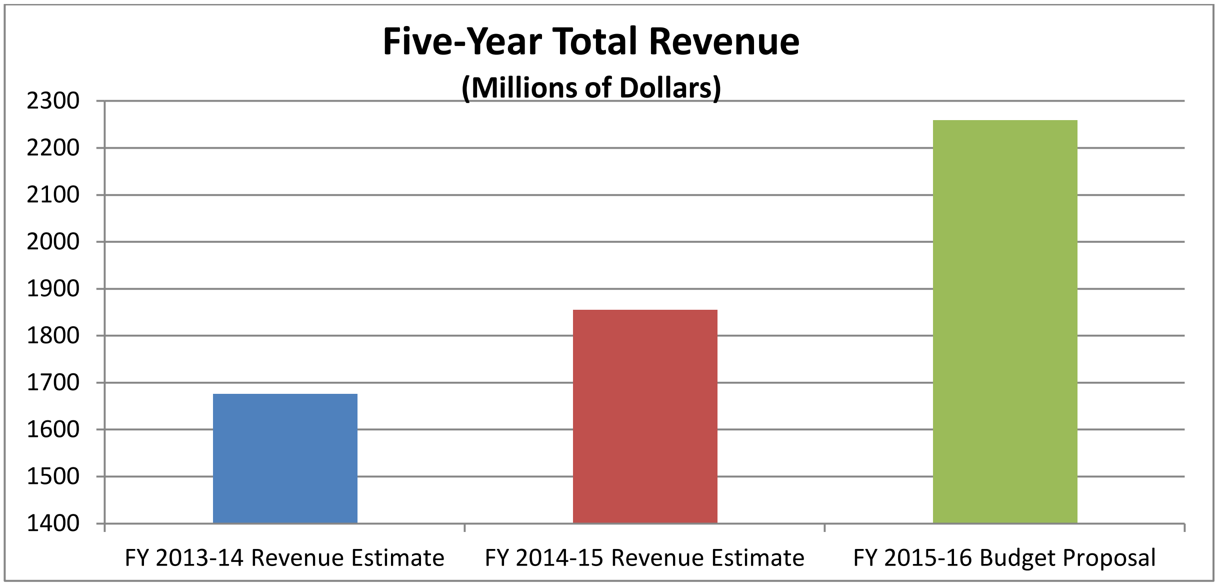
We see absolutely no justification for raising the Bank Shares Tax rate to 1.25% retroactive to 2014 when by the department's own data that would increase Pennsylvania banks' state tax burden far in excess of even a $350M measure of "revenue neutrality."

According to the Governor's Budget Proposal, if the tax rate is increased to 1.25% retroactive to 2014, total Financial Institutions Tax collections for the five fiscal years from 2013-14 through 2017-18 will be $583.5M higher than the collections for this five year period as were estimated by the Department of Revenue in its *2013-2014 Estimate Documentation* (Bureau of Research, February 19, 2013) prior to the enactment of Act 52 of 2013 and $404.6M higher than the collections for this five year period were estimated by the Department of Revenue in its *2014-15 Estimate Documentation* (Bureau of Research, February 18, 2014) after the enactment of Act 52.[8]

[8] http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/Pages/Reports%20and%20Statistics/Estimate%20Doc.aspx.

Five-Year Total Financial Institutions[9] Tax Collections (millions of dollars)

	2013-14	2014-15	2015-16	2016-17	2017-18	Total	Excess of FY 15-16 Tax Over Prior Estimates
FY 2013-14 Revenue Estimate	322.7	328.8	335	341.4	347.9	1675.8	583.5
FY 2014-15 Revenue Estimate	325.5	355.3	372.9	390.7	410.3	1854.7	404.6
FY 2015-16 Budget Proposal	317.8	314.8	672.1	467.5	487.1	2259.3	



Among these three estimates of "revenue neutrality," we believe the original Fiscal Year 2013-14 estimate to be the most accurate of the three because it anticipated a reduction of the growth rate of tax liabilities. In response to and in anticipation of changes in regulatory requirements, we believe that by 2013 and 2014 many banks had already increased their capital levels. The subsequent revenue estimates were overly optimistic, however, because they expressly assumed the same growth rate would occur in the future as occurred in the 2008 to 2013 period.[10] We believe that any such assumption was inaccurate and unrealistic. In addition, we believe even the Fiscal Year 2013-14 estimate is unreliable as a measure of "revenue neutrality" because, like all of the subsequent estimates, it failed to account for short term factors that may cause cash collections to exceed or fall short of tax liabilities. When comparing two tax systems in terms of their revenue generation potential, it is essential to consider the extent to which they generate actual tax liabilities and to disregard unpredictable short term events that may cause temporary cash-flow variations. [11]

[9] This includes revenue projected to be received from the Mutual Thrift Institution Tax (MTIT).
[10] The *2015-2016 Estimate Documentation*, prepared by the Bureau of Research of the Department of Revenue, for example, states that for the Bank Shares Tax, "Growth for 2014-15 and beyond is determined using historical BST collections." See p. 37.

[11] Virtually all banks account for their income, expenses and liabilities on an accrual basis, rather than on a cash basis. Generally only governmental units account for liabilities on an accrual basis and account for revenues on a cash basis. In addition, it is an unique Pennsylvania peculiarity that cash receipts generated by any particular tax take into account only collections, and disregard any refunds paid.

Even if the fairness issue were set aside, the impact to the Commonwealth's economy should be enough to reject this proposal. Using a rough approximation[12] of the impact of this tax increase on the Pennsylvania banking industry's ability to lend to your constituents, an increase to a 1.25% Bank Shares Tax rate could result in $ 3.8B fewer loans over a five-year period. That is a serious reduction in credit availability that would diminish individuals' and businesses' ability to prosper in the Commonwealth with further economic impacts that we cannot calculate. We respectfully urge your opposition to that proposal.

Thank you for your invitation and your attention today. If you have any questions, I will answer them to the best of my ability.

[12] This estimate is based upon the following formula: (Additional shares tax multiplied by inverse of the marginal income tax rate) multiplied by equity multiple. In other words, since banks typically have assets equal to (roughly) 10 times their equity, the after-tax additional expense has an impact of 10 times that amount in reduced funds available for lending.