INTERIM JOINT COMMITTEE ON BANKING AND INSURANCE

Minutes of the 2nd Meeting
of the 2019 Interim

September 11, 2019

Call to Order and Roll Call

The 2nd meeting of the Interim Joint Committee on Banking and Insurance was held on Wednesday, September 11, 2019, at 10:00 AM, in Room 149 of the Capitol Annex. Senator Jared Carpenter, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Jared Carpenter, Co-Chair; Representative Bart Rowland, Co-Chair; Senators Julie Raque Adams, Rick Girdler, Christian McDaniel, Morgan McGarvey, Dennis Parrett, Albert Robinson, Brandon Smith, and Reginald Thomas; Representatives Terri Branham Clark, Joseph M. Fischer, Deanna Frazier, Jim Gooch Jr., Kathy Hinkle, Stan Lee, Derek Lewis, Michael Meredith, Wilson Stone, Ken Upchurch, and Rob Wiederstein.

Guests: Charles Vice, Commissioner, Kentucky Department of Financial Institutions; Ballard Cassady, President and Chief Executive Officer, and Debra Stamper, General Counsel and Executive Vice President, Kentucky Bankers Association.

LRC Staff: Jessica Sharpe, Breanna Miller, and Dawn Johnson

Approval of Minutes

A motion by Senator Raque Adams and second by Senator Parrett to approve the minutes of the August 21, 2019, meeting carried by voice vote.

Access to Financial Products and Banking Services for Lawful Hemp Farmers and Producers

Commissioner Charles Vice, Kentucky Department of Financial Institutions said the hemp industry is a tremendous opportunity for the state, though, the financial regulatory aspects can be frustrating. While hemp is a legal product, several financial institutions have been hesitant to offer financial services to the industry. The growth in product sales is notable, increasing from $16.7 million in 2017 to $57.75 million in 2018. Capital improvements of $23.4 million have been made and in 2018, the industry employed 459 people. In 2017, 3,200 acres were approved for hemp production. That number increased to 50,000 in 2019. Commissioner Vice described his tours of two hemp facilities—Hempwood, a manufacturer of hemp "wood" flooring, and GenCanna, a facility that will be able to process 100,000 acres of hemp annually once construction is complete. Hemp can be grown for fiber or wood production, oils, and seed, offering tremendous economic potential for Kentucky. During the tour, a farmer stated he can produce approximately $6,000 net income per acre.

The 2014 Farm Bill passed by the U.S. Congress established the hemp production pilot program. It required producers to sign a memorandum of understanding with state agricultural departments as well as requiring extensive oversight relative to the growth and production of hemp, including Global Positioning System (GPS) coordinates and notification of harvesting and transporting. The 2018 Farm Bill removed hemp from the controlled substance list, but requires the United States Department of Agriculture (USDA) to develop guidelines.

Commissioner Vice said Kentucky is at the forefront of the hemp industry. Once complete, the GenCanna facility will be the largest hemp production facility in the world. The USDA is looking to the Kentucky Department of Agriculture to help them develop guidelines. Once complete, each state will be responsible for passing its own hemp laws. In April 2019, Senate Majority Leader McConnell sent letters to federal financial services regulatory agencies requesting that the agencies provide guidance to financial institutions under their jurisdiction to ease concerns they may have with providing services to hemp industries. Commissioner Vice said while there are many opportunities for hemp farmers, it is frustrating that many banks are still hesitant to offer financial services to them. The KDFI issued guidance in 2016 based on the Bank Secrecy Act. From the KDFI's perspective, there are no expectations that hemp customers will be treated as high risk simply because they are in the hemp business. After the 2018 Farm Bill was signed, KDFI released further guidance in 2019 acknowledging that hemp was removed from the controlled substance list. Some hesitancy remains because federal regulators, including the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Financial Crimes Enforcement Network (FinCEN), have not issued formal guidance relative to a financial institution offering services to companies involved in the hemp industry. The National Credit Union Association (NCUA) released a letter on August 19, 2019, providing limited guidance, but the letter stated that additional guidance will be issued once the USDA issues guidelines.

Ballard Cassady, President and CEO of the Kentucky Bankers Association (KBA) said hemp, once a popular crop in Kentucky, fell out of favor in the 1970s when it was rated as an abusive substance. Hemp is now produced in 101 out of 120 counties in Kentucky. He noted that Agriculture Commissioner Ryan Quarles had the foresight in the state's pilot program to allow farmers to oversee the program. Other states are overseen by universities only. Currently, hemp is still produced under the 2014 program permits; however, new permits based on the 2019 Agriculture Act will be issued soon. He has heard complaints that hemp products are being stopped and seized in other states because officials mistake it for marijuana. Some Kentucky banks do not provide services to the hemp industry; although, most community banks are working with hemp businesses. The KBA provides guidelines to assist banks with the process. Mr. Cassady said certain credit card companies refuse to accept any hemp-related transaction due to varying state laws regarding marijuana and hemp. He also noted that there is proposed federal legislation, titled the SAFE Banking Act, that legalizes, regulates, and taxes marijuana. As the hemp industry grows, the KBA is standing ready to help Kentucky farmers. Ms. Debra Stamper, General Counsel and Executive Vice President, said that constituents can call the KBA regarding hemp financing.

Senator Parrett said hemp farmers in his district have had to deal with people taking plants from fields to smoke.

Chairman Carpenter said he has noticed that hemp fields are replacing tobacco fields and that no other crop can net close to $6,000 an acre. Some financial institutions are concerned that once hemp is produced, finding a market for the product could be problematic. Until the recent guidelines took effect, local banks were hesitant to provide services to farmers. Mr. Ballard added that the 2018 Farm Act classified hemp as a commodity crop so farmers can now get crop insurance.

Commissioner Vice noted that GenCanna is partnering with Murray State University's engineering and marketing departments.

Kentucky Department of Financial Institutions Update

Commissioner Vice provided an overview of state financial institutions. From year-end 2016 to March 31, 2019, the number of state-chartered banks decreased from 133 to 120; the number of smaller banks, banks with less than $100 million in assets, decreased from 26 to 23; total assets for all state-chartered banks increased from $50.7 billion to $52.7 billion; and total loans for all state-chartered banks increased from $35 billion to $37.5 billion. Commissioner Vice reviewed Kentucky's state-chartered banking conditions as compared to contiguous states and nationally. As of March 31, 2019, Kentucky was highest in net interest margin at 3.94, fourth for return on average assets at 1.28, third in return on equity at 11.22, and first in capital ratio at 11.31. Commissioner Vice said that he considered a one percent return on average assets to be a strong indicator for the banking industry after the recession. Kentucky's rate is now 1.28, an outstanding achievement that is partially due to 2017 federal legislation reducing the corporate tax rate from 35 to 21 percent. Tax relief provided by the 2019 Kentucky legislature will also benefit Kentucky. When banks experience higher returns, they reinvest in their employees and the community. Commissioner Vice also discussed bank merger activity in Kentucky, which showed consolidation in the industry with no new banks since 2009. In 2013, state bank mergers were generally by Kentucky-acquired banks, but recent mergers have mostly involved out-of-state acquisitions. He said this was concerning because decision-making and capital many times will be outside of Kentucky, losing community focus. He stated that bank consolidations occur for many reasons, but one of the most impactful is increasing bank prices. The number of credit unions has decreased as well from 24 in 2016 to 22 in 2019. The majority tend to be smaller credit unions. Total assets have increased from $3.8 billion to $4.4 billion and total loans increased from $2.6 billion to $3 billion. It has been a long time since a new credit union was formed. Kentucky credit unions have a net worth ratio of 12.32, ranking third in contiguous states. Commissioner Vice also reviewed Kentucky credit union growth ratios. Strong growth numbers in 2015 reflect several federal credit unions converting to state charter.

Commissioner Vice gave an update on the Non-Depository Division, which oversees mortgage companies, consumer loan companies, money transmitters, check cashers, and payday lenders. As of June 30, 2019, there were 1,628 mortgage companies and brokers, 6,885 mortgage loan originators, 365 consumer loan companies, 125 money transmitters, and 438 check cashers and payday lenders. The number of payday lenders has steadily declined due to the 2009 moratorium on new licenses. In 2019, the moratorium was extended indefinitely.

As of June 30, 2019, the Securities Division reports 1,416 broker-dealer registrations, 129,946 registered broker-dealer agents, 1,335 state investment advisors (IA), and 5,791 investment advisor representatives.

Commissioner Vice said the Conference of State Bank Supervisors and the Federal Reserve Board hold a case study competition for universities to introduce college students to the banking industry. The winning university presents a paper and video at the conference. Typically, there are 55 to 60 entries in the competition. Murray State University was a finalist in 2016. Eastern Kentucky University (EKU) entered the competition for the first time in 2018 and won, and came in second place in 2019. EKU team members from both competitions are now employed with the KDFI.

Responding to Senator Thomas' question regarding what NIM means, Commissioner Vice explained that NIM is one of the biggest measures of community bank performance relative to earnings. It is interest income less interest expense divided by earning assets. The ratio is used to measure the profitability of community banks.

Public Deposit Banking in Kentucky

Debra Stamper explained that collateralization of public deposits has become a complicated compliance issue for Kentucky banks. The KBA receives many calls for direction on how to comply with the public deposit laws as they are applied to the various administrations in state and local government. Collateralization of public deposits is a protection measure in case of bank failure, a legitimate concern when the statutes were drafted. Since then, banks are stronger and regulations have become more strict and complicated, and thus, there is a question as to whether the current statutes are still needed. There are various statutes in various chapters that refer back to one another. The statutes are so complicated and knotted that even the most experienced banking attorneys have a difficult time untangling them. Banks have to jump through a bunch of hoops to accept and maintain public deposits. Statutory issues include the use of unfamiliar terms, undefined or vague terminology, and differing standards. The definition of a public depository has become more complicated in the most recent session because Kentucky now allows local entities to invest a portion of their funds in securities. If you put your deposit in a public depository bank, the deposit is insured up to the amount of the FDIC insurance and that current law requires that any deposit over the FDIC insurance amount be 100 percent collateralized. While there is list of collateralization that is accepted in the statutes, the options are nuanced and not available to all banks. This collateralization requirement prevents banks from using their capital for loans and other community investments. When you look at particular types of deposits, like sheriff's deposits which are temporary and can be very large during tax season, banks are required to tie up that collateral for what might be a very short period of time. Another problem is that the statutes addressing when these collateralizations must be reconciled are very confusing. State auditors are telling banks they have to reconcile the collateral daily, which can cause problems. The KBA is looking for a solution to these problems and would ask that the legislature start thinking with them about a solution. She suggested the possibility of using a sliding scale of collateralization for banks, which is an approach used in other states.

Senator McDaniel cautioned that many institutions that failed during the 2008 financial crisis were as stable as it came until they got wiped out. He expressed concern about changing collateralization requirements, but stated that he would be open to making clarifications. Senator McDaniel stated that he recognizes that the federal bailout of banks from that crisis is related but not the same and that everyone should closely review this discussion. Ms. Stamper said she agreed it is related but stated that the recent law allowing local governments to invest in securities flies in the face of the 100 percent collateralization requirement for bank deposits because securities are much riskier than bank deposits. She said she appreciated the Senator's concern.

Representative Meredith said that enacting the Local Government Investment Bill was a three year process. The law allows local governments to invest 20 percent of their assets in high-quality uncollateralized investments which is necessary to participate in the market's risk-reward relationship, but do not have the same surety as funds in a bank. He said Kentucky has not experienced a true bank failure since the 1980s, and there is a large difference between local depository institutions and investment banks, like Solomon Brothers. Locally-controlled banks are investing through home, vehicle, and small business loans in Kentucky citizens. He stated that these collateralization requirements do create a liquidity problem for banks, because much of the collateral put up for temporary public deposits are longer term securities. Now that up to 20 percent of local government deposits can go into the market, Representative Meredith said that it is against the will of the General Assembly's previous actions to require 100 percent collateralization for public deposits. Ms. Stamper stated that also, some banks might not want to take larger deposits if it pushes that bank into the next level of regulation where they would have more compliance burdens. Senator Carpenter said he experienced these issues working at a community bank.

Senator McDaniel said he understands the banking side's perspective, but taking deposits is a voluntary business decision. While he understands what the legislature did for the cities and counties and their ability to invest, there is a difference between that law and the public deposit laws. He is not necessarily opposed to changes in the statutes, but that the discussion requires more oversight and scrutiny. Mr. Cassady said he understands what the Senator is talking about. The KBA's interest in starting to think about safe alternatives. Mr. Cassady suggested that bank ratings, given as a result of regulatory examinations, could be used as a way to manage collateralization requirements for public deposits. There is an array of other avenues other than matching cash for cash because this hurts the bank's ability to serve the community.

Senator Thomas said he was inclined to agree with Senator McDaniel in needing to proceed with great caution. He discussed the collapse of Wachovia Bank, which he said was very prominent. Senator Thomas said it is incumbent that legislators keep in mind that people rely on banks to keep their family assets. No bank is immune in an economic downturn. Mr. Cassady said there has never been a depositor in Kentucky that lost their deposits, that he does not think anyone in Wachovia lost money, and that depositors are probably the safest people within that kind of structure.

Referring to Commissioner Vice's comments, Representative Meredith said that Kentucky banks are strongly capitalized and that capital is what matters because it offsets bank failure risk. He stated that at times, 100 percent collateralization does cost a bank more than what the bank can make off the deposit. Another thing is that if local banks have to send depositors to another bank because the deposit is too much of a burden, then that depositor is potentially going to a bigger bank headquartered in a bigger place. Representative Meredith said that in most rural communities, one of the largest tax payers is the local bank. Every time a city or county invests in a community bank, he said the bank is paying them back taxes on the money. He said there are a lot of factors to keep in mind as the legislature works through the issues to see if some relief can be given to banks.

Senator Carpenter said there is a lot involved in the banking industry and regulations have become very complicated. The number of small banks is decreasing because it is harder for them to survive in the marketplace. He said that small banks are the backbone of communities and that they understand local people.

There being no further business, the meeting adjourned at 11:18 AM.