January 31, 2008

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Part 363—Independent Audits and Reporting Requirements

Dear Mr. Feldman:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer comments in connection with the Federal Deposit Insurance Corporation's proposed amendments to part 363 of its regulations concerning independent audits and reporting requirements.

Summary of ICBA's Comments

ICBA is concerned that the proposed changes to part 363 of the FDIC's regulations will significantly increase the regulatory burden of privately held community banks with assets of $500 million or more without commensurate benefits. We are particularly concerned with the proposal to incorporate the Public Company Accounting Oversight Board's auditor independence standards into the FDIC's regulations. This will adversely impact those community banks or holding companies with over $500 million or more in

[1]*The Independent Community Bankers of America represents 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

assets that are located in areas with limited access to accounting services. It also reflects a disturbing trend by the banking regulators to apply the principles and practices of the Sarbanes Oxley Act of 2002 (SOX) to privately held banking institutions**.** ICBA recommends that the FDIC not incorporate the PCAOB standards into its own accounting requirements and instead provide an exemption from any independence standard for covered community banks located in areas with limited access to auditing and tax services.

ICBA also believes that the existing FDIC's Guideline 28, "*Independent of Management*" *Considerations* and Guideline 29, *Lack of Independence* provide sufficient guidance for determining whether a director is independent and that the FDIC's proposal to provide expanded guidance based on the national securities exchange independence standards for directors will only complicate the process of recruiting competent audit committee directors for many privately held community banks. ICBA also objects to some of the proposed new requirements for the part 363 management report and believes that SOX practices regarding auditor communications should not be applied to privately held community banks.

Background of the Proposal

Section 36 of the Federal Deposit Insurance Act (FDI Act) and the FDIC's implementing regulations (e.g., part 363) set forth annual independent audit and reporting requirements for insured depository institutions with $500 million or more in total assets. In order to incorporate the auditing practices of the SOX and to clarify some of the requirements for banks and independent public accountants, the FDIC is proposing to amend part 363 of its regulations.

Currently, insured depository institutions with $500 million or more in total assets are required to submit to the FDIC and other appropriate federal and state agencies an annual report comprised of audited financial statements, assessments by management of the effectiveness of internal control over financial reporting, and an independent public accountant's attestation report on internal control over financial reporting. Part 363 also requires that each covered institution establish an independent audit committee comprised of outside directors who are independent of the management of the institution. In November 2005, the FDIC amended part 363 to raise the asset-size threshold from $500 million to $1 billion for the assessments of internal control over financial reporting by management and the independent public accountant. All of the other audit and reporting requirements of part 363 (e.g., the requirement for audited financial statements, an independent audit committee, etc.) continue to apply to all institutions with $500 million or more in total assets.

The significant changes to Part 363 that are being proposed by the FDIC include the following:

(1) **Auditor Independence**: Section 36 of FDI Act states that an "independent public accountant" must perform the audit and attestation services required by section 36 but it does not define "independent." As proposed, Section 363.3(f) of the FDIC

regulations would clarify that the independent public accountant must comply with the independence standards and interpretations of the Public Company Accounting Oversight Board (PCAOB) as well as the standards and interpretations of the AICPA.

(2) **Audit Committee Independence**: Currently, covered institutions must have audit committees comprised of outside directors who are "independent of management." The FDIC proposes that in determining whether an audit committee member meets the "independent of management" requirements, a bank's board may use the independence criteria for audit committee members in the listing standards of the national securities exchanges. The FDIC is also proposing expanded guidance which includes a list of criteria to determine whether an outside director is independent of management.

(3) **Management Report Contents**: The FDIC is proposing that the management report include an assessment of compliance with the safety and soundness laws and identify the internal control framework that management used to make its internal control evaluation, including a statement that the evaluation included controls over the preparation of regulatory financial statements.

(4) **Auditor Communications:** Consistent with Section 204 of SOX, the FDIC is proposing that auditors report to the audit committee all auditor communications to the bank with regard to critical accounting policies, alternative accounting treatments, and schedules of unadjusted differences.

ICBA's General Comments

While the proposed changes to part 363 will not significantly increase the regulatory burden of publicly held banks that are already subject to SOX, ICBA is concerned that the proposed changes will significantly increase the regulatory burden of privately held community banks with assets of $500 million or more and, in particular, those banks that are located in areas of the country where access to public accounting services is limited. Regulatory and paperwork requirements such as the ones that would result if the proposed part 363 amendments are adopted impose a burden on community banks, diminishing their profitability and their ability to attract capital, support the credit needs of their customers, serve their communities and contribute to the local economies.

In many of its letters to the banking regulators regarding regulatory burden, ICBA has consistently emphasized the vital role that community banks play in the economic well being of countless individuals, neighborhoods, businesses, organizations and communities throughout the country. They are one of the key sources of credit and other financial services to small businesses, the most prolific job creating sector of our economy, accounting for more than a third of all commercial bank small business loans which is more than twice the community bank's share of total U.S. banking assets. It is vital to the economy that public policy promote the competitiveness and efficiency of community banks and support and encourage a diverse financial system.

Even though the last several years have been profitable for the banking industry as a whole, there is a gap between community banks' profitability and the rest of the industry, in part due to the disproportionate impact of regulations on community banks. ICBA is concerned that more community banks will consider selling or merging as the costs of regulation increases, fulfilling the prediction that OTS Director John Reich made several years ago when he stated before Congress that in the future " regulatory burden will play an increasingly significant role in shaping the industry and the number and viability of community banks….if we do not do something to stem the tide of ever increasing regulation, America's community banks will disappear from many of the communities that need them most." [2]

Regulatory burden has increased substantially in the past few years. In particular, regulations under the USA PATRIOT Act of 2001 and the Sarbanes Oxley Act of 2002 as well as the increased attention from bank examiners on Bank Secrecy Act (BSA) compliance have substantially increased regulatory burden. In response to the recent subprime lending crisis, Congress is now considering several pieces of legislation that will again impose more burdens on the industry. Although the recently completed EGRPRA[3] project tried to streamline banking regulation, it failed to make a meaningful impact on the overall regulatory burden.

ICBA's Specific Comments

ICBA's specific comments about the proposed amendments to part 363 are as follows:

Auditor Independence. As proposed, Section 363.3(f) of the FDIC regulations would clarify that the independent public accountant must comply with the independence standards and interpretations of the Public Company Accounting Oversight Board (PCAOB) as well as the standards and interpretations of the AICPA. **ICBA believes this proposed amendment reflects a disturbing trend by the banking regulators to apply SOX principles and practices to privately held banking institutions.** The PCAOB is an agency established by the Sarbanes Oxley Act of 2002 to establish accounting standards for auditing firms that audit public companies. When SOX was approved, Congress did not intend the PCAOB to become the accounting standard setter for auditors that perform audits of private companies. Private banking institutions and their auditors should be subject to the accounting standards set by the banking agencies, by FASB or by the AICPA, and not by the PCAOB.

The FDIC's proposal to incorporate PCAOB standards on independence into part 363 of its regulations will adversely impact those community banks or holding companies with over $500 million or more in assets that are located in areas with limited access to accounting services. PCAOB standards prohibit auditors from performing audit services for a company while simultaneously performing audit or tax services for certain officers and directors of the company. In many rural areas of the

[2] Statement of John M. Reich, then Vice Chairman, Federal Deposit Insurance Corporation on Consideration of Regulatory Reform Proposals before the Committee on Banking, Housing and Urban Affairs, United States Senate, June 22, 2004

[3] The Economic Growth and Regulatory Paperwork Reduction Act of 1996. The EGRPRA project, which was an overall review of agency rules to identify outdated, unnecessary, or unduly burdensome regulatory requirements, was conducted by the agencies pursuant to their authority under that law.

country where there is a shortage of corporate auditing and tax firms, this prohibition will become an obstacle for those community banks and their executive officers and directors that require competent corporate auditing services from a local accounting firm. It will force many community banks, particularly those who file under the complicated Subchapter S tax provisions of the Internal Revenue Code and use their local auditing firms to perform valuable tax services for their directors and major stockholders, to incur the substantial additional expense of retaining auditing firms from outside the service area of the bank. Publicly held community bankers in Nebraska have reported to ICBA that the PCAOB restrictions have forced them to hire audit firms hundreds of miles away from the main offices of their banks since their only local accounting firm could not perform the bank audit without violating the PCAOB's independence standards.

ICBA recommends that the FDIC not incorporate the PCAOB standards into their own accounting requirements and instead provide an exemption from any independence standard for covered community banks located in areas with limited access to auditing and tax services. This exemption would provide significant regulatory relief for those community banks that have only limited access to these services and would be required to retain auditing services from outside the service area of their bank.

Audit Committee Independence. Currently, banking institutions with $500 million or more in assets must have audit committees comprised of outside directors who are "independent of management."[4] The FDIC's Guideline 28, "*Independent of Management*" *Considerations* and Guideline 29, *Lack of Independence*, identifies five factors for a board of directors to consider when determining the independence of an outside director. To further clarify and expand on the current guidance in the area and to borrow from some of the guidance issued by the national securities exchanges, the FDIC is proposing combining guidelines 28 and 29 and publishing one guideline with a long list of criteria that a bank would consider when determining whether an outside director should be considered "independent of management." Publicly held banks or holding companies could apply the listing standards for the national securities exchange that the bank or holding company is subject to while privately held banks could elect a national securities exchange for determining audit committee member independence.

ICBA is concerned that any movement by the FDIC toward adopting the director independence standards of the national securities exchanges for privately held banks will impose challenges for those community banks located in areas where it is difficult to find competent directors to serve on audit committees. Publicly held community banks already have already reported problems with finding directors to serve on their boards and audit committees as a result of the SOX independence standards and the requirements of the national securities exchanges. In many rural areas, it is difficult enough for community banks to find persons who are competent enough and willing to serve on the board much less the audit committee.

[4] According to part 363 of the FDIC regulations, a minority of the audit committee members of institutions with $500 million or more but less than $1 billion in total assets need not be "independent of management." Institutions with $1 billion or more in assets must have audit committees comprised entirely of outside directors who are "independent of management."

ICBA believes that the existing FDIC Guidelines 28 and 29 are sufficient guidance for banks to determine the independence of a director. Any attempt to provide a long list of criteria for independence will only complicate the process of recruiting competent audit committee directors for covered privately held community banks. It may force many of these banks to raise their director fees and establish costly director compensation programs such as deferred compensation plans to attract candidates to serve on their audit committee. It may also force them to search for competent director candidates from outside their service area, diminishing their local focus and knowledge of local markets.

Management Report Contents. In its proposal, the FDIC said that it reviewed the management reports filed pursuant to part 363 and noted differences in the content of these reports and insufficient information regarding the results of the assessments that management must perform. Accordingly, the FDIC is proposing to expand Section 363.2(b) so that the management assessment of compliance with the safety and soundness laws and regulations include a clear statement as to management's conclusion regarding compliance and disclose any noncompliance with such laws and regulations. In addition, amended Section 363.2(b) would require management's assessment of internal control over financial reporting to identify the internal control framework that management used to make its evaluation, include a statement that the evaluation included controls over the preparation of regulatory financial statements, include a clear statement as to management's conclusion regarding the effectiveness of internal control over financial reporting, disclose all material weaknesses identified by management, and preclude management from concluding that internal control over financial reporting is effective if there are any material weaknesses.

For privately held companies with $1 billion or more in assets that are not subject to SOX 404, these new requirements will significantly complicate the preparation of the part 363 management report. It will impose upon banks an obligation to publish any and all instances of noncompliance with a lengthy list of safety and soundness laws and regulations. It will also force the management of those covered institutions to seek advice from their outside counsel and their outside auditor prior to completing the management report to make sure that all laws have been complied with and that a correct internal control framework was used. Audit fees and legal fees will increase as management will have to rely increasingly on the language and advice of counsel and the auditors to prepare the report.

These new requirements also increase the potential liability of the institution and management if the right internal control framework is not correctly identified in the report or if all instances of noncompliance with safety and soundness laws are not disclosed. Management will be required to further document the assertions it makes in its report and perform specific testing procedures over the preparation of regulatory financial statements.

Rather than imposing more burden and liability on management with respect to the part 363 management report, ICBA believes that the FDIC should reduce the burden and liability particularly since the regulations call for an outside auditor to

attest to management's report. Management should only be required to give its best assessment of the integrity of the internal controls that are in place and not have to attest to a long list of internal control items which includes the bank's regulatory financial statements or publish all instances of noncompliance with the safety and soundness laws and regulations.

Auditor Communications. ICBA believes that the FDIC's proposal to incorporate the requirements of SOX Section 204 regarding auditor communications into the FDIC's part 363 regulations is another example of inappropriately applying SOX practices to privately held banks. We do not think that auditors should be required to report to the audit committee all auditor communications to the bank with regard to critical accounting policies, alternative accounting treatments, and schedules of unadjusted differences. Such a requirement will result in management disclosing, out of abundance of caution, all communications between the bank's auditor and the bank concerning these issues.

ICBA believes that management should have some discretion as to whether these communications should be reported to the audit committee. While we do believe that the audit committee should have a significant role in the company's relationship with its auditor, we do not believe that management's role should be diminished and replaced by the audit committee. More importantly, we believe that SOX practices and principles regarding audit communications should be restricted to publicly held community banks.

Conclusion

ICBA is concerned that the proposed changes to part 363 of the FDIC's regulations will significantly increase the regulatory burden of privately held community banks with assets of $500 million or more without commensurate benefits. We are particularly concerned with the proposal to incorporate the PCAOB's auditor independence standards into the FDIC's regulations. This will adversely impact those community banks or holding companies with over $500 million or more in assets that are located in areas with limited access to accounting services. It also reflects a disturbing trend by the banking regulators to apply SOX principles and practices to privately held banking institutions**.**

ICBA also believes that the existing FDIC's Guideline 28, "*Independent of Management*" *Considerations* and Guideline 29, *Lack of Independence* provide sufficient guidance for determining whether a director is independent and that the FDIC's proposal to provide expanded guidance based on the national securities exchange independence standards for directors will only complicate the process of recruiting competent audit committee directors for many privately held community banks. ICBA also objects to some of the proposed new requirements for the part 363 management report and believes that SOX practices regarding auditor communications should not be applied to privately held community banks.

ICBA appreciates the opportunity to offer comments in connection with the FDIC's proposed amendments to part 363 of its regulations concerning independent audits and

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reporting requirements. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,

Christopher Cole

Christopher Cole
Senior Regulatory Counsel