WBA WASHINGTON BANKERS ASSOCIATION

September 17, 2015

William A. Longbrake, Chairman
Washington State Citizen Commission for Performance Measurement of Tax Preferences
1300 Quince Street SE
P.O. Box 40910
Olympia, WA 98504-0910

Dear Chairman Longbrake,

While we appreciate the work of the JLARC staff on these very difficult tax preference reviews, we have significant concerns with the recommendations to narrow the definition of eligibility for the first mortgage interest deduction.

We believe the legislature successfully crafted a definition that fulfilled its intent and there have not been indications that this Legislative intent was not met. The Washington State statute was carefully crafted by DOR with input from DFI, industry representatives and the AG's office.

As requested by the Commissioners, the comments below will focus on the six questions you have asked all stakeholders to address when presenting written or oral testimony.

The questions and responses are as follows:

<u>Question 1:</u> Is there evidence that the tax preference achieved its purpose, as noted in the 2015 tax preference reports? Please provide any relevant evidence.

JLARC staff inferred two public policy objectives for the tax preference as follows:

I. To stimulate Washington's residential housing market by making loans available and affordable to home owners; and
II. To limit the tax preference to "community banks."

We believe the legislative objectives were slightly different:

I. To stimulate Washington's residential housing market by making loans available to home owners;
II. To maintain the competitiveness and viability of Washington based banks; and
III. Ensure Washington based banks were eligible for the first mortgage interest deduction.

Stimulate the residential housing market

Since the passage of the B&O tax in the 1930's, first mortgage interest was not taxed in order to encourage home ownership. In 2012, the legislature changed this tax policy but intentionally left the deduction in place for banks located in less than ten states. This was done to encourage lenders, particularly smaller Washington based banks, to stay in the Washington housing finance business, making residential loans available. Home loans have relatively low margins compared to other loans. The data below showing the state historical real estate excise tax collections, gives a good sense of the trends in the market of real estate, which was severely impacted by the recession:

REAL ESTATE EXCISE TAX STATISTICS			
State REET Collections and			
Estimated Value of Sales			
Fiscal Years 2005 – 2014			
Fiscal Year	Number of Sales	State Real Estate Excise Tax Collections ($000)	Estimated Value of Sales ($000,000)
2014	242,434	$645,919	$50,462
2013	241,595	579,062	45,239
2012	209,442	417,408	32,610
2011	206,805	378,041	29,534
2010	215,233	409,796	32,015
2009	198,515	397,623	31,064
2008	250,971	707,995	55,302
2007	316,432	986,721	77,088
2006	364,906	1,003,138	78,370
2005	364,900	855,350	66,824

As you can see the number of sales and real estate excise tax collections dropped to a low in 2009. While the market is recovering the state is not yet fully recovered. There are many factors impacting a healthy real estate market, this deduction encourages these residential transactions by Washington based banks which generates significant revenue for the general fund.

The first mortgage interest deduction has been used as a tool to encourage lenders to stay in the cyclical housing finance business because home loans have relatively low margins compared to other loans. The loss of this tax treatment would simultaneously impact the availability of loans. Taxes for these institutions are a direct reduction to their available capital, placing pressure on meeting minimum capital requirements by regulators and potentially reducing the resources available for residential loans.

We have spoken with a number of Washington State based bank leaders, and they all assert that if this tax treatment would be removed it would impact their ability to lend at the local level. Capitalization levels and competitiveness in the marketplace were the most commonly reasons as to why they would have to rethink their level of commitment to these products. The overall level of regulation on consumer mortgages is increasing. For example the Consumer Financial Protection Bureau is implementing the new TILA-RESPA Integrated Disclosure rules, which come on top of the new Qualified Mortgages rules that went into place in January 2014. The net result is that it is becoming more complicated and less profitable to make home loans. If taxes are increased on community banks in Washington State, it will only exacerbate the problem which likely will result in less available credit, thus increasing the cost of financing to consumers.

II. Ensure Washington based institutions are a) competitive and b) viable

a) ***Competitive:***

In Washington's financial sector, there are significant inequities that impact competitiveness. Washington based-banks compete with larger national banks. In addition, credit unions have a complete exemption from the B&O tax. Credit unions in recent years have become much more aggressive home lenders, and further increasing this disparity with other financial institutions would mean credit unions would become the state's most favored lender.

For example the following is a comparison of Washington Federal (WAFD) and the Boeing Employees Credit Union (BECU) in 2014:

	WAFD	BECU
Assets	$14.7 B	$13 B
Customer Accounts	$10.7 B	$11.5 B
Net Income	$157.3 M	$180.5 M
Taxes	$88 M	$0
Effective Tax Rate	**36.70%**	**0.00%**

In 2012, lawmakers recognized the challenges created by credit union competition and larger national banks, and specifically chose to protect community banks by maintaining the first mortgage deduction for banks doing business in 10 or fewer states.

b) **Viable:**

Collectively community banks lost more than $3.4 billion from 2008-2010, and 18 banks have failed in Washington state since 2008. In 2012, the legislature carefully crafted the definition of banks eligible for the first mortgage interest deduction because they did not want to significantly impair the recovery of financial health for banks and thrifts headquartered in Washington. Washington's banks are just now recovering from a fiscal crisis after losing billions of dollars, and experiencing the failure of many community banks.

One important factor for the health of the financial sector in Washington is maintaining local decision by keeping Washington based banks. In recent years Washington has lost many Washington based banks:

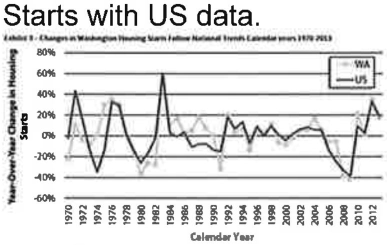
- Seafirst Bank
- Rainier National Bank
- Washington Mutual
- Peoples National Bank
- Seattle Trust and Savings Bank
- Puget Sound Bank of Tacoma
- Old National Bank in Spokane

III. Limit tax preference to Washington based Institutions

JLARC recommends alternative definitions for eligibility of the first mortgage interest deduction.

On both the federal and statewide scale, the term "community bank" varies greatly; there has not been a consistent standard set to-date. The FRB's asset-based threshold is used to allocate auditing resources, meaning institutions with less assets do not receive in-person audit, while institutions with more assets receive in-person auditing. In addition, the FDIC definition is based on a complicated formula. Finally, it is not necessary to limit to eligibility to portfolio lenders, because the tax incentive already incentivizes portfolio lending because the amount of the deduction is reduced if the loan is sold in the secondary market.
The definition in Washington statute was carefully crafted by DOR with input from DFI, industry representatives, and the AG's office with the intent of protecting Washington based financial institutions and incentivizing residential loans.

We believe this preference has successfully achieved its public policy objective by narrowing the deduction to entities that are located in ten or less states. Additional changes would negatively impact Washington businesses that are just now recovering from the recession.
In addition the report draws the conclusion that "the effect of these cost savings on loan availability and on stimulating Washington's overall housing market is less likely given that housing markets appear to follow national trends and do not appear to be driven by local factors." This conclusion is drawn from exhibit 3 which compares Washington Housing Starts with US data.



The chart is of concern because Washington's trends are sometimes 10-20% above or below the national trends. So, while there may be a high-level trend, this does not depict any the nuances of Washington's lending market. Additionally, these data fail to consider the tax differences with WA's gross receipts tax and the majority of other states, which tax on a net income basis.

This conclusion raises concerns that these data do not answer the question of whether the first mortgage interest deduction stimulates Washington community banks to provide residential loans.

Question 2: Does the preference provide benefits in addition to those stated in its intended or implied purpose, consistent with one or more of the six public policy objectives stated in RCW 82.32.808(2)?

Response: We believe this deduction achieves the objective of improving industry competitiveness, which we have already outlined in our response on question 1.

Question 3: Is there a loss of tax revenue as a result of the preference; and if so, do any increased taxes from new economic activity exceed that loss?

Response: The value to the economy of single family home transactions is significant. Availability of first mortgages impacts whether people decide to rent or own a home. Any incentive that encourages access to credit for home loans is positive for the economy, consumer confidence, and state revenue collections. For example the June 2015 Revenue Forecast projects real estate excise tax collections in the 2015-17 Biennium to be almost $1.4 billion. This compares to $783 m in the 2009-11 Biennium, when access to credit for home loans was still tight.

Question 4: Specifically in the case of property tax preferences, what would be the impacts on taxpayers and economic activity if the preference is eliminated or modified?

Response: NA

Question 5: Does this preference have negative consequences? For example, were other industries, workers, or the environment harmed by activities stimulated by this tax preference?

Response: NA

Question 6: How does the overall impact of the "preference" affect the tax burden in Washington compared with similar tax burden in other states?

Response:
Washington State has a unique gross receipts tax business tax system. A comparison to other states is an apples to oranges comparison, because most other states have a corporate net income tax allowing the deduction of expenses and business costs. In addition, in 2010, the B&O tax rate on banks in Washington State was increased by 20%.

Taxes for these institutions are a direct reduction to their available capital, placing pressure on meeting minimum capital requirements by regulators. Since that time, federal and state regulations have only increased, making it continually more difficult for smaller institutions to maintain operations competitively. We believe this deduction levels the playing field in a unique and inherently uncompetitive tax structure. Removing this deduction would make it more difficult for smaller, Washington institutions to remain in the housing finance business.

In conclusion, federal and state regulations have increased significantly over the last few years making it continually more difficult for smaller institutions to maintain operations. We believe this deduction levels the playing field in a unique and inherently uncompetitive tax structure. Removing this deduction would make it more difficult for smaller, Washington institutions to remain in the housing finance business. This preference plays an important role stimulating the residential housing market and maintaining the competitiveness and health of Washington based banks.

We respectfully request the Tax Preference Commission recommend this tax preference continue without a change in the current definition.

Sincerely,

James Pishue
President and CEO
Washington Bankers Association

Cc Members of the Washington State Citizen Commission for Performance Measurement of Tax Preferences
Mr. Keenan Konopaski; Legislative Auditor, Joint Legislative Audit &Review Committee