



**Testimony  
of  
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**On behalf of**

**Independent Community Bankers of America  
Washington, DC**

***“Legislative Hearing on H.R. 4777, the Internet  
Gambling Prohibition Act”***

**United States House of Representatives**

**Committee on the Judiciary  
Subcommittee on Crime, Terrorism, and Homeland  
Security**

**April 5, 2006**

Mr. Chairman, Ranking member Scott and members of the committee, my name is Sam Vallandingham. I am Vice President of the 101 year-old First State Bank in West Virginia. I am also a member of the Payments and Technology Committee for the Independent Community Bankers of America.<sup>1</sup> My bank is located in Barboursville, a historical town of 3,183 people in the far western part of the state near the Kentucky border. We have 50 employees, two branches and \$127 million in assets.

Banking has been in my family for four generations. My great grandfather, a Kentucky tobacco farmer, sold his farm to raise capital to start the First State Bank. It is said that my grandfather came to West Virginia in a horse and buggy and these too were eventually sold, with the proceeds used to set up the bank. The original charter, dated September 1, 1905 and the certificate of authority still hang on the wall in the bank's main office.

On behalf of ICBA, I would like to extend my appreciation for the opportunity to testify on the proposed use of the checking and electronic payments systems to limit criminal behavior, in this case, Internet gambling. We appreciate the committee's willingness to have an open dialogue on the effect of this proposed legislation on community banks.

### **Background and Summary of ICBA Position**

This committee and members of the House should be commended for actively engaging in the fight against terrorism and anti-money laundering. We urge you to recognize that through the passage of the USA Patriot Act and Bank Secrecy Act, small banks like mine have undertaken a substantial burden to confirm the identity of our customers while documenting and reporting suspicious transactions. ICBA believes that it is critical that our resources be focused where risks to our national safety and financial soundness are greatest.

**Our concern is that the added burden of monitoring all payment transactions for the taint of Internet gambling will drain finite resources currently engaged in complying with anti-terrorism, anti-money laundering regulations and the daily operation of our bank to meet the financial needs of our customers and community.** While we share concerns about Internet gambling, it is highly doubtful that the pending legislation, if passed, would affect the popularity of Internet gambling. **Ultimately, we question whether the Internet gambling bills currently before the House will efficiently and effectively regulate the targeted behavior at a level which will justify the**

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<sup>1</sup> The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. 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. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).

**time and expense required by community banks to comply with another layer of regulation.**

There are two bills pending before the House of Representatives that purport to end Internet gambling through the restriction of payments: H.R. 4777, sponsored by Representative Goodlatte of Virginia and H.R. 4411, recently passed by the Financial Services Committee. Although the bills have many similarities, there are some important differences.

H.R. 4411 prohibits any person engaged in the business of betting or wagering from knowingly accepting credit, electronic fund transfers, checks or any other types of financial transactions in connection with unlawful Internet gambling. The bill also directs the Treasury Department and the Board of Governors of the Federal Reserve System in consultation with the Justice Department to issue regulations requiring payment systems to identify and prevent restricted financial transactions.

Unlike H.R. 4411's focus on prohibiting the underlying financial transactions, H.R. 4777 would amend the prohibition against interstate gambling and criminalize the knowing acceptance of credit, credit proceeds, electronic fund transfers or other such monetary payments by anyone in the gambling business.

The burden of regulation and compliance created by these proposals is substantial, as a key enforcement mechanism would require banks to identify and block transactions between bank customers and Internet gaming companies. **These proposals do not recognize that the check clearing system and the Automated Clearing House (ACH) network do not have the same capabilities as the credit card association networks to identify different types of transactions.** These systems were never intended to identify illegal activity, monitor individual transactions and regulate enforcement functions. The payments system was not designed to be a transaction monitoring service. It was designed to be an effective and efficient method for transferring dollars from one party to another.

**This legislation, if passed, would not only necessitate a massive overhaul of our nation's check clearing and ACH systems, but also create enormous regulatory burden requiring the deputation of financial institutions to identify and block illegal transactions. For these reasons, we oppose the use of the check and ACH payments system to monitor Internet gambling transactions. If in the opinion of this committee, a bill must be passed to address the Internet gambling problem, then we respectfully request rule writing and regulatory oversight be given to the Federal Reserve Board of Governors (Federal Reserve) which is well acquainted with the functionality of the payments system and the limitations of the nation's check clearing and ACH networks. Additionally, given the limitations of the check clearing and ACH networks, we request an exemption for check and ACH payments.**

## **Community Banks are Disproportionately Burdened with Regulation and the Cost of Compliance**

Recently, ICBA testified about community banks' need for relief from severe regulatory burdens and the resulting substantial costs of compliance.<sup>2</sup> In January 2004, two economists at the Federal Reserve Bank of Dallas concluded that the competitive position and long term viability of small banks is questionable due to the crushing regulatory burden shouldered by our industry.<sup>3</sup> The costs are disproportionately heavy for community banks because unlike the large multinational banks, we cannot benefit from economies of scale and a large workforce to ultimately pass the high cost of compliance to a national customer base.

When discussing the cost of compliance and the disproportionate effect of regulation on community banks, there is one basic difference between our largest and smallest financial institutions. Large banks have many hundreds or thousands of employees and the financial resources to easily and quickly hire and train more employees to work exclusively on ensuring that the bank complies with the growing number of regulations. In contrast, a community bank with \$100 million in assets typically has 30 full-time employees; a \$200 million bank may have up to 60 employees. Unlike the big banks, if my bank is faced with new regulations, we must train one of our 50 current employees to be responsible for compliance. This not only creates costs, but takes our employees away from their core duty of serving our customers and our community.

**This disproportionate regulatory impact caused by legislation like the proposed Internet gambling bill makes it difficult for us to fulfill our central mission of financing and supporting our local communities. Community bankers provide tremendous leadership in their communities. Additional regulatory burden is detrimental not only to the bank, but to the community that depends on us for economic stimulus, small business funding, job creation and continued community revitalization.**

### **How Different Elements of the Payment System Function**

Our nation's payment system includes check clearing, ACH, a myriad of credit and debit card products, wire transfers and new innovations. Each type of payment operates over a different network. For example, the credit card network, an all-electronic system, is vastly different from the ACH and check clearing networks. Businesses desiring to accept and process credit card

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<sup>2</sup> Testimony of Ms. Terry Jorde, President/CEO, CountryBank USA, Cando, ND and Chairman-Elect of the Independent Community Bankers of America, March 1, 2006 *and* testimony of Mr. David Hayes, President/CEO, Security Bank, Dyersburg, TN and Chairman of the Independent Community Bankers of America, June 21, 2005 to the United States Senate Committee on Banking, Housing and Urban Affairs.

<sup>3</sup> Gunther and Moore, "Small Banks' Competitors loom Large," *Southwest Economy*, Federal Reserve Bank of Dallas, Jan/Feb. 2004.

payments receive a merchant category code to identify the type of merchant or business. Every transaction routed from a specific business has the corresponding merchant category code. Therefore, credit card networks are able generally to identify transactions originated by an Internet gambling company and block payment as required in the proposed legislation. However, merchants can be assigned the correct merchant category code only if they fully disclose all lines of business. For example, a general merchandiser could operate an Internet gambling enterprise, but fail to disclose this business line to the organization sponsoring the merchant's credit card system.

Generally, debit card networks have capabilities similar to credit card networks.

Conversely, the **check clearing system** is a paper-based network that is beginning to migrate to an electronic system. According to the Federal Reserve System's 2004 Federal Reserve Payments System Study, more than 36 billion paper checks were processed nationally in 2003.<sup>4</sup> Although paper-based, banks do have an automated process for clearing and settling paper checks. The check clearing system relies on machines to read the Magnetic Ink Character Recognition Line, commonly known as the MICR line. The MICR line includes the paying bank's routing and transit numbers, the customer's bank account number, the check serial number, and the amount of the check. Checks are cleared, settled, and deducted from customer accounts using this MICR line information. The payee information is NOT processed. Although the industry is making progress in converting paper checks to electronic images, the process still relies on processing the MICR line information of the check image. Unlike the credit card system, **the check clearing system does not have a merchant or transaction coding process.** This is a long-standing commercially acceptable banking practice. The check clearing process does not provide a means to identify and prohibit checks payable to Internet gambling companies and it cannot be reconfigured to function as a transaction monitoring service.

**Electronic payment systems were developed to provide an alternative to the paper check.** Electronic payment systems include all forms of electronic payments, including ACH payments, debit and credit cards, money transmittals and wire transfers. Similar to the check clearing network, the ACH network does not have the capability to identify and prohibit certain transactions. Transactions are routed from the originator of the payment, in this case the Internet gambling company, to the receiver, the customer, using the customer's bank routing, transit and account numbers. The only way to identify the originator is by the company name. **Therefore, the ACH network, like the check clearing system, does not provide a means to identify and prohibit payments originated by Internet gambling companies and it cannot be reconfigured to function as a transaction monitoring and blocking service.**

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<sup>4</sup>Federal Reserve System, *The 2004 Federal Reserve Payments Study, Analysis of Noncash Payments Trends in the United States: 2000 – 2003*, updated December 15, 2004 (2004).

**Using this system to identify and to block Internet gambling transactions is unfeasible.** Banks cannot control Internet gambling because check and ACH networks offer limited information to the bank about the underlying transaction. A bank can neither distinguish between legal and illegal transactions nor identify the ultimate recipient of funds, particularly where a third party payment system is utilized. In short, to a bank, a simple purchase of bread and milk at a grocery store paid for using a check looks substantially similar to an Internet gambling transaction paid for with the same checking account. **Recognizing the specialized purpose of the check clearing and electronic payment systems, we strongly urge the Committee to exempt checks and electronic payments, like ACH transactions, from the proposed legislation.**

### **The Burden of Regulation and the Cost of Compliance**

One of the most difficult aspects of implementing the proposed regulation is that **financial institutions would have the judicial-like duty of distinguishing between legal and illegal acts.** The proposed Internet gambling bills do not prohibit all Internet gambling. Rather, they create a distinction between legal and illegal Internet gambling. This distinction turns on the type of gambling (horseracing versus poker), the location of the transaction (interstate, intrastate or tribal lands) and the source of the gambling (offshore Internet website versus US-based casino). Thus, the burden is placed on a bank to identify if a transaction originated at an Internet gambling site, to distinguish what portion of the transaction was legal or illegal and to determine where the transaction occurred. Particularly in the case of checks which move with the customer, it is impossible for a bank to determine the location of a transaction and thus, whether a wager was legal or illegal.

**This legislation, if passed, would necessitate a cumbersome and expensive overhaul of the ACH and check networks. This overhaul would impede their efficiency and accuracy and increase inconvenience and costs to customers.** Our nation's payments system is the global model of speed and efficiency. It was designed to permit consumers and businesses to complete transactions quickly and accurately. The proposed legislation would undermine the system and threaten the economy. In order to comply with the proposed legislation, these networks would have to be substantially reengineered and significant resources would have to be diverted to investigating parties, payees and transactions. The customer would not only absorb the resulting costs, but also the inconvenience of time consuming transactions. Under this proposed regulatory framework, the simple act of writing a check would require recording extensive additional information, including the location of the transaction, business of the payee and legal character of each part of the transaction. The likely result is that banks would deny many legal transactions and the payments system will be significantly slowed.

## **Check and ACH Transactions Should Be Exempted**

This legislation promises to create substantial regulatory burden and significant costs as it would require banks to act as the gatekeepers for all check and ACH transactions. As a primary clearing house for checks and ACH transactions, the Federal Reserve is familiar with the limitations of using the payments systems to regulate Internet gambling transactions. A possible solution to this dilemma is to exempt check and ACH transactions from the scope of this legislation or to direct the Federal Reserve to exempt any transactions where it is unfeasible to identify and block illegal gambling activity. **If it is not reasonably practical to block such transactions without harming the efficiency of the payments system, then they should be exempted.**

If check and ACH transactions are not exempted, the resulting compliance costs to banks and the payments system would be enormous. On Friday, March 31, the Congressional Budget Office (CBO) released its analysis of H.R. 4411. The analysis determined that the enactment cost of this bill to the private sector would be below \$128 million<sup>5</sup> if regulators *only apply rules to credit card transactions* and not to other payment options. “However, **if the regulations also include the requirement for banks to identify and block checks and other bank instruments...the direct cost to comply with the mandates could increase significantly....**”<sup>6</sup> These resulting costs would not be limited to the redesign and rebuilding of the payments system structure, but increased labor and training costs to the banks, redesign of check and ACH forms, education of the customer as to how to complete the redesigned forms as well as the high economic costs of payment delays and a significantly slowed payments system.

**Congress may still wish to make these transactions illegal, but should adopt enforcement solutions that do not require extraordinary costs to the nation’s payment systems and will not saddle the nation’s banks with the burden of enforcement. Moreover, the responsibility for identifying and blocking prohibited credit and debit card transactions should lie with the credit and debit card networks and NOT the financial institutions. Only the credit and debit card networks have the ability to determine the character**

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<sup>5</sup> The \$128 million threshold was established in the Unfunded Mandates Reform Act of 1995. 2 U.S.C. § 1501 (1995). The act requires the CBO to estimate the costs of bills with federal mandates reported out of committees. The CBO must provide a detailed cost estimate for each bill containing an annual aggregate impact of \$50 million or more on the public sector (i.e., state and local governments) or \$100 million on the private sector. The act allows a point of order in both the House and Senate against any bill or joint resolution reported by an authorizing committee that lacks the necessary CBO statement, or that result in direct costs in excess of \$50 million a year to state and local governments. A proposed bill is in order if it provides funding to cover the costs of the mandate. In addition, federal agencies must assess the effects of new regulations on state, local, tribal governments and the private sector while seeking to minimize burdens where possible.

<sup>6</sup> Congressional Budget Office, *Congressional Budget Office Cost Estimate, H.R. 4411: Unlawful Internet Gambling Enforcement Act of 2006 as ordered reported by the House Committee on Financial Services on March 15, 2006*, 30 March 2006 at 4.

**of the transaction and thus, only the credit and debit card networks have adequate information to identify an illegal transaction.**

### **Protections are in Place to Protect Minors from Abusing Check and ACH Payments to Gambling Websites**

One of the primary motivations behind this bill is the desire to prevent minors from accessing online gambling resources. Fortunately, there are many consumer protections in place that allow the customer to be made whole when there is fraudulent use of an ACH or check payment. Federal Reserve Regulation E<sup>7</sup> creates a right of recession for 60 days following the receipt of the account statement showing the fraudulent ACH payment or debit card transaction. The fraudulent use of a check is subject to the Uniform Commercial Code Article 4<sup>8</sup> which gives the customer 12 months to request a return of funds.

### **Conclusion**

**As a representative of the ICBA, I urge you to reject proposals to use the banking system to restrict Internet gambling unless there is a reasonable chance that the measures will be effective and will not add to the tremendous regulatory burden of our nation's financial institutions.** The proposals that we have seen do not meet this test. Congress should not pass legislation that claims to "do good" but neither effectively and efficiently restricts bad behavior nor encourages positive action.

Community bankers oppose the use of the payments system to control antisocial or unseemly behavior, such as gambling, particularly where the regulatory burden and compliance costs to the private sector would be astronomical. Banks should not be deputized and given the duty of both identifying and blocking illegal activity. I am concerned that the proposal before this committee would merely increase my regulatory burden and compliance costs to the detriment of my community without the payoff of effectively stopping Internet gambling. **Despite the sincere intentions of the authors, neither my bank nor our nation's payment systems can function as a transaction monitoring and blocking service as envisioned by this legislation.** In so much as this legislation attempts to protect families and minor children, I assure the committee that there are processes and procedures in place that permit a customer to rescind a fraudulent ACH or check transactions.

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<sup>7</sup> FRB Electronic Funds Transfer (Regulation E), 12 C.F.R. § 205 (2006).

<sup>8</sup> Bank Deposits and Collections, U.C.C. § 4-406 (2001).



**If in the opinion of this committee, the legislation will be effective and the social need to restrict Internet gambling outweighs the potential harm to small banks like mine, then I respectfully ask that regulatory supervision be given to the Federal Reserve. We strongly urge the committee to modify the legislation to exempt the check clearing and ACH networks or to direct the Federal Reserve to exempt these transactions.**

On behalf of my community bank and the nearly 5,000 members of the Independent Community Bankers of America, I ask you to remember this as you consider this legislation and the increased regulatory burden it will create for our industry. Thank you.