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TESTIMONY OF

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On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

EXAMINING REGULATORY BURDENS – REGULATOR PERSPECTIVE

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INTRODUCTION

Good morning, Chairman Neugebauer, Ranking Member Clay, and distinguished Members of the Subcommittee. My name is Charles Cooper. I serve as the Banking Commissioner for the Texas Department of Banking and I am the Vice Chairman of the Conference of State Bank Supervisors (CSBS). It is my pleasure to testify before you today on behalf of CSBS.

CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. Presently there are 6,423 federally insured banks. State banking regulators have chartered and now supervise 77 percent of these banks. In addition, state regulators also supervise a wide variety of non-bank financial services providers. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to state financial regulators and represents its members before Congress and the federal financial regulatory agencies.

I have more than 45 years of experience in the financial services industry – 12 as an FDIC bank examiner, 26 as a banker in both community and large banks, and now seven years as the Texas Banking Commissioner. Over these years, nothing has become more evident to me than the indispensable value of community banks. Community banks are vital to economic development, job creation, and financial stability of their local economies. Put simply, community banks are the backbone of thousands of communities across the country, and community banks play a foundational role in an increasingly diverse financial system. I appreciate the continued efforts of you and your colleagues to examine regulatory approaches for smaller financial institutions.

Over the past several years, many of Congress' regulatory reform efforts have rightfully addressed systemic problems presented by the nation's largest banks. However, there is widespread concern among state regulators, myself included, that the cumulative effects of existing and new regulations are creating an undue burden for many of the nation's community banks. When CSBS last testified before this Subcommittee just nine months ago, there were 6,665 banks, most of which are community banks. Today, there are 6,423 banks,[1] and that number continues to dwindle. While continued inquiry is necessary to understand to what extent regulatory burden is compelling these banks to consolidate, it is clear that the status quo is leading to fewer community banks for consumers with increasingly diverse financial needs.

State regulators are focused on right-sizing community bank regulation and supervision. Right-sized regulation does not necessarily mean fewer regulations, but rather means that regulations are tailored to the community bank business model.

Confronting the challenge of bank consolidation and crafting appropriate, right-sized regulations for community banks will require a more holistic approach to identifying and

[1] "FDIC Institutions Directory, Summary Statistics." Accessed April 20, 2015. Available at: https://www2.fdic.gov/idasp/index.asp

defining community banks. This is a high priority for state supervisors. Not only are state regulators responsible for the safety and soundness of our regulated entities, we are also charged with facilitating economic progress. In Texas, both state law and my Department's mission statement explicitly require us to increase economic prosperity and promote a competitive financial system. Put simply, state supervisors are uniquely positioned to promote right-sized regulation and supervision of banks consistent with their size, complexity, overall risk profile, and risk to the financial system.

My testimony today will highlight the importance of community banks and their relationship-lending business model. I will also discuss the value state regulators bring to their supervised institutions and their local economies, state regulators' efforts to right-size regulations for community banks and tackle emerging regulatory challenges, and the condition of state-federal regulatory coordination. Finally, my testimony will discuss specific ways in which Congress and the federal banking agencies can promote right-sized policy solutions for community banks.

COMMUNITY BANKS AND RELATIONSHIP LENDING ARE ESSENTIAL

The U.S. financial system is incredibly diverse, ranging from single-branch community banks to global financial conglomerates. This diversity is not a mistake, but rather a product of our unique dual-banking system. The dual-banking system, anchored by state and national banks chartered by state and federal regulators, has encouraged financial innovation and institutional diversity for more than 150 years.

Community banks are essential to the U.S. financial system and economy. The Federal Deposit Insurance Corporation (FDIC) classifies more than 92 percent of all U.S. banks as community banks, meaning there are 6,037 community banks embedded in local communities throughout the country.[2] The defining characteristic of a community bank is its relationship-lending business model – a business model that relies on the bank's knowledge of its local market, citizens, and economic conditions. This is why community banks have an outsized role in lending to America's small businesses, holding 45.3 percent of the banking industry's small loans to farms and businesses while only making up 13.2 percent of the banking industry's assets.[3] A community banker knows the entrepreneur opening a new business around the corner. A community banker also knows the local real estate market and the homebuyer seeking a mortgage loan. While a larger bank may reject a nontraditional borrower based on a predetermined model, a community banker's local knowledge allows him or her to offer personalized solutions designed to meet the specific needs of the borrower.

Community banks engage in relationship lending in the largest U.S. cities and the smallest rural markets. Their role in providing credit and banking services is just as vital as that of the largest financial institutions. In fact, many individuals and businesses are not particularly

[2] "Quarterly Banking Profile: Fourth Quarter 2014." FDIC. Available at: https://www2.fdic.gov/qbp/2014dec/qbp.pdf

[3] "FDIC Community Banking Study." FDIC, pp. 3-4 (December 2012). Available at: http://www.fdic.gov/regulations/resources/cbi/study.html

well-served by larger banks' standardized, model-driven lending. This is especially the case in rural areas, where the FDIC has found that community banks are three times more likely to operate a banking office outside of a metro area than their large bank counterparts.[4]

There are more than 600 counties – or one out of every five U.S. counties – that have no physical banking offices except those operated by community banks.[5] In Texas, there are four counties without a single banking office, 20 counties with only one bank office, and 113 of the state's 254 counties have five or fewer bank offices. The success of our community banks is instrumental to the success of the Texas economy: as research presented at the CSBS-Federal Reserve Community Bank Research conference shows, communities in which a community bank fails experience measurable drop-offs in economic performance, including lower income and compensation growth, higher poverty rates, and lower employment.[6]

Simply put, community banks are a vital part of a diverse financial services marketplace and help ensure credit flows throughout the nation's diverse markets. They provide credit and banking services in a flexible, innovative, and solutions-focused manner, characteristics that are inherent in the community bank relationship business model.

COMMUNITY BANKS NEED A RIGHT-SIZED REGULATORY FRAMEWORK

State regulators believe policymakers in Congress, the federal banking agencies, and state banking agencies must rethink how we all approach regulating and supervising community banks. The statistics are clear – most banks are community banks that operate in local markets.

Nearly 90 percent of today's 6,423 banks have less than $1 billion in total assets and hold less than 9 percent of the banking industry's total assets. On the other end of the industry spectrum, we find a very different type of bank: four U.S. banks exceed $1 trillion in total assets and hold around 42 percent of the banking industry's total assets.[7]

The community bank and megabank business model are also radically different. Community banks serve local economies by tailoring their loans and financial services around the customers within their geographically limited markets. Conversely, the largest banks leverage economies of scale in order to offer standardized mortgage and consumer products across a diversity of U.S. and global markets, provide financial services to multinational corporations, and engage in extensive capital markets activity.

These are vastly different businesses, and policymakers must regulate and supervise these financial institutions differently based on their size, complexity, overall risk profile, and risk to the financial system.

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[4] Ibid.

[5] Ibid.

[6] Kandrac, J. "Bank Failure, Relationship Lending, and Local Economic Performance." *Community Banking in the 21st Century Research Conference.* Federal Reserve System and the Conference of State Bank Supervisors, September 2013. https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Kandrac_BankFailure_CBRC2013.pdf.

[7] FDIC Call Report data. https://www2.fdic.gov/Call_TFR_Rpts/.

Recent regulatory reform efforts have rightfully centered on addressing the problems posed by the largest, most systemically important banks. However, there is also widespread concern among policymakers and the banking industry that many of these new rules, in addition to existing regulatory requirements, pose an undue burden for community banks. Congress and federal regulators have undertaken measures to provide a right-sized regulatory framework for community institutions. While these efforts are positive, there remains a need for a much more comprehensive approach based on a common understanding of what constitutes a community bank. Appendix A of this testimony provides a list of asset-based regulatory relief provisions illustrating this point.

State regulators are concerned that an approach that relies solely or primarily on asset thresholds falls short in providing a right-sized regulatory framework for community banks that meaningfully distinguishes them from their larger competitors. True regulatory right-sizing for community banks will require a holistic approach.

State Regulators Support a Definitional Approach to Right-Sizing Community Bank Regulation

Regulatory right-sizing requires a process for determining how safety and soundness and consumer protection requirements can better reflect the community banking business model. To start this process, policymakers and regulators need to know which institutions should be the focus of our regulatory right-sizing efforts. To date, a consensus definition has eluded policymakers.

A definitional approach would provide the necessary foundation for a more appropriate regulatory framework for community banks. The definitional approach could be used as a basis for a broad range of regulatory right-sizing initiatives. With a new process in place to identify community banks, Congress and regulators could then move forward in a holistic manner to provide regulatory and supervisory right-sizing for these institutions.

Community banks are best identified by a set of principles that can be applied on a case-by-case basis, not by simple line drawing. CSBS is committed to getting this right, and my colleagues and I urge Congress to create a process for community bank identification that is not solely based on asset thresholds, but takes qualitative criteria into account. For example, state regulators believe characteristics such as the following can help identify community banks:

- Operating primarily in local markets;
- Deriving funding primarily from these local markets, specifically through deposits of members of the communities in which it operates;
- Focusing on lending out the deposits it collects to the communities in which it predominately operates;
- Having a lending model based on relationships and detailed knowledge of the communities and its members, not volume-driven or automated;
- Focusing on providing high-quality and traditional banking services; and
- Having locally based corporate governance.

A definitional approach such as this will provide the necessary framework for policymakers to better align community bank regulation with the community bank business model, a concept that state regulators refer to as "right-sizing" community bank regulation.

STATE REGULATORS PLAY A VITAL ROLE IN REGULATORY RIGHT-SIZING

State regulators have a long history of innovating to improve our regulatory and supervisory processes to better meet the needs of banks, their customers, and our states. Many bank products and services that now seem commonplace evolved as a result of the regulatory flexibility fostered by the dual-banking system. This regulatory flexibility is a strength of the state banking system. After all, community banks in Texas might face local issues that my department should address in one manner, while another state's banking regulator might have a different set of supervisory challenges to address.

State Agencies Strive For Supervisory Efficiency and Excellence

State regulators supervise a diverse range of depository and non-depository institutions, many of which are unique in their composition, size, and overall risk profile. The Texas Department of Banking supervises 263 depository financial institutions. The Department supervises more of our state's financial institutions than any federal regulatory agency, a fact that holds true for most state banking departments. Most state banking departments also regulate a variety of non-bank financial service providers, including mortgage lenders, mortgage servicers, and money services businesses. Beyond state-chartered banks, the Texas Department of Banking also supervises other businesses including money service businesses, trust companies, and foreign bank agencies.[8]

Having such a diverse and multifaceted number of supervisory responsibilities means that state agencies must retain highly-skilled, specialized staff for examinations and supervision. Of the over 140 examiners in the Texas Department of Banking, we have examiners specialized in Information Technology examinations, Trust examinations, Capital Markets examinations, and Bank Secrecy Act (BSA) examinations. For all of our supervised industries, state regulators adhere to a philosophy that supervision must be tough, but also fair, an approach that ensures appropriate but effective examination procedures.

To ensure our Department maintains high-level standards for our examinations, our staff attends a series of national schools presented by the federal regulatory agencies and CSBS. CSBS offers cutting edge training and certification opportunities on topics like lending principles, operations and deposits, and fair lending examination techniques. This training is supplemented by intensive on-the-job training, as well as advanced and specialty training designed by our Department and specifically tailored to meet the needs of Texas institutions. State examiners across the nation are committed to meeting the needs of their local communities, and the state-of-the-art training provided by CSBS and individual departments reflects that commitment.

[8] The Texas Department of Banking also supervises check verification companies, private child support companies, funeral contract sellers, perpetual care cemeteries, and cemetery brokers.

Just as thorough training enhances the professionalism of the state examiner workforce, a rigorous accreditation program, administered by CSBS, enhances the standards by which states fulfill their supervisory responsibilities. The Texas Department of Banking has been accredited by CSBS since 1993, signifying that my Department has maintained the highest standards and practices in banking supervision.

Highly-trained, locally-accountable examiners who are keenly aware of the needs of their local community are a hallmark of the state banking system. Their innovative and tailored approach to supervision provides value to their chartered institutions, their constituents, and the financial system as whole.

State Regulators Promote Research and Dialogue on Community Banking

Equally important as having the necessary professional training and proper supervisory tools at their disposal, state regulators recognize that designing a right-sized regulatory framework requires truly understanding the state of community banking, the issues community banks face, and the nuances within the community banking industry. Data-driven and independently developed research on community banks is sorely lacking when compared to the breadth of research dedicated to the nation's largest financial institutions.

To address the need for research focused on community banks, state regulators, through CSBS, have partnered with the Federal Reserve to conduct the annual Community Banking in the 21st Century Research Conference.[9] Bringing together state and federal regulators, industry experts, community bankers, and academics, the research conference provides valuable data, statistics, and analysis about community banking. Our hope is that community bank research will inform legislative and regulatory proposals and appropriate supervisory practices, and will add a new dimension to the policy dialogue about community banks.

The conference represents an innovative approach to research. The industry recommends many of the themes studied, providing their perspective on issues through a national survey and local industry roundtables. At the same time, academics explore issues in a neutral, empirical manner, while also contributing their own independent research topics. This approach ensures that three research elements – quantitative survey data, qualitative town hall findings, and independent academic research – all enhance and refine one another, year after year. The research conference's early success underscores the interest and need for community bank research: in 2014, more than 1,000 community bankers participated in the national survey, more than 1,300 bankers attended local town hall meetings, and more than 37 research papers were submitted by academics for consideration, a considerable increase from the number of papers submitted for the inaugural 2013 conference.

Some of the findings of the conference and the research initiatives surrounding the conference are detailed in Appendix C. The third annual Community Banking in the 21st Century Research Conference will occur September 30 and October 1, 2015, at the Federal

[9] "Community Banking in the 21st Century." Federal Reserve System/CSBS. Available at: https://www.stlouisfed.org/banking/community-banking-conference-2015/

Reserve Bank of St. Louis.[10] We are pleased that Federal Reserve Chair Yellen will be attending and delivering the keynote address.

Promoting Executive Leadership of Cybersecurity

The persistent threat of cyber-attacks is a global problem that threatens all industries, especially the financial services industry. We appreciate Congress' ongoing efforts to address cybersecurity challenges. Cybersecurity is a national priority, and state regulators are focused on ensuring that banks have the necessary information and the appropriate tools to address this vital issue. State regulators have heard from community bank executives that, while they understand the harm cyber-attacks can cause to their financial institutions, the abundance of information available on cybersecurity is overwhelming and largely technical, making many bankers uncertain as to what information applies to their particular institution.

This prompted state regulators, through CSBS, to launch the Executive Leadership of Cybersecurity (ELOC) initiative in 2014.[11] The ELOC initiative seeks to raise awareness among bank CEOs that managing an institution's cybersecurity risks is not just a "back office" issue, but also an executive and board level issue. ELOC is part of a larger state and federal effort through the FFIEC to help combat the threat of cyber-attacks in the financial services sector.

The launch of the ELOC initiative included a nine-week educational outreach effort. From that outreach, more than 500 community bankers signed up to receive CSBS's exclusive *Cyber 101: A Resource Guide for Bank Executives,*[12] a resource guide that compiles recognized industry standards for cybersecurity and financial services industry best practices into one booklet. The ELOC outreach campaign and resource guide provided community bank executives with the knowledge and necessary tools to better understand cyber threats at their institutions, better prepare for and protect against cyber threats, and to better understand their role as bank executives in managing cybersecurity risks at their banks. The high level of community banker interest in the ELOC initiative sent a strong message to state regulators that community banks are looking for more leadership and clear guidance on how to manage cybersecurity risks at their institutions.

In addition to the ELOC website and the cyber resource guide, CSBS is working with state banking departments to host a series of cybersecurity industry outreach events throughout 2015. Having worked with Texas community banks since 2010 on cybersecurity issues like Corporate Account Takeover (CATO), the Texas Department of Banking was pleased to partner with the Texas Bankers Association, Independent Bankers Association of Texas, the Southwestern Automated Clearing House Association (SWACHA), and law enforcement to hold the inaugural ELOC summit in Austin, Texas in December 2014. The summit brought together more than 300 bank CEOs, senior executives, and board members to learn about the current

[10] https://www.stlouisfed.org/Bank-Supervision/2015-Community-Banking-Conference.

[11] "Executive Leadership of Cybersecurity." CSBS. Available at: http://www.csbs.org/cybersecurity

[12] http://www.csbs.org/CyberSecurity/Documents/CSBS%20Cybersecurity%20101%20Resource%20Guide%20FINAL.pdf.

cyber threat landscape, best practices for managing cybersecurity, and information sharing resources.

ELOC and initiatives like it provide direct, tangible value to community banks. All banks face an enormous challenge in securing their systems against a growing number of cyber threats, and state regulators are providing valuable tools to mitigate cybersecurity risks.

States Enhance Non-Depository Supervision through NMLS

Effective supervision of such a diverse financial landscape requires that state regulators have all the necessary supervisory tools at their disposal. To help meet this need and ensure the most effective collaboration between one another, state regulators developed the Nationwide Multi-State Licensing System and Registry (NMLS or the System). NMLS is a powerful tool for state regulators. In 2006, state regulators began developing NMLS as the "back office" for state licensing and supervision of mortgage loan originators (MLOs), allowing state regulators to quickly and efficiently conduct background checks on license applicants, have access to a nationwide database of licensed MLOs and companies, and safely share information with one another. The System also provides for increased efficiency for license applicants and the industry as a whole, as licensees are able to submit their applications through a single, uniform application system.

Congress recognized the benefits of a unified system for mortgage licensing, and as such codified the NMLS into federal law as part of the 2008 Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act). As the System became more ubiquitous and more efficient, the states expanded their use of the System to include licensing a broad range of non-bank financial services industries including money transmitters, consumer finance lenders, check cashers, debt collectors, and payday lenders.

State regulators commend the House for passing H.R. 1480, a commonsense bill that supports state regulators' expanded use of NMLS as a licensing system without the loss of privilege or confidentiality protections provided by state and federal laws, and we encourage swift passage of the bill into law.

As states continue to expand their use of NMLS as a licensing and regulatory system, we continue to seek ways to enhance efficiencies that the System provides for regulators and for regulated entities. One such area is the processing of background checks through NMLS. Many state laws require background checks as part of the licensing process in certain financial services industries. In the case of mortgage loan originators, the SAFE Act enables NMLS to obtain a criminal background history from the Federal Bureau of Investigations in 24 hours, a process that used to take several weeks or months. State regulators would like to bring this same efficiency to licensing in other non-bank financial services industries processed through NMLS.

Accomplishing this goal requires legislation. State regulators began working with Congress last year on a change to the SAFE Act that would explicitly authorize NMLS to process criminal background checks for non-depository licensees beyond MLOs when state law requires such a background check. By authorizing NMLS to receive criminal background data for financial services providers beyond the mortgage industry, this proposal enhances consumer protection, reduces regulatory burden, and ensures state regulators have the tools they need for effective supervision. We hope the Subcommittee and the full Committee will support this effort.

While NMLS focuses on licensing non-bank financial service providers, the System provides increased collaboration between state banking departments, reduces the risk of bad actors continuing financial services operations, and improves the safety and soundness of the financial system as a whole. In short, NMLS provides an added level of assurance to community banks that their business customers and vendors are operating legally, and an added level of assurance to consumers that their financial service providers are subject to regulatory accountability.

The states' work on examiner training, community bank research, cybersecurity awareness and preparedness, and use and expansion of the NMLS all demonstrate state regulators' commitment to seek innovative solutions and methods to provide comprehensive and effective supervision. Financial institutions should be in the business of supporting their communities, and state regulators make every effort possible to create a responsive, dynamic regulatory framework that allows our supervised financial institutions to do just that. We are working to achieve supervision that ensures safety and soundness and consumer protection, while allowing these institutions to serve their customers most effectively and contribute to the success of our local communities, our states, and our nation.

More examples of how state regulators are working to right-size regulations for community banks are included within this testimony's Appendix B. For a comprehensive discussion of states' work in regulatory right-sizing for supervised entities, please refer to "An Incremental Approach to Financial Regulation," [13] and "The Public Benefit of State Financial Services Regulation,"[14] CSBS white papers published in December 2013 and January 2015, respectively.

STATE REGULATORS WORK CLOSELY WITH OUR FEDERAL COUNTERPARTS

State regulators do not work in isolation. One of the key strengths of the dual-banking system is the ability to leverage the specific advantages of state and federal regulatory agencies: while state agencies have the ability to provide flexibility and address specific, localized issues, federal agencies provide a platform through which emerging trends or threats can be addressed on a national scale. This state-federal partnership, known as "cooperative federalism," leverages the strengths of both state and federal regulators.

This cooperative federalism has resulted in strong relationships among state and federal regulators. Cooperative federalism is well-established in banking, as states have worked for decades with the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency

[13] http://www.csbs.org/legislative/testimony/Documents/An%20Incremental%20Approach%20to%20Financial%20Regulation.pdf.
[14] http://www.csbs.org/news/csbswhitepapers/Documents/The%20Public%20Benefit%20of%20State%20Financial%20Services%20Regulation.pdf

(OCC). With both depository and the non-depository institutions, state regulators coordinate with the Consumer Financial Protection Bureau (CFPB).

Cooperative Agreements between State and Federal Regulators

Banking law over the past several decades – including the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal),[15] the Riegle-Neal Amendments Act of 1997 (Riegle-Neal II), and more recently the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[16] – has reflected a robust statutory mandate of coordination and cooperation between state and federal financial regulators. These legal requirements are buttressed and delineated in a series of agreements the states have signed with federal financial regulators.

State/Federal Supervisory Agreements

The 1996 Nationwide State/Federal Supervisory Agreement and accompanying State/Federal Supervisory Protocol[17] established a framework for coordinated examinations and enforcement. The agreement and protocol was signed by all 50 state banking departments, the FDIC, and Federal Reserve Board (FRB or the Board) in 1996. The goals of the agreement are to provide for a seamless supervisory process, to ensure that supervision is flexible and risk-focused, and to minimize regulatory burden and costs for covered institutions. While the nearly 20 year old agreement was developed to respond to the supervisory challenges stemming from interstate branching, the goals and principles that it contains are even more important in today's complex and continuously evolving banking environment.

The 1996 agreement recognizes an institution's consumer compliance functions have a critical impact on its safety and soundness. The agreement provides the required foundation for coordination between the states and the federal agencies on compliance examinations, and represents a spirit of cooperation and coordination that has served the dual-banking system well.

CSBS-CFPB Memorandum of Understanding

In 2011, state regulators, CSBS and the CFPB signed a memorandum of understanding (MOU) establishing a foundation of state and federal coordination on consumer protection supervision of financial service providers.[18] The MOU seeks to regulatory burden while ensuring consumer protection by promoting consistent examination procedures and effective enforcement of state and federal consumer laws. The MOU also provides that state regulators and the CFPB will consult each other regarding the standards, procedures, and practices used by state regulators and the CFPB to conduct compliance examinations.

[15] Section 105 (amending 12 U.S.C. § 1820)
[16] Section 1015 (12 U.S.C. § 5495)
[17] http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide_state_fed_supervisory_agrmnt.pdf.
[18] http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/CFPB%20CSBS%20MOU.pdf.

Based on the MOU, CSBS and the CFPB signed in 2013 a supervisory coordination framework further establishing the process for how state regulators and the CFPB will coordinate supervision of non-depository financial service providers and covered depository institutions with more than $10 billion in assets. Much like the 1996 State/Federal Supervisory Agreement, this framework provides for a coordinated supervisory system for those providers regulated jointly by CFPB and the states.

State regulators are represented in the framework through the State Coordinating Committee (SCC), a body comprised of two representatives from each of the six state financial regulatory associations.[19] The SCC is responsible for acting as a voice of leadership on behalf of state regulators and the state non-depository supervision system, advancing supervisory and regulatory policy among state regulators and their federal counterparts.

State regulators commend Congress for including language in Title X of the Dodd-Frank Act that requires this collaboration with the CFPB. The MOU and framework allow for regulators to implement a flexible, dynamic process that helps achieve efficiency in examination and avoid duplication of time and resources.

State Regulators and the Financial Stability Oversight Council (FSOC)

FSOC was established by the Dodd-Frank Act to identify risks to the financial stability of the United States, to promote market discipline by eliminating expectations that the U.S. government would shield financial institutions from losses in the event of failure, and to respond to emerging threats to the stability of the U.S. financial system.

State regulators commend Congress for requiring that FSOC include as a nonvoting member a state banking supervisor as chosen and designated by their colleagues. Providing state regulators a "seat" at this table has enhanced regulatory coordination and informed state efforts to address potential emerging risks.

For example, the 2014 FSOC Annual Report identified non-bank mortgage servicing as an area requiring heightened risk management and supervisory attention and recommended state regulators work with the CFPB and Federal Housing Finance Agency (FHFA) to establish prudential standards. In response, state regulators, through CSBS, launched the Mortgage Servicing Rights Task Force[20] to evaluate options for prudential regulatory standards for non-bank mortgage servicers.

[19] American Association of Residential Mortgage Regulators (AARMR), CSBS, the Money Transmitter Regulators Association (MTRA), the National Association of Consumer Credit Administrators (NACCA), the North American Collection Agency Regulatory Association (NACARA), and the National Association of State Credit Union Supervisors (NASCUS).

State-Federal Coordination through the Federal Financial Institutions Examination Council

CSBS and state regulators play a major role in the efforts of the Federal Financial Institutions Examination Council (FFIEC or Council). In 2006, the State Liaison Committee (SLC) was added to the Council as a voting member. The SLC was established to incorporate the state supervisory perspective into the FFIEC and to make recommendations to promote uniformity in the supervision of financial institutions at the state and federal level. The SLC includes representatives from CSBS, the American Council of State Savings Supervisors, and the National Association of State Credit Union Supervisors.

Through the FFIEC, state regulators coordinate with their federal counterparts on a whole host of supervisory issues. One example among many is the collaborative work the FFIEC has undertaken in the realm of cybersecurity. Like my Department's work on Corporate Account Takeovers (CATO) and CSBS's outreach to bank executives, the FFIEC is taking proactive steps to mitigate cybersecurity threats in the financial services industry.

In March, the FFIEC provided an overview of its cybersecurity priorities for the remainder of 2015. The planned work includes the development and issuance of a self-assessment tool that financial institutions can use to evaluate their readiness to identify, mitigate and respond to cyber threats. The FFIEC also will enhance their incident analysis, crisis management, training, and policy development and expand their focus on technology service providers' cybersecurity preparedness.

When the FFIEC can rally around an issue like cybersecurity and deliver real value to the industry both in terms of awareness and practical tools to mitigate risk, the entire financial services industry becomes a safer, more effective place to do business.

Economic Growth and Regulatory Paperwork Reduction Act

Another area where the FFIEC is engaging in partnerships to improve the health of the financial industry is through the review of banking regulations mandated by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). State regulators, through our membership on the FFIEC, are committed to using this review as an opportunity to pinpoint regulations that may not be properly suited to the business model of community banks. We are participating in this process through the FFIEC with our federal colleagues at the FDIC, FRB, and OCC.

State regulators are attending and participating in the regional outreach events. State regulators are particularly pleased that there will be an event later this year in Kansas City focused on rural banks. Additionally, the feedback received during the outreach events and through the ongoing comment process will provide important input to the State Liaison Committee and state regulators as a whole as we continue to seek ways to minimize duplicative regulation and to make supervision of state-chartered banks more efficient.

The FFIEC and federal regulatory agencies are contributing significant time and resources to ensure the EGRPRA process is a fruitful endeavor. The federal regulators' commitment to this effort is evidenced by the attendance of Comptroller Curry, Federal Reserve Governor Powell, and FDIC Chairman Gruenberg at EGRPRA outreach meetings throughout the country. Their commitment will help make this a meaningful process of reducing regulatory burden.

While the comment process and outreach events have just begun, they are already yielding meaningful areas for us to consider changes, including burdens associated with the quarterly call report, other regulatory filings, and BSA compliance. The industry is also building a reasonable case for extending the examination cycle for certain institutions. We also greatly appreciate Comptroller Curry's and Governor Powell's comments that there are changes we can start making now before we complete the EGRPRA process.

State regulators are also encouraged by the possibility that Dodd-Frank regulations could be considered as part of the EGRPRA process. It makes sense to review the regulations contained within Dodd-Frank in the same way all other regulations are reviewed. State regulators welcome any steps that can be taken to eliminate inappropriate or unduly burdensome regulation.

Examination Tools

The state banking departments, through CSBS, enjoy a strong partnership with the FDIC and Federal Reserve in the development and use of interagency examination tools. Coordinated supervision depends on consistent processes and uniform tools. Providing uniform technology tools for examinations promotes a consistent, standardized supervisory process across state and federal regulators. This ultimately leads to a more coordinated supervisory approach that is clear, efficient, and concise, thus reducing regulatory burden on the supervised institutions.

AREAS OF IMPROVEMENT FOR STATE-FEDERAL COORDINATION

The examples of successful coordination between state and federal regulators all share one common feature: from the outset, state and federal regulators were regularly engaged with one another, communicating their needs and interests, and considering the best possible outcome based on the input of all involved parties. As I mentioned before, regulatory burden stands the greatest chance of being reduced when all parties work together.

Additionally, while statutory and other requirements are helpful in providing a framework, coordination is most effective when the leadership of state and federal agencies is committed to a culture of cooperation and collaboration. The examples above are occasions where such a culture has succeeded.

With these notions in mind, state regulators feel there are certain areas where state-federal coordination could be improved.

Improving Coordination of Compliance Examinations

The 1996 State/Federal Supervisory Agreement provides the required foundation for coordination between the states and federal regulators on compliance examinations. A growing number of states desire the option to conduct alternating or joint compliance examinations. A coordinated and joint approach to examinations, reports of examination, regulatory actions, and enforcement orders would result in more coordinated and efficient supervision.

State regulators are currently working with the Federal Reserve on how to more effectively coordinate on compliance exams. State regulators value their working relationship with the Federal Reserve and are committed to the collaborative principles outlined in the 1996 Agreement. Coordinated compliance supervision reduces regulatory burden and encourages states to fully participate in this critically important space.

Improving Collaboration and Coordination on Rulemakings

While our agreements with the various federal financial regulators and state regulators' role on the FFIEC provide important avenues for coordination and information sharing, the federal agencies' processes for drafting federal rules does not have any mechanism for state regulators to have a view into rules in progress. As a result, state regulators are left to discover through the federal register rules that impact institutions they charter.

State banking regulators participation in the FSOC has provided us with valuable insight and perspective. CSBS asks for Congress' help in developing a mechanism for providing state regulators with this same insight and perspective when it comes to the development of federal regulations affecting our regulated institutions.

Preserving a Thriving Dual-Banking System

The 1996 State/Federal Supervisory Agreement is just one example of how, for more than 150 years, the United States has gone to great lengths to promote the uniquely American dual-banking system, with national banks chartered and supervised at the federal level and state banks chartered and supervised at the state level. The dual-banking system is a primary example of the government's longstanding intent on U.S. financial diversity, innovation, and dynamism. In addition to state-chartered banks, state regulators license, credential, and supervise a variety of non-depository financial services companies. These state-regulated, non-depository financial services providers add another layer of diversity to the U.S. financial system.

The dual-banking system, and the checks and balances it creates between the federal and state systems, has been foundational to the country's economic success. Historically, national banks brought the benefits of uniformity to the U.S. banking system since they operated under a uniform set of federal standards. On the other hand, state banks operating under local standards contributed flexibility, diversity, and innovation to the U.S. banking system. Time has shown that both sides of the dual-banking system provide benefits to the economy.

As of late, there has been increased interest by some pundits in Washington to consolidate the financial regulatory agencies. Debate about improving the existing regulatory structure is healthy and can result in positive reforms. However, this idea is not new, and this discussion has already occurred several times.[21] In the wake of nearly every recession, pundits have called for the consolidation of supervisory authority and the creation of a behemoth federal regulatory agency. When these plans are actually deliberated, however, policymakers have intentionally declined to consolidate supervision under a single federal regulator. Instead, policymakers have consciously chosen to preserve, and sometimes even enhance, the checks and balances of the dual-banking system.

Recent proposals would charge a newly-created monolithic and unadaptable agency with supervising the most dynamic and diverse financial services industry in the world. The dual-banking system is well-equipped to supervise an innovative financial services industry and should be preserved.

SPECIFIC RECOMMENDATIONS FOR COMMUNITY BANK REGULATORY RIGHT-SIZING

As the effort to address a right-sized regulatory framework has evolved over the last several years, state regulators have worked to identify specific recommendations that we believe would be meaningful for community banks. As state regulators, we believe that finding a right-sized regulatory balance does not necessarily mean fewer regulations, but rather means that regulations are appropriately targeted, properly balanced, and prudently implemented. While I provide individual recommendations for the regulatory issues presented below, the definitional approach to identifying community banks I discussed earlier would provide the foundation to address many of these issues.

Study Risk-Based Capital for Smaller Institutions

The Basel Committee on Banking Supervision designed risk-based capital standards for internationally active banks. These standards are overly complex and inappropriate for community banks and their business model. Indeed, research presented at the Community Banking in the 21st Century Research Conference has shown that a simple leverage requirement would be equally, if not more, effective than risk-based capital requirements for community banks, and would be much less burdensome.[22]

Congress should mandate the U.S. Government Accountability Office (GAO) investigate the value and utility of risk-based capital for smaller institutions. The resulting GAO study should seek to understand how risk weights drive behavior in the volume and type of credit a bank originates, as well as the burden of providing the necessary data for calculating capital ratios.

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[21]Similar suggestions were raised in the Bloomberg-Schumer Report, the Paulson Plan, and the Geithner White Paper.

[22] Moore, R., and M. Seamans. "Capital Regulation at Community Banks: Lessons from 400 Failures." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Capital_Regulation_at_Community_Banks.pdf.

Mortgage Rules Should Better Reflect the Realities of Community Bank Portfolio Lending

Community banks that hold the full risk of default of a loan are fully incented to determine the borrower's repayment ability. Laws and regulations regarding mortgage lending should reflect this reality.

Qualified Mortgage Status for Mortgages Held in Portfolio

State regulators have long supported a flexible approach to underwriting for institutions that retain mortgages in portfolio because interests are inherently aligned between consumers and lenders that retain 100 percent of the risk of default. When the consumer defaults, portfolio lenders are incentivized to work with the borrower to fix the problem.

Yet, a national community bank survey and community bank town hall meetings conducted in conjunction with the 2014 Community Banking in the 21st Century Research Conference point to a problem: while many community banks' existing mortgage businesses are consistent with the Ability-to-Repay (ATR) and Qualified Mortgage (QM) requirements, community bankers report that the regulation is creating an outsized burden.

One solution that would tailor the requirement to the nature of community bank mortgage lending is to grant the QM liability safe harbor to all mortgage loans held in portfolio by a community bank. Congress explored this issue through hearings and CSBS-supported legislation during the 113th Congress. While broader in scope, legislation has been introduced this Congress addressing this issue (H.R. 1210). We encourage this Congress to pursue similar legislation to promote portfolio lending by community banks.

Improving the CFPB's Rural Designation Process

The Dodd-Frank Act's ATR requirement's restrictions on balloon loans and the CFPB's efforts to provide limited relief for balloon loans made by smaller institutions in rural areas illustrate the need for regulatory right-sizing and for a conscious effort to understand and adapt regulation to the community bank business model. When used responsibly, balloon loans are a useful source of credit for borrowers in all areas. Properly underwritten balloon loans are tailored to the needs and circumstances of the borrower, including situations in which the borrower or property is otherwise ineligible for standard mortgage products.

As a regulator, I prefer that lenders and borrowers in my state have flexibility and options when selecting consumer products and mortgages. Since the mortgage is held in portfolio, community banks must work to ensure that the loan terms take into consideration all risks associated with the borrower in order to avoid default.

Community banks retain balloon mortgages in portfolio as a means of offering credit to individuals that do not fit a standard product but nonetheless can meet the monthly mortgage obligation. That is the logic behind the Dodd-Frank Act provision providing balloon loans with QM status if those loans are originated in rural or underserved areas by a small creditor. However, the CFPB's original approach to identifying such areas relied solely on the Department of Agriculture's Urban Influence Codes, producing many illogical and problematic outcomes for community banks.

CSBS raised this concern shortly after the original rule was proposed, and we worked with Congress to develop a petition process for interested parties to seek rural designation. We applaud Congress for its focus on this issue, and we appreciate the CFPB's recent efforts to improve its rural and underserved designation framework by adding rural census blocks as defined by the U.S. Census Bureau. While a welcome step, the CFPB rule still lacks the sufficient flexibility to capture the geographic and demographic diversity of the United States.

More fundamentally, portfolio lending is not a "rural" issue or an "underserved" issue; it is a relationship lending issue for all community banks. Accordingly, we support legislation creating a petition process for CFPB rural designations (H.R. 1259 and S. 871). This legislation passed the House by voice vote in the previous 113th Congress. The 114th Congress passed the bill by an overwhelming bi-partisan vote on April 13, 2015, and we hope this measure can quickly pass the Senate and be signed into law.

Tailor Appraiser Qualifications for 1-4 Family Loans Held in Portfolio

Current appraisal regulations can curtail mortgage lending in markets that lack qualified appraisers or comparable sales. Congress should require regulations to accommodate portfolio loans for owner-occupied 1-4 family loans, recognizing the lender's proximity to the market and the inherent challenge in securing an accurate appraisal by a qualified appraiser.

Fair Lending Supervision Must Acknowledge the Community Bank Business Model

State regulators take the difficulties that many underserved borrowers have had in obtaining access to credit very seriously, especially in regard to mortgage lending and homeownership. State regulators are committed to the enforcement of fair lending laws, but we are concerned about regulators' overreliance on opaque statistical models that use small samples to judge fair lending performance. Many times it is not the statute that creates the problem, but the interpretation, guidance, and the examination techniques utilized. Federal agency leadership must commit to a more pragmatic and transparent approach to fair lending supervision. Specifically, the federal bank regulatory agencies should share their fair lending models and examination methodologies with the industry to provide greater transparency and reduce uncertainty about the process.

Federal regulators should not use one-size-fits-all techniques in fair lending examinations. Smaller institutions make case-by-case lending decisions based on local knowledge. While statistical analysis plays a role in fair lending supervision, it should not be the beginning and end of the analysis. Supervisors must utilize their flexibility to look beyond statistical models to take a more complete view of the lending decision or the result will be the continued standardization and commoditization of consumer credit in this country.

The current approach to fair lending for community banks is having a chilling effect on credit availability as banks become frustrated by the examination process. I am concerned that this approach may be causing community banks to curtail or exit certain consumer credit products. From a public policy perspective, we should want community banks doing this business.

The Application Process for Community Banks Must Reflect the Business Model

Community bank applications submitted to federal banking agencies for transactions such as mergers and capital investments can take an extended time to process because the agencies have to ensure the decision will not establish a precedent that could be exploited by larger institutions. The approval of a merger, acquisition, or expansion of activities should be related to the overall size and complexity of the transaction, and community banks should not be unnecessarily penalized for the potential action of larger financial institutions. Federal law, an agency rule, or a clause in an approval letter could provide the necessary protection by stating that application decisions for community banks do not establish a precedent for systemically important financial institutions.

To further address the length of time the agencies take to review community bank applications, the application review and approval process for a defined subset of community institutions should be de-centralized with more final decision-making authority given to FDIC Regional Offices and the regional Federal Reserve Banks.

Federal Regulatory Agency Leadership and State Supervisory Representation

A key to the success of the dual-banking system is robust coordination among regulators. Meaningful coordination in regulation and supervision means diversity at the highest governance levels at the federal regulatory agencies. The current FDIC Board does not include an individual with state regulatory experience as required by law. The Federal Deposit Insurance (FDI) Act and congressional intent clearly require that the FDIC Board must include an individual who has worked as a state official responsible for bank supervision. As the chartering authority for 77 percent of all banks in the United States, state regulators bring an important regulatory perspective that reflects the realities of local economies and credit markets. State regulators were pleased to see bi-partisan legislation introduced last Congress in the Senate and the House that refined the language of the FDI Act to ensure that Congress' intent is met and that the FDIC Board includes an individual who has worked in state government as a banking regulator. We are again pleased the proposal has been re-introduced this Congress (H.R. 1601).

We also thank Congress for passing legislation requiring community bank or community bank supervisory representation on the Federal Reserve Board of Governors through the Terrorism Risk Insurance Program Reauthorization Act of 2014. Passage of Senator Vitter's provision reinforces Congress' intent to bring together a range of perspectives on the Board, and reaffirms the important role of community banks in the financial marketplace.

Practical Privacy Policy Notice Requirements

State regulators firmly believe that financial institutions have an affirmative and continuing obligation to respect customer privacy. However, there are commonsense practices for communicating privacy policies. If a bank's privacy policy does not change, the bank should not be required to repeatedly inform customers of the policy. Redundant notifications are costly and limit the effectiveness of important privacy communications with customers. Accordingly, CSBS supports any fix to the Gramm-Leach-Bliley Act that exempts financial institutions from mandatory annual privacy policy mailings if the institution's privacy policy does not change. State regulators commend the House for passing H.R. 601, the Eliminate Privacy Notice Confusion Act, a bill that provides such an exemption to financial institutions, and we encourage swift passage of the bill into law. We encourage the Senate to act on this measure.

Improvements to the Call Report

Call Report data is a vital component of effective supervision. Call Report data allows regulators to quickly identify red flags in a single bank's balance financials as well as analyze emerging risks in the greater financial marketplace. While the benefits of this data are clear, so too are the burdens borne by community banks in delivering this data to regulators. It is important that regulators remain mindful of these burdens and work to eliminate unnecessary burden throughout the Call Report.

CSBS supports efforts to reduce regulatory burden associated with Call Report preparation, including the efforts of the FFIEC to evaluate the specific components of the call report. CSBS believes it is important that regulators fully understand the problems presented by community bankers concerning the Call Report at a very granular level, specifically the manual effort required to gather and provide information for certain Call Report schedules.

VIEWS ON SPECIFIC LEGISLATIVE PROPOSALS

The House Financial Services Committee and the Senate Banking Committee, through a series of hearings over multiple Congresses, have thoroughly illustrated how regulation and supervision are negatively impacting the community banking business model. These hearings have built momentum for reform, and several reform items are now pending before the Committee. In addition to those legislative proposals discussed above, this section provides state regulators' perspectives on certain other proposals pending before Congress.

Reforming Exam Procedures

State regulators have heard concerns from community bankers about the examination process. Various legislative proposals have been introduced to reform the exam process.

State regulators, because of our proximity to the institutions we regulate, frequently have a more local understanding and appreciation of the unique characteristics of the institutions we supervise. This local knowledge and decision-making helps inform the state examination process and make it stronger. Moreover, local decision-making expedites many processes and typically leads to quicker return times for exam findings.

State regulators support the OCC model of an Ombudsman who operates outside bank supervision channels and, with the consent of the Comptroller, may supersede OCC decisions or actions during the resolution of an appealable matter. We encourage other federal bank regulators to consider the merits of this model.

Changes to the Exam Cycle

In addition to reforming the exam process, there are proposals to lengthen the exam cycle to 24 months and to raise the threshold for banks eligible for an 18 month exam cycle.

While state regulators are aware of complaints about the federal exam process, complaints tend to center around the nature of the exam rather than the exam cycle. Exams need to be more focused on the risks institutions pose and better tailored to the business model of the institution. State regulators are concerned about our ability to fulfill our responsibilities as regulators of safety and soundness with a lengthier exam cycle. In addition, a 24 month exam cycle would exceed the limit imposed by some states' laws.

Federal law provides for an 18-month exam cycle for banks having $500 million or less in assets that are well capitalized, well managed, has a composite condition ratio of Outstanding, and has no formal enforcement actions.[23] The OCC has testified in support of raising the threshold to $750 million.[24] There is a Congressional proposal to raise the threshold to $1 billion (H.R. 1553). While we have not taken a formal position, raising the threshold to $750 million or $1 billion would be a welcome step. Since institutions of $1 billion or less do not pose the same risks as larger institutions, an 18 month exam cycle is entirely appropriate for these institutions.

MOVING FORWARD

State regulators are uniquely capable of right-sizing regulation for the relationship-lending business model of community banks and leading in the supervision of non-depository financial service providers.

Establishing a new definitional approach for identifying community banks is essential to creating a regulatory framework that supports the community bank relationship lending model. Providing legal authority to state regulators to process criminal background checks through NMLS for all non-depository financial service providers is a necessary step toward creating a dynamic, effective regulatory system that works well for non-depository institutions and their consumers. And, in order for the dual-banking system to maintain its strategic advantages, state and federal regulators must remain committed to a culture of collaboration.

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[23] 12 USC 1820(d)(4).
[24] United States. Cong. Senate. Committee on Banking, Housing and Urban Affairs. *Regulatory Relief for Community Banks and Credit Unions.* Hearings, February 10, 2015. 114th Congress. 1st Session.
3. 15 U.S.C. § 1639c(b)(2)(E)(iv)(I).

CSBS remains prepared to work with members of Congress and our federal counterparts to right-size regulations, ensure effective supervision of non-bank institutions, and promote our common goals of safety and soundness and consumer protection.

Thank you again for the opportunity to testify today, and I look forward to answering any questions you may have.

APPENDIX A

Differing Asset Thresholds for Small Bank Exemptions

- Federal Reserve Small Bank Holding Company (BHC) Policy Statement – Exempts BHCs with assets less than $1 billion from the consolidated BHC capital guidelines and grants them simplified reporting requirements.

- Consumer Financial Protection Bureau (CFPB) Jurisdiction – The CFPB does not have direct supervisory authority over institutions that fall below $10 billion in assets.

- CFPB Small Creditor Definition – Residential mortgage loans are granted Qualified Mortgage status if the bank has less than $2 billion in total assets.

- CFPB Balloon Loan Qualified Mortgages – Residential mortgage loans are granted Qualified Mortgage status if the bank has less than $2 billion in total assets and the institution originates 50 percent or less of its mortgages in rural or underserved areas.

- CFPB Escrow Exemptions – Banks are exempt from escrow requirements if the bank has less than $2 billion in total assets and the institution originates 50 percent or less of its mortgages in rural or underserved areas.

- Treatment of Trust Preferred Securities (TruPS) Under the Collins Amendment – Grandfathers TruPS issued before May 19, 2010 into regulatory capital for BHCs with less than $15 billion in assets.

- Home Mortgage Disclosure Act (HMDA) Reporting Criteria – Banks with less than $44 million in assets are exempt from reporting HMDA data as required under Regulation C.

- Interchange Transaction Fees -- debit card issuers with less than $10 billion in assets are not subject to Dodd-Frank cap on interchange transaction fees.

APPENDIX B

Below are just a few cases in which state regulators have proven to be particularly adept at developing and implementing flexible practices to better serve our smaller institutions and our local constituents. Some of these examples are broad, historic initiatives that have significantly shaped the trajectory of U.S. banking regulation and supervision, such as the joint and coordinated bank examination framework. Other examples provide local snapshots highlighting the flexibility that individual states exercise on a regular basis.

Texas Financial Education Initiatives

The Texas Department of Banking became actively involved in financial education in 2006. Over the years, it has developed tools and helpful material to encourage bankers to get involved in financial literacy. One of the Department's initiatives was to encourage state-chartered banks to start in-school banking programs. By establishing a rule in 2008, similar to federal regulation, a Texas bank is permitted to operate a financial facility in a school without it being deemed a branch. The initiative is named the Center of Monetary Education for Texans, or COMET.

The Department's Financial Education Coordinator (FEC) is active in community outreach activities and participates in a variety of speaking engagements and training events in English and Spanish. One outreach tool utilized to encourage financial education in the community is quarterly webinars. The Department's FEC organizes webinars on a variety of topics, offering resources and guidance to audiences of bankers and professional educators from around the country.

Joint Examinations of Multi-Charter Holding Companies

Joint bank examinations trace their roots back more than two decades, when due to interstate branching restrictions, bank holding companies would often own independently chartered banks in different states. To improve regulatory efficiency, state banking agencies began conducting joint examinations of multi-charter holding companies with other state regulators.

Before the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal), states like Iowa and Indiana were already coordinating with other state banking regulators to conduct joint state examinations for multi-charter holding companies. This approach eliminated regulatory duplication, reduced the regulatory burden on the individual banks and the holding company, and helped the regulators develop a holistic view of the entire holding company. Once Riegle-Neal was passed, states built upon their existing practices in order to coordinate with federal supervisors, crafting examination plans across state and agency lines. In 1996, the states formalized cooperative and coordination agreements, the Nationwide Cooperative Agreement[25] and Nationwide State-Federal Supervisory Agreement,[26] to facilitate

[25] Nationwide Cooperative Agreement (Revised 1997). Available at: http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide_coop_agrmnt.pdf

the supervision of multi-state banks and to define the nature of state-federal supervision. These agreements set up a model centered on the examination team of the holding company or lead institution and, while close to 20 years old, still form the basis for state-federal supervisory interaction. These agreements foster effective coordination and communication among regulators and have led to a supervisory model that reduces burden and enhances responsiveness to local needs and interests in an interstate banking and branching environment.

This process ultimately leads to a more consistent examination experience for these community institutions. Rather than the holding company having to handle numerous examinations throughout the year, regulators conduct coordinated examinations of all the holding company's institutions at the same time, satisfying state and federal supervisory requirements in a streamlined manner.

This is just one of many illustrations of how state regulatory agencies have shown great flexibility and willingness to reduce burden for their state-chartered institutions, all while maintaining the same level of effective oversight.

Central Point of Contact

Many state banking departments follow the practice of assigning a single individual as a central point of contact to specific institutions to conduct ongoing off-site surveillance and monitoring. The off-site portion of this process promotes efficient and effective state supervision, allowing examiners to carry out their work away from the bank, freeing up bankers' time and office space. At the same time, central points of contact also provide banks with a single person to turn to when they have supervisory questions and issues, ensuring a more direct, faster response to their needs.

CSBS Loan Scoping Job Aid

In addition to coordination with the industry to make supervision more efficient, state regulators are increasingly turning to technology to enhance and streamline supervision. In 2012, CSBS published a Loan Scoping Job Aid (job aid) for examiners that encourages state regulators to consider institution-specific criteria that may lead to a smaller, yet more effective, loan review methodology.[27] Loan review is the cornerstone of safety and soundness examinations, providing examiners the best avenue for determining a bank's health. The CSBS job aid provides methods for examiners to improve their loan scope by reviewing a different sample of loans than would otherwise be the case. This more thoughtful, risk-focused, yet surgical approach will help regulators identify new risks and provide community banks with more meaningful and useful examination results.

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[26] Nationwide State/Federal Supervisory Agreement (1996). Available at: http://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide_state_fed_supervisory_agrmnt.pdf

[27] Available at: http://www.csbs.org/regulatory/resources/Pages/JobAids.aspx

Appendix C

Part and parcel of promoting safety and soundness for community banks is ensuring that we have the necessary understanding of the health, opportunities, and challenges facing community banks in the 21st century. As such, state regulators are regularly engaged in several complementary initiatives designed to better inform their understanding of community banks.

I would like to share some of the findings we have gathered through our community bank research conferences from academic research, the national survey of community banks, and our town hall meetings with community banks. I would also like to illustrate how our holistic approach to research can lead to better policy outcomes for community banks.

Academic Research on Community Banks

While there have only been two community bank research conferences thus far, we have already benefitted from valuable data and research findings that show the importance of community banks and the centrality of their relationship lending model. For example, we now know that when a bank fails, the end result is measurable economic underperformance.[28] Research also shows that the closer a business customer is to a community bank, the more likely the start-up borrower is to receive a loan.[29] Community banks also have a key advantage through "social capital," which supports well-informed financial transactions. This so called "social capital" is the basis for relationship lending and exists because community bankers live and work in the same communities that their banks do business. The success of the community bank is tied directly to the success of consumers and businesses in those communities. This is especially true in rural areas, where the community bank relationship lending model results in lower default rates on U.S. Small Business Administration loans than their urban counterparts.[30]

We are also discovering the extent to which governmental policies can impact community banks. For example, research shows that more than 80 percent of community banks have reported a greater than 5 percent increase in compliance costs since the passage of the Dodd-Frank Act.[31] Research has also informed us that the federal banking agencies' appeals processes are seldom used, inconsistent across agencies, and at times dysfunctional.[32] We can also see that macro-prudential regulation can have a meaningful impact on bank behavior, but

[28] Kandrac, J. "Bank Failure, Relationship Lending, and Local Economic Performance." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Kandrac_BankFailure_CBRC2013.pdf.
[29] Lee, Y., and S. Williams. "Do Community Banks Play a Role in New Firms' Access to Credit?" Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Lee_Williams.pdf.
[30] DeYoung, R., et. al. "Small Business Lending and Social Capital: Are Rural Relationship Different?" Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/DGNS_2012_SBA_lending.pdf.
[31] Peirce, H., I. Robinson, and T. Stratmann. "How Are Small Banks Faring Under Dodd-Frank?" Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION3_Peirce_Robinson_Stratmann.pdf
[32] Hill, J. "When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION2_AndersonHill.pdf

that it may also cause unintended consequences.[33] We hope that findings like these will inform policymakers' work designing a right-sized policy framework for community banks.

National Survey of Community Banks

The community banker survey we conduct as part of the research conference provides us with crucial information straight from the industry.[34] For example, bankers have been very vocal about the compliance burdens associated with the new Ability-to-Repay and Qualified Mortgage rules. Our research finds that community banks continue to see residential mortgage lending as a meaningful business opportunity, but have a mixed view of making non-QM loans, with 26 percent of respondents indicating that they would not originate non-QM loans and an additional 33 percent only originating non-QM on an exception basis. Assessing the new ATR and QM mortgage standards against existing loans, 67 percent of bankers identified a low level of non-conformance, suggesting the two rules generally align with existing bank practices.

Community banks have long voiced concerns about increasing regulatory compliance costs, but these costs have been difficult to quantify historically. To encourage additional data and research in this area, the national survey sought to identify how increased compliance costs are realized in community banks' operations. Survey data show that rising compliance costs primarily take the shape of spending additional time on compliance, hiring additional compliance personnel, and increasing reliance on third-party vendors.

The survey also showed us that less than a quarter of respondents plan to add new products and services in the next three years. We must take this as an important red flag. Any industry that is not in a position to innovate while the world around it is innovating has questionable long-term viability.

Community Banker Town Hall Meetings

Community bankers in the town hall meetings were quite clear: the ATR and QM mortgage rules have required banks to make significant operational changes in order to comply. These changes have increased the cost of origination, the cost to the consumer, and have reduced the number of loans a bank can make.

Bankers also indicated that compliance burdens and security concerns are significant headwinds to launching new products and innovation. Similarly, bankers expressed that new regulations have changed how they approach serving their customers, shifting their mentality away from creating flexible products for customers and towards what regulations allow them to do.

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[33] Bassett, W. and W. Marsh. "Assessing Targeted Macroprudential Financial Regulation: The Case of the 2006 Commercial Real Estate Guidance for Banks." Available at: https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2014/SESSION2_Bassett_Marsh.pdf

[34] The survey data is available at: https://www.stlouisfed.org/bank-supervision/2014-community-banking-conference/2014-survey-data.

Holistic Research Leads to Better Policy Outcomes

Looking at these research conference findings together should cause policymakers to ask serious questions about our approach to regulating community banks. In the context of the ATR and QM mortgage rules, if new requirements are generally consistent with most community banks' practices, should implementation of these rules result in increased costs and a reduction in credit availability? When we think about community banking products, should regulatory compliance burdens inhibit community banks from offering innovative products to their customers? These are not outcomes any policymaker should want, and we must be responsive to what the industry and empirical research is telling us.

More importantly, this information can lead policymakers to better policy outcomes, if we let it. We are seeing more clearly the role and value that community banks play in our economies. This should inform and inspire us to not establish broad asset thresholds out of political pressure, but to craft a meaningful regulatory framework for a community banking business model that provides real value and presents limited risk to the financial system.

The 2015 Community Banking in the 21st Century Research Conference will be held this fall at the Federal Reserve Bank of St. Louis. We are pleased that Chair Yellen is planning on attending and addressing the conference. We have already issued a call for research papers and are planning our national survey and town hall events. State regulators have been encouraged by the overwhelming demand for this conference. We have been pleased at the growing response to the call for papers over the past two years and expect the response and interest in the conference to continue to grow.