TESTIMONY OF

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On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"EXAMINING THE STATE OF SMALL DEPOSITORY INSTITUTIONS"

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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INTRODUCTION

Good morning, Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee. My name is Charles Vice, and I serve as the Commissioner of Financial Institutions for the Commonwealth of Kentucky and I am the Immediate Past 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. State banking regulators charter and supervise more than 5,000 insured depository institutions. Additionally, most state banking departments also regulate a variety of non-bank financial service providers, including mortgage lenders, mortgage servicers, and money services businesses. 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 banking and financial regulators and represents its members before Congress and the federal financial regulatory agencies.[1]

In my 25 years as both a federal and state bank regulator, it has become abundantly clear to me that community banks are vital to economic development, job creation, and financial stability. I know this Committee shares my convictions, and I appreciate your efforts to examine the state of our country's community banks and regulatory approaches to smaller institutions.

My testimony today will highlight the importance of community banks and their relationship-based business model, state regulators' vision of a right-sized community bank

[1] www.csbs.org

regulatory framework, and the states' efforts to produce new and enhanced research to promote a better understanding among policymakers about the role of community banks and the impact they have upon our local, state, and national economies and communities. I will also expand upon state and federal regulators' efforts at right-sizing regulation and supervision, and highlight specific ways in which Congress and the federal banking agencies can adopt right-sized policy solutions for community banks.

COMMUNITY BANKS & RELATIONSHIP LENDING ARE ESSENTIAL

The U.S. banking system is incredibly diverse, ranging from small 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, comprised of 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 nearly 93 percent of all U.S. banks as community banks, meaning there are 6,163 community banks embedded in local communities throughout the country.[2] The defining characteristic of a community bank is its relationship-based business model – a business model that relies on the bank's knowledge of its local market, citizens, and economic conditions. Community banks are able to leverage this personal, soft data in a way that large, model-driven banks cannot. This is why community banks have an outsized role in lending to America's small businesses, holding 46 percent of the banking industry's small

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

loans to farms and businesses while only making up 14 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. These relationships allow community bankers 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 the largest financial institutions. Their relationship-based lending business model is a complement to the largest banks' model-driven, economies-of-scale business model. In fact, many consumers, businesses, and farms are not served particularly well by 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]

Simply put, community banks are a vital part of a very 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 problem-solving manner, characteristics that are inherent in the community bank relationship-based business model.

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

STATE REGULATORS' VISION FOR COMMUNITY BANK REGULATION

State regulators charter and supervise banks of all sizes, and we support and encourage banking industry diversity as a central goal of the dual banking system. Just as community banks have a first-hand knowledge of their local communities, we state regulators have an in-depth knowledge of our state-chartered banks and the communities in which they operate. Our local focus and authority provide us with flexibility. The 50+ different state banking agencies are able to serve as laboratories of regulatory and supervisory innovation, developing practical solutions and approaches that fit the needs of their particular states.

We are concerned that one-size-fits-all banking regulations are not differentiating enough between types of banks and are preventing community banks from delivering innovative, flexible services and products to their customers and the markets in our states. Recent regulatory reform efforts have centered on addressing the problems posed by the largest, most systemically important banks, and rightfully so. However, a global megabank and a small community bank are simply not the same.

Statistics on the U.S. banking industry illustrate the immense differences between a typical community bank and global megabank. Nearly 90 percent of the 6,656 U.S. depository institutions have less than $1 billion in total assets. The 5,983 banks falling below this threshold hold less than 9 percent of the banking industry's total assets. On the other hand, there are four U.S. banks with more than $1 trillion each in total assets – J.P. Morgan Chase, Bank of America, Wells Fargo, and Citigroup. These four institutions hold approximately 41 percent of the banking industry's total assets. The average size of a community bank's assets in the United States is $225 million, and employs 54 people on average. The four largest banks, all exceeding

$1 trillion in total assets, average 188,100 employees. You can quickly see that a global megabank and a community bank have very little in common, and regulations designed for the former simply should not be applied to the latter. While there are examples in which laws and regulations have established certain applicability thresholds, this needs to occur more often and the differentiation in approach more meaningful.

Design dictates outcome, and state regulators believe that rules that treat all banks the same, regardless of size and business model, promote further consolidation and will lead to a banking system with very little diversity and innovation. Indeed, I continue to hear from my community banks in Kentucky that regulations are driving flexibility and local problem-solving out of their banking decisions and forcing them into standardized banking products and practices. Community banks rightfully fear that this standardization hurts their communities and customers and runs counter to their time-proven relationship-based lending business model.

Regulators have the responsibility to regulate and supervise our community banks in a manner that recognizes their relationship-based business model. My testimony outlines a regulatory approach that counters one-size-fits-all, an approach that state regulators call right-sized regulation, and how it is particularly well-suited for community banks. This search for right-sized regulation and supervision is a matter that state regulators take very seriously and, as my testimony illustrates, have taken considerable measures to achieve. Based on this Committee's work and the measures taken by both federal and state regulators, I am confident that we as policymakers can undertake this effort to recognize the community bank business model.

Right-sized regulation does not mean less regulation, but rather regulations and supervisory processes that are appropriately designed to accommodate an institution's underlying business model. In the context of community banks, right-sizing requires understanding the business of community banking, tailoring regulations to meet this business model, and utilizing risk-based supervision. Congress and federal regulators have undertaken measures to aid community institutions using each of these elements. These efforts are positive, but must be built upon in a purposeful, comprehensive manner to form an appropriate regulatory framework for community banks that allows them to thrive.

THE NEED FOR ROBUST COMMUNITY BANK RESEARCH

State regulators recognize that designing a right-sized regulatory framework requires us to truly understand 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 largest financial institutions and their impact upon the financial system and the nation. 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.[5] Bringing together state and federal regulators, industry experts, community bankers, and academics, the research conference provides valuable data, statistics, and analyses 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 dialogue between the industry and regulators.

[5] "Community Banking in the 21st Century." Federal Reserve System/CSBS. Available at: https://www.stlouisfed.org/banking/community-banking-conference-2014/

The research conference represents an innovative approach to research. The industry informs many of the themes studied, providing their perspective on issues through a national survey and local town hall meetings. At the same time, academics explore issues raised by the industry 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: this year, 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 2013 conference.

Last year's inaugural conference has already provided us with valuable data and research findings on the importance of community banks and the centrality of their relationship-based lending model. For example, a study presented last year found that community bank failures lead to measurable economic underperformance in local markets.[6] 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.[7] 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

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[6] Kandrac, J. "Bank Failure, Relationship Lending, and Local Economic Performance." Available at: https://www.stlouisfed.org/banking/community-banking-conference/PDF/Kandrac_BankFailure_CBRC2013.pdf

[7] Lee, Y., and S. Williams. "Do Community Banks Play a Role in New Firms' Access to Credit?" Available at: https://www.stlouisfed.org/banking/community-banking-conference/PDF/Lee_williams.pdf

the success of consumers and businesses in those communities. This is especially true in rural areas, where the community bank relationship-based lending model results in lower default rates on U.S. Small Business Administration loans than their urban counterparts.[8]

These highlights provide examples of the value this type of research can provide. Policymakers can have better understanding of the role and value that community banks play in our economy. This should inform and inspire us to not establish broad asset thresholds out of political pressure, but craft meaningful approaches that are consistent with a banking model that we want to exist because of the value community banks bring to the economy and the limited risk they present to the financial system.

The second annual Community Banking in the 21st Century research conference is next week, September 23-24, at the Federal Reserve Bank of St. Louis. While this year's survey results are not yet public, I want to share a few key findings with you today.

Bankers have been very vocal about the compliance burdens associated with the new Ability-to-Repay (ATR) and Qualified Mortgage (QM) rules. Our research finds that community banks continue to see opportunity in residential mortgage lending, 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.

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[8] DeYoung, R., et. al. "Small Business Lending and Social Capital: Are Rural Relationship Different?" Available at: https://www.stlouisfed.org/banking/community-banking-conference/PDF/DGNS_2012_SBA_lending.pdf

However, 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. If a new requirement is generally consistent with most community banks' practices, why does implementation produce increased cost and a reduction in credit availability? This is not an outcome that any of us should want.

It will come as no surprise to hear that community banks have 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 survey seeks to identify how increased compliance costs are realized in the bank's 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 shows less than a quarter of respondents looking to add new products and services in the next three years. This was confirmed in the town hall meetings, where bankers indicated that the compliance burdens and security concerns are significant headwinds to 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. 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.

In addition to the qualitative feedback from the town hall meetings and the survey results, a dozen research papers will be presented next week. This year's lineup of research papers and

speakers will build upon last year's research, and provide some interesting perspectives.[9] For example, one paper set to be discussed looks at the current regulatory burden surrounding community banks, and finds that more than 80 percent of responding banks report a greater than 5 percent increase in compliance costs. Another paper examines the federal banking agencies' appeals processes, finding the processes seldom used, inconsistent across agencies, and at times dysfunctional. The paper recommends establishing an independent authority for appeals that could apply a more rigorous standard of review. Still another paper provides new research on de novo banks. State regulators are concerned by the lack of de novo banks during the economic recovery, and we believe more research is needed to appreciate the role new bank formations play in a vibrant, healthy banking system and to see if there are any regulatory impediments to de novo banking activity. Findings like these are just what policymakers need to inform their work toward designing a right-sized policy framework for community banks.

STATE EFFORTS TO RIGHT-SIZE COMMUNITY BANK REGULATION & SUPERVISION

State regulators have a long history of innovating to improve our regulatory and supervisory processes to better meet the needs of our banks, their customers, and our states. Because of our roles and where we fit in the regulatory framework, state banking departments are able to pilot programs at the local level based on our particular needs. This often leads to innovative practices bubbling up from individual states and expanding into other states. At the same time, each state has the authority to choose what works best in their local context. This regulatory flexibility is a strength of the state banking system. After all, community banks in

[9] The full line-up of papers presented and the conference webcast will be available at: https://www.stlouisfed.org/banking/community-banking-conference-2014/

Kentucky might face localized 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.

I would like to highlight 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. 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. The significance that these are state-based solutions cannot be understated. States have the dexterity to experiment with supervisory processes in ways that the federal government cannot without applying sweeping changes to the entire industry. This is by design and a trademark of our dual-banking system. As states develop these practices, CSBS has developed several vehicles for states to share techniques and best practices with one another, allowing for the speedy deployment of successful models nationwide and maximizing regulatory efficiency.

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[10] and Nationwide State-Federal Supervisory Agreement,[11] to facilitate 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.

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

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

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.

Arkansas Self-Examination Program

A state-specific example of regulatory innovation can be found in the Arkansas Self-Examination Program. The program serves both as an off-site monitoring program and an effective loan review report for bank management. Since its introduction in 1986, the program has created significant regulatory efficiencies and benefits to participating community banks.

When an Arkansas bank volunteers to participate in the Self-Examination Program, it provides the Arkansas State Bank Department with roughly three pages of financial information each month. Arkansas regulators use this information to spot problem areas and trends that may threaten the bank's safety and soundness. In exchange for this data, the Department provides participating institutions with reports that reflect the bank's month-by-month performance, a performance comparison with peer institutions, and early warnings that flag issues of concern.

Both the information provided by the banks and reports generated by the Arkansas State Bank Department remain confidential. While the program is not a replacement for examinations, it is an excellent supplement that benefits the regulator and the bank.

Although the program is optional, the participation rate of Arkansas banks typically exceeds 90 percent. By creating a simple, direct, and valuable tool for community banks, Arkansas regulators can better protect consumers and the marketplace and ensure the continuing success of their financial institutions.

New Examiner 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.[12] 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.

These examples demonstrate the willingness of state regulators to seek innovative solutions and methods to provide comprehensive and effective supervision, while tailoring our efforts to the business models of banks. Banks should be in the business of supporting their

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

communities. We are working to enact supervision that ensures safety and soundness and consumer protection, while allowing state-chartered banks to serve their customers most effectively and contribute to the success of our local communities, our states, and our nation.

RIGHT-SIZED REGULATION IN THE FEDERAL CONTEXT

While some see the industry's regulatory challenges as being about the volume of regulation, state regulators see the issue as the type of regulation and the compatibility between a given regulation and the business model of the regulated entity. State regulators are concerned that regulations seem aimed at removing all risk from community banking. The tendency is to focus on the 489 banks that have failed since the crisis as justification for a more conservative approach overall. However, when you approach regulation and supervision from the perspective of the over 5,000 community banks that did not fail, I believe you come to a more balanced and accommodative approach. The many smaller banks that successfully navigated the financial crisis and continue to operate today have shown their ability to manage the risks of their business. Laws and regulations should recognize this, and regulators, in implementing policies and regulations, need to focus on whether institutions are properly managing and mitigating – not necessarily eliminating – the risks of their business.

FEDERAL EFFORTS AT REGULATORY RIGHT-SIZING

State regulators recognize that our federal counterparts have made some positive and constructive contributions to a right-sized regulatory framework for community banks. However, we must recognize that in some cases, these efforts would not have been necessary had statutes or rules been appropriately designed or applied to community banks in the first place. By and large, the efforts outlined below prove that federal policymakers, both in Congress and at

the federal banking agencies, have the commitment to promote right-sized regulations in additional areas.

The CFPB's Small Creditor QM

The Consumer Financial Protection Bureau's (CFPB) ATR mortgage regulations represent an effort at regulatory right-sizing. Portfolio lending – originating loans with the intent of holding them in portfolio – is an important part of many community banks' mortgage business. Portfolio lenders have an aligned economic interest with the borrower. These banks bear the full risk of default, which incentivizes them to ensure the consumer can afford the loan in the first place.

The CFPB recognized this inherent alignment of interests in creating the Small Creditor QM, a part of the ATR rule which provides smaller lenders with greater flexibility for mortgages made and held in portfolio. This regulatory right-sizing provides benefits to the communities served by these small creditors, as community bank portfolio lenders can continue making loans designed for borrowers who might not fit standardized credit profiles such as small business owners, seasonal workers, the self-employed, and young graduates with short credit histories but otherwise sound financial management.

Tailoring Regulatory Communication to Smaller Institutions

The federal regulatory agencies have made efforts to produce useful and accessible guides for smaller institutions on complex rules. While state regulators question whether overly complex rules should apply to community banks, we acknowledge the agencies have taken important steps in communicating the requirements of such rules.

For example, the ATR and QM statutes in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) resulted in a thorough and complex final rule.[13] To ensure the industry was better informed about this complex final rule, the CFPB undertook a communications campaign designed to ease compliance with the rule for institutions of all sizes. Similarly, the FDIC sought to tailor communications and outreach regarding new Basel III capital rules to community banks, hosting community bank-focused outreach sessions, an on-demand video, a national conference call, and capital estimation tool to solicit meaningful input from community banks.

The Federal Financial Institutions Examination Council

A key ingredient to making regulation responsive is effective regulatory coordination. Congress has created a federal body tasked with doing the type of agency coordination necessary for right-sizing regulation and supervision across the banking industry. The Federal Financial Institutions Examination Council (FFIEC) was established in 1978 "to promote consistency" and "ensure progressive and vigilant supervision."[14] The FFIEC provides all community institution regulators with a forum for right-sizing regulation. Congress originally encouraged state interaction at the FFIEC by mandating that the states participate in FFIEC meetings at least twice a year. Congress subsequently cemented the importance of the state perspective in bank regulation by giving the states a voting seat on the FFIEC in 2006.[15]

State regulator involvement in the FFIEC is conducted through the State Liaison Committee (SLC). Currently, Massachusetts Banking Commissioner David Cotney chairs the

[13] Dodd-Frank Act Sections 1411 and 1412.
[14] 12 U.S.C. § 3301.
[15] P.L. 109-351, Title VII, § 714(a).

SLC. I have also served as a member of the SLC, representing the states on the FFIEC's Task Force on Supervision.

One of the FFIEC's current major projects is the review of banking regulations mandated by the Economic Growth and Regulatory Paperwork Reduction Act.[16] State regulators, through our presence 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 eager to participate in this process with our federal colleagues and look forward to a productive result for right-sized regulations.

Another area of focus for the FFIEC is cybersecurity. State regulators are active participants in the cybersecurity work being done through the FFIEC, and encourage fellow FFIEC members to continue the commitment to raise awareness and strengthen the oversight of cybersecurity readiness for community institutions. States are furthering this effort through a cybersecurity outreach program. The Executive Leadership of Cybersecurity initiative is designed to create awareness and provide tools to bank executives as they navigate the complex security issues facing financial institutions.[17] With the FFIEC as a coordination forum, the states are confident that the collective action between states and federal regulators will be a reliable resource for all parties looking to minimize & mitigate the risks facing financial institutions today.

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[16] 12 U.S.C. § 3311.
[17] http://www.csbs.org/cybersecurity

Automated Exam Tools

State regulators' ability to tailor loan review to the risks facing an institution, as discussed above, is possible because of technology developed by the FDIC. The Examination Tools Suite Automated Loan Examination Review Tool (ETS-ALERT) has been an excellent resource for automated loan examination and review, serving as the backbone for risk scoping that takes a community bank's business model into account. The FDIC, Federal Reserve, and states use this program to review loans during the course of an examination. This program serves as a standardized platform that greatly improves the efficiency of the examination process across the country and reduces regulatory burden.

Dodd-Frank and the Role of State Regulators

State regulators are best positioned to recognize risks building up in their local markets, and they can quickly address these local risks at the state and local level. Congress recognized the importance of state regulators and local intervention in the Dodd-Frank Act by reaffirming the importance of the states in the financial regulatory fabric. Through measures including recalibrating the relationship between the National Bank Act and applicable state law, the intentional requirements for the CFPB to coordinate with state regulators, and the role of state regulators in the Financial Stability Oversight Council, Congress has affirmed the importance of the state regulatory perspective and the local focus and greater flexibility that perspective provides.

Money Remittance Improvement Act

Recognizing the unique approach of state supervisory agencies and the value such an approach can bring to federal partners, the recently-enacted Money Remittances Improvement

Act improves the Financial Crimes Enforcement Network's ability to coordinate with state regulators and leverage state anti-money laundering compliance examinations. We applaud Congress for this simple, direct act that simultaneously allows state regulators to add value to the work of federal regulators as well as reduce the overall regulatory burden on institutions engaging in money remittances.

OPPORTUNITIES FOR POLICYMAKERS TO RIGHT-SIZE COMMUNITY BANK REGULATIONS

Right-sizing regulation is not a one and done undertaking; for state regulators, this concept is in our regulatory DNA and part of our regulatory mission, and we urge our fellow regulators and Congress to pursue this approach at every opportunity. State regulators – individually and collectively, through CSBS – have devoted a great deal of energy to identifying ways to ensure that our financial regulatory system reflects and supports the diversity of the banking system. Through groups such as the CSBS Community Bank Steering Group, we have an ongoing effort to identify ways to meet our responsibilities as regulators in a manner that supports the growth and health of our state and local economies and the community institutions that serve those economies. Accomplishing this requires a focus on right-sizing regulation, throughout the entire policymaking process, from legislation, to regulation, to supervision, and to Congress's ongoing oversight role.

The following represent specific actions that Congress and/or the federal banking agencies can undertake to promote right-sized regulations for community banks.

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 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.[18]

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.

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.

QM for Mortgages Held in Portfolio

When a community bank makes a mortgage and holds that loan in portfolio, the interests of the bank and the borrower are inherently aligned. Yet, the survey and town halls conducted in conjunction with our upcoming Community Bank Research Conference point to a problem: while much of community banks' existing mortgages businesses are consistent with the Ability-to-Repay and Qualified Mortgage requirements, complying with the regulations is not only creating an outsized regulatory burden but also curtailing lending. One solution that would tailor

[18] Moore, R., and M. Seamans. "Capital Regulation at Community Banks: Lessons from 400 Failures." Available at: https://www.stlouisfed.org/banking/community-banking-conference/PDF/Capital_Regulation_at_Community_Banks.pdf

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. To accomplish this, CSBS supports passage of S. 2641 and a similar House measure, H.R. 2673, as an appropriate means of facilitating portfolio lending.

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 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 where the borrower or property is otherwise ineligible for standard mortgage products. Because banks can restructure the terms of a balloon loan more easily than an adjustable rate mortgage, they are able to offer the borrower more options for affordable monthly payments, especially in a rising interest rate environment. 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 product is tailored to take into consideration all risks associated with the credit 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 approach to implementing this provision relies on one analytical framework, the Department of Agriculture's Urban Influence Codes. Unfortunately, this approach produces many illogical outcomes. For example, Nye County, Nevada, is the third-largest county in the United States. Despite containing only 2.42 persons per square mile and its Yucca Mountain once being considered for a nuclear waste repository due to its remoteness, Nye County is not considered rural because it neighbors Clark County, the home of Las Vegas. This is the difficulty of applying one framework to something as inherently localized and granular as evaluating whether an area is "rural."

CSBS has suggested that the CFPB adopt a petition process for interested parties to seek rural designation for counties that do not fit the Urban Influence Code definition – a step that is within the CFPB's current authorities. My fellow state regulators and I were pleased to see Congress take up this issue, with the introduction and House passage of H.R. 2672. We urge the Senate to act on S. 1916, the Senate companion to H.R. 2672.

More fundamentally, portfolio lending is not a "rural" issue or an "underserved" issue, it is a relationship-based lending issue for all community banks. Eliminating the rural or underserved balloon loan limitations for qualified mortgages would effectively expand the CFPB's Small Creditor QM framework to include all loans held in portfolio by community banks. Similarly, removing the rural or underserved requirements from the exception to mandatory escrow requirements for higher-priced loans would make right-sized regulations business model focused, not geographically focused.

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.

Community Bank Fair Lending Supervision Must Acknowledge the Business Model and Be Applied Consistently

State regulators take the difficulties that many underserved borrowers have had in obtaining access to fair credit very seriously, especially in regards to mortgage lending and homeownership. State regulators are committed to enforcing institutions' compliance with the letter and spirit of our fair lending laws, but we are concerned about regulators' overreliance on opaque statistical models that use small samples to judge fair lending performance and inconsistencies in federal regulators' approach to fair lending supervision. 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.

Federal regulators should not use one-size-fits-all techniques and tools on community banks in fair lending examinations. A smaller institution makes case-by-case lending decisions based on local knowledge and local relationships. While statistical analysis plays a role in fair lending supervision, it is not the beginning and end of the analysis. Supervisors must utilize their flexibility to look beyond statistical models to take a more holistic view of the lending decision.

Despite assurances of consistent approaches from "headquarters" to "the field" and of continued collaboration to ensure consistency, state regulators have observed meaningful differences in how the three federal banking agencies treat community banks on fair lending issues and as well as a disconnect within the individual agencies. Federal agency leadership has the responsibility to make sure this is not the case, and they must be accountable for ensuring transparency and consistency.

The current approach to fair lending for community banks is having a chilling effect on credit availability, as banks, frustrated by the examination process, are curtailing or exiting many consumer credit products. From a public policy perspective, we should want community banks doing this business. If there were only 66 banks that had compliance or Community Reinvestment Act problems in 2013,[19] and referrals to the Department of Justice are minimal, why are banks experiencing such in-depth and extensive reviews?

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

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[19] "FDIC Annual Report 2013." FDIC. Available at:
https://www.fdic.gov/about/strategic/report/2013annualreport/AR13section1.pdf

that application decisions for banks below a specified size (perhaps $10 billion) do not establish a precedent for institutions above a certain size threshold.

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

Additionally, the federal agencies need to be open-minded when faced with circumstances that do not fit within predetermined parameters. Most recently in my state of Kentucky, two banks took over two years to gain regulatory approval for a merger despite being affiliates that would clearly benefit from becoming one institution. In this particular situation, I saw that the strengths in one institution addressed the other's weaknesses. Had the federal agency focused on the actual circumstances of each institution and on the merger's positive impact for each institution and the organization as a whole, both institutions – particularly the smaller of the two – could have avoided prolonged burden and the expense that resulted from redundant processes and management.

Federal Regulatory Agencies Leadership Should Include State Supervisory Representation

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.[20] 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

[20] 12 U.S.C. § 1812(a)(1)(C).

chartering authority for more than 76 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. Congress should refine the language of the FDI Act to ensure that Congress's intent is met and that the FDIC Board includes an individual who has worked in state government as a banking regulator.

Similarly, to ensure the Federal Reserve's Board of Governors (the Board) properly exercises its supervisory and regulatory responsibilities, Congress should require that at least one Governor on the Board has demonstrated experience working with or supervising community banks. Last fall, CSBS released a White Paper[21] on the composition of the Board of Governors and an infographic[22] that illustrates the background and experience of the members of the Board of Governors throughout the Board's history. The White Paper highlights two key trends: Congress' continuing efforts to ensure the Board's composition is representative of the country's economic diversity, and the Board's expanding supervisory role. The infographic illustrates the growing trend of naming academics to the Board. In addition to adhering to Congressional intent, ensuring that at least one Governor has demonstrated experience working with or supervising community banks will also help the Federal Reserve as it exercises its monetary policy and lender of last resort functions. Governors with practical community banking and regulatory experience have a unique and tangible perspective on the operation of local economies that will assist the Federal Reserve as it performs these vital functions.

[21] "The Composition of the Federal Reserve Board of Governors." CSBS. Available at: http://www.csbs.org/news/csbswhitepapers/Documents/Final%20CSBS%20White%20Paper%20on%20Federal%20Reserve%20Board%20Composition%20(Oct%2023%202013).pdf

[22] Available at: http://goo.gl/eCKVrS

CSBS was pleased to see that the Senate endorsed this concept by adopting Senator Vitter's amendment to the Terrorism Risk Insurance Act requiring that at least one member of the Board of Governors have community bank supervisory or community banking experience.

MOVING FORWARD

Congress, federal regulators, and state regulators must focus on establishing a new policymaking approach for community banks. We must embrace creativity, innovation, and customized solutions to the problems facing small banks today.

Community banks need a broad, principles-based regulatory framework that effectively complements and supervises their unique relationship-based lending model. Such a framework acknowledges community banks' distinct contribution to thousands of local markets, ensures banking industry diversity, and ultimately promotes economic growth.

Policymakers are capable of right-sizing regulations for these indispensable institutions, but we must act now to ensure their long-term viability. CSBS remains prepared to work with members of Congress and our federal counterparts to build a new right-sized framework for community banks that promotes our common goals of safety and soundness and consumer protection.

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