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REGULATORY LANDSCAPE: BURDENS ON SMALL FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS

OF THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

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TUESDAY, DECEMBER 3, 2013

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building. Hon. David Schweikert [chairman of the subcommittee] presiding.

Present: Representatives Schweikert, Rice, Clarke, and Chu.

Chairman SCHWEIKERT. I have received a request from Mr. Luetkemeyer of Missouri to participate in today's hearing. Without objection, Mr. Luetkemeyer, welcome. And as you all know, Mr. Luetkemeyer has an interesting banking background.

Good morning. The hearing will come to order. I have already struck the gavel.

Complaints with federal regulations create costs for all businesses but those costs are particularly burdensome for small businesses. The burdens are higher because small businesses do not have the capacity, compliance staff, the ability to do regulatory arbitrage as larger organizations do. For the past several years it has been difficult for small businesses and financial institutions. Many have been forced to close their doors or merge with others. And many times larger financial institutions have acquired those. For those institutions that have survived, the regulatory burden have required staff to spend more time on compliance than on helping customers. If this trend continues, banking customers and credit union members will have less choice when it comes to accessing financial services.

Regulations can play an important role in preserving the health of the financial service sector. They can ensure that banks have sufficient resources to protect depositors and customers so they can continue to serve the needs of their communities. However, it is not adding layers of regulation that makes institutions safer. It is smarer regulation that does not arbitrarily add costs without adding benefits.

Today we will hear from a distinguished panel of experts who will discuss the current regulatory burden and tell us what effects these rules are having on their businesses.

And with that I would like to yield to Ms. Chu. Would you like to do the opening statement for the democrats?

When Ms. Clarke shows up we will roll that in.

In a previous life I spent a lot of time on Dodd-Frank, before being moved around on committees, and we have had this great question. I am hoping actually we partially hear this from the panel. How much it is preparing for the new regulatory environments, how much it is actually complying with, how much is it just getting definitions and mechanics, and how much of it is also now coming from rule sets that may be being promulgated through the CFPB? And are the mechanics coming from that sort of a "one size fits all"? So if you are a small regional credit union, is it appropriate to in many ways face some of the same rule sets that a money center financial institution will face?

Why don't we now go into testimony? As all of you know, or hopefully know, you have five minutes each. You will see the clock light up. When you see yellow, just talk faster.

I would like to introduce Ms. Peirce. Our first witness today is Hester Peirce, senior research fellow for the Mercatus Center at George Mason University where she focuses her work on financial regulation. Prior to joining the Mercatus Center, Hester worked for the Senate Banking Housing and Urban Affairs Committee. She also serves as a staff attorney for the Securities Exchange Commission under Paul Atkins and has a law degree from Yale, which we will not hold that against her.

Ms. Peirce, thank you for being here. You have five minutes. Share with the Committee.

STATEMENTS OF HESTER PEIRCE, SENIOR RESEARCH FELLOW, GEORGE MASON UNIVERSITY; LINDA SWEET, PRESIDENT AND CEO, BIG VALLEY FEDERAL CREDIT UNION; B. DOYLE MITCHELL, JR., PRESIDENT AND CEO, INDUSTRIAL BANK; ADAM J. LEVITIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER.

STATEMENT OF HESTER PEIRCE

Ms. PEIRCE. Thank you, Chairman. It is a real honor to be here today. I think this is a very important topic that we are talking about. It is important for all of us to have a financial system that is healthy, dynamic, and that has variety in it. We all benefit from having a range of financial institutions from the smallest ones to the largest ones. They meet different types of consumers and small businesses' and large businesses' needs.

Unfortunately, the regulatory scheme that we are putting in place and that we have been putting in place over a number of years and decades is endangering this variety and we are moving more towards a system where we are going to end up with several very large financial institutions and that is going to leave needs unmet and small businesses and consumers will find it much harder to get their financial needs met. So today what I want to talk about is several ways in which this is happening. First, the regulatory system is just designed with large financial institutions in mind. Second, the regulatory burdens just fall more heavily on small financial institutions. It is much more difficult for them to deal with the regulations coming out. And third, the administrative procedures that are in place for agencies to take consequences of

their actions into consideration, they are just not spending enough time and they are not taking those processes seriously enough.

Small financial institutions serve a very important function in the community. They often serve rural communities and small businesses get a lot of their loans from small financial institutions, so they definitely fill a niche, and they do this through relationship lending, which is getting to know their consumers in the context of the local community and understanding what financial products and services they need.

Unfortunately, the regulatory system is set up to not accommodate that relationship lending well. Instead, it is set up, for example, you can take the new Consumer Bureau, which views financial products and services in a plain vanilla lens, and so for them it is easy if they can deal with a large financial institution that offers standardized products, and they can go in and they can say, okay, these are the terms that we want you to offer those products according to. Well, for a smaller financial institution that is dealing with consumers and small businesses based on their individual facts and circumstances, that standardized model does not work as well. And just more generally, when financial regulators sit down to write regulations, they are thinking of the big, multinational bank. They are not thinking of a small bank down the street from them.

And so what that means is that we end up with regulations that just work better for large institutions. So, for example, when the U.S. regulators go over to Switzerland to write the capital regulations, they are not thinking of small banks. They are thinking of international banks. Then they come back to the U.S., the put the regs out, and they realize, oh, this does not work as well for small financial institutions, and so they make some accommodations, but it is after the fact accommodations.

And then another area is Dodd-Frank created a new system of identifying the biggest and most systemically important financial institutions, and in doing that it is sending the message that the government stands behind these large financial institutions. The smaller financial institutions are left to fend for themselves, so there is definitely now an understanding in the country that there are certain financial institutions that the government is really concerned about making sure that they survive, and that is just not a healthy system.

The other issue with regulation is that just dealing with the mass of regulations that comes down is much more burdensome for a small financial institution that cannot afford to hire an army of consultants and lawyers and does not have a lot of regulatory staff, and so it just becomes much more burdensome for them to sort through regulations and figure out what those regulations mean for them.

And then finally, I will just say that there are administrative processes that regulators can use to make federal rules. One of these is using economic analysis. Unfortunately, financial regulators have shown themselves to be very loathe to use economic analysis to try to figure out what the problem is, to look at different alternatives, and to look at the costs and benefits, and that

would help them to identify unintended consequences of regulations.

So I just want to thank you and just mention in closing that the Mercatus Center has done a survey on small banks, and the message that we are getting is loud and clear that the regulations are really an overwhelming burden for them. Thank you.

Chairman SCHWEIKERT. All right. Thank you, Ms. Peirce.

I would like now to introduce our second witness, Linda Sweet. Ms. Sweet is president and CEO of Big Valley Federal Credit Union located in Sacramento, California. Linda has been with Big Valley for 40 years and president and CEO for 25. Big Valley Federal Credit Union was founded in 1953 and has 56 million in assets. Big Valley serves residents of Gold River, California and employees of Safeway grocery stores, Pepsi, and Automotive Aftermarket Services, Inc. Ms. Sweet is testifying on behalf of the National Association of Federal Credit Unions. Thank you for being here. You have five minutes.

STATEMENT OF LINDA SWEET

Ms. SWEET. Thank you.

Good morning, Chairman Schweikert, Ranking Member Clarke, and members of the Subcommittee. My name is Linda Sweet, and I am testifying this morning on behalf of the National Association of Federal Credit Unions. I serve as president and CEO of the Big Valley Federal Credit Union in Sacramento, California.

NAFCU and the entire credit union community appreciate the opportunity to discuss the regulatory burden credit unions face. The overwhelming tidal wave of new regulations in recent years is having a profound impact on credit unions and their 97 million members. Credit unions are some of the most highly regulated of all financial institutions facing restrictions on who they can serve and their ability to raise capital.

There are many consumer protections already built into the Federal Credit Union Act. This is why during the debate on Wall Street Reform, NAFCU opposed credit unions being included under the Consumer Financial Protection Bureau rulemaking authority. We are still concerned about this today. Unfortunately, while credit unions did not cause the financial crisis and actually helped blunt the crisis by continuing to make loans, they are still firmly within the regulatory reach of the Dodd-Frank Act. The impact of this growing compliance burden is demonstrated in the declining number of credit unions, dropping by more than 800 institutions since 2009. A main reason for this decline is increasing costs and complexity of regulatory compliance. Many smaller institutions simply cannot keep up.

A 2012 NAFCU survey of our members found that 94 percent of respondents had seen their compliance burdens increase since the passage of the Dodd-Frank Act in 2010. A 2013 survey found that over 70 percent of respondents have had noncompliant staff members take on compliance-related duties, thus not serving members.

At my credit union, I have seen our compliance costs skyrocket. These increased costs have resulted in the inability to provide the quality of service our members expect. Now we are often slower to offer services and there are some that we are forced to cut back.

In order to truly comply with a rule, a credit union employee must read the regulation in its entirety, interpret the law and its intent, write or rewrite the credit union's policy and procedures, and identify which supervisor is assigned the responsibility for monitoring, complying, and reporting back to management on the necessary information.

Keep in mind that this is required by each regulation. For most small credit unions, a single employee may be the only handling regulatory compliance. Megabanks have entire teams dedicated to compliance. NAFCU has called on Congress in a five-point plan to provide broad-based regulatory relief to help credit unions of all sizes, especially smaller credit unions like mine. A number of provisions in this plan have been introduced as part of the regulatory relief for Credit Union Act introduced by Representative Gary Miller. We urge the Subcommittee members to support this legislation.

In conclusion, the overwhelming tidal wave of new rules and regulations has hampered the ability of credit unions to serve their members, and relief should be extended to the entire industry.

Thank you for the opportunity to testify today, and I welcome any questions that you may have.

Chairman SCHWEIKERT. Thank you, Ms. Sweet.

Our third witness is Mr. Doyle Mitchell, Jr., president and CEO of Industrial Bank located here in Washington, D.C. It is a pleasure to have you here. I have come across your name in a number of articles.

Industrial Bank was founded by Mr. Mitchell's grandfather in 1934 and is currently the sixth largest African-American owned bank in the country, with 370 million in assets. Mr. Mitchell has worked at Industrial Bank since 1994. Mr. Mitchell is testifying on behalf of the Independent Community Bankers of America. Thank you for joining us today. You have five minutes.

STATEMENT OF B. DOYLE MITCHELL, JR.

Mr. MITCHELL. Thank you, Chairman Schweikert, and good morning. Also, Ranking Member Clarke and members of the Subcommittee.

My name is B. Doyle Mitchell, Jr., and I am president and CEO of Industrial Bank. As you indicated in Washington, D.C., founded in 1934 at the height of the Great Depression by my grandfather. We are the oldest and largest African-American commercial loan bank in the Washington metropolitan area. We employ over 120 individuals, and today I do testify on behalf of 7,000 community banks represented by Independent Committee Bankers of America, so I do thank you for convening this hearing.

In addition to being a member of ICBA, I am also the chairman of the National Bankers Association. That is a trade association for the nation's minority and women-owned banks. There is an important segment of community banks like mine that were founded to serve minority communities in historically underserved areas often ignored by other institutions.

In order to reach their full potential as a catalyst for entrepreneurship, economic growth, and most importantly job creation, community banks must have regulations that are calibrated to our size, our low-risk profile, and our traditional business model. ICBA

has developed its plan for prosperity, a platform of legislative recommendations that will provide meaningful relief for community banks. The plan for prosperity is attached to my written testimony in addition to a list of the 23 bills that have been introduced in the House and the Senate that incorporate plan provisions.

I would like to use this opportunity to highlight the single bill that best captures the full scope of the plan. That is the CLEAR Relief Act, H.R. 1750, introduced by Representative Blaine Luetkemeyer, a former community banker and member of this Committee, as well as the Financial Services Committee. 1750 has almost 90 co-sponsors with strong bipartisan representation. A Senate companion bill has similar bipartisan support. Key provisions of 1750 would provide relief for new mortgage rules that threaten to upend the economics of community bank mortgage lending which we do and drive further industry consolidation. Specifically, 1750 recognizes the overriding incentive of a lender to ensure that loans held in portfolio with full credit exposure are well underwritten and affordable. Under 1750, the community bank loans held in portfolio will be granted qualified mortgage status, or QM as it is called, which shields the lender from heightened liability exposure under the CFPB's new ability to repay rules. If my bank holds a loan in portfolio, it is in our best interest to ensure that the borrower has the ability to repay. Withholding QM status for loans held in portfolio and exposing the lender to litigation risk will not make loans safer, nor will it make underwriting more conservative; it will merely detour community banks from making such loans and curb access to credit.

By the same token, 1750 would exempt community banks, bank loans held in portfolio for new escrow requirements for higher priced mortgages. Again, portfolio lenders have every incentive to protect their collateral by ensuring the borrowers make tax and insurance payments. For low volume lenders in particular, the escrow requirement is expensive and impractical. And again, it will detour lending to borrowers who have no other options.

Another provision of 1750 will raise the threshold for the CFPBs small service exemption from 5,000 to 20,000 loans. Community banks have a strong personalized servicing record and no record of abusive practices. To put the 20,000 threshold in perspective, consider that the five largest servicers have an average portfolio of over 6.8 million loans.

Other provisions of 1750 will provide relief from unworkable new appraisal requirements, Sarbanes-Oxley internal control esthestation, redundant privacy notices and other expensive requirements intended for large, complex banks. 1750 provides strong, clear, legislative response to the threat of mistargeted regulation to the community banking charger without compromising safety and soundness or vital consumer protections.

I encourage you to reach out to the bankers, community bankers in your districts and ask them whether 1750 would help them better serve their community. Your co-sponsorship would be greatly appreciated by community banks and ICBA. Thank you again for the opportunity to testify today.

Chairman SCHWEIKERT. Thank you, Mr. Mitchell. And there is always that request for co-sponsorship, isn't there?

I would actually like to hand the mic over to Ranking Member Clarke to do her opening statement and introduce her witness.

Ms. CLARKE. I thank you, Mr. Chairman, and I thank the members of the panel for being here with us this morning. And I think it is prudent to take a moment to remember why Dodd-Frank was implemented in the first place. For those who might be experiencing selective amnesia, five years ago widespread malfeasance brought our nation to the brink of financial collapse. Were it not for swift congressional action on behalf of the American people, we would be living in a very different American today. And the American people have overwhelmingly supported this action. According to a survey conducted by the Center for Responsible Lending, 83 percent of those surveyed, including 75 percent of republicans, favored tougher regulation for financial institutions. Dodd-Frank has been a lightning rod for critics and supporters alike throughout its debate, and even as it has stood as the law of the land for the past three years.

The Consumer Financial Protection Bureau, the agency whose responsibility it is to protect consumers from unfair, deceptive, and abusive financial products, was created by Title X of Dodd-Frank and remains one of the provisions under the most scrutiny. Since beginning operations, the CFPB has secured more than $750 million for consumers who were subjected to deceptive practices, imposed penalties on companies to deter future activity, and warned others to clean up their deceptive practices. While the CFPB's primary responsibility is to regulate financial products, it is clear that small financial institutions were not the cause—and I repeat, were not the cause—of the recent financial calamity.

Small businesses use these products as well in the form of personal credit cards and home equity loans to finance their businesses. Therefore, it is important that the CFPB balance the need to regulate abusive practices without adversely affecting the credit market for small businesses.

Understanding that small financial institutions were not the cause of the financial crisis, Congress took steps to shield small community banks, merchants, and retailers from the extreme and extra scrutiny by the CFPB. Additionally, the CFPB must conduct small business advisory review panels, becoming only the third agency to be required to do so. These protections were put in place with the small business community in mind and to assure that the engines of our national economy would be able to power us to a full recovery without undue burden. The CFPB is vitally important to improving the integrity of our financial apparatus and it is important that the CFPB ensure its integrity, while ensuring that small business community is allowed to thrive with little interruption.

Today, as we have heard, experts and stakeholders are looking at the state of the CFPB's regulatory activities.

I want to again thank each and every one of you for coming and lending your expertise at today's discussion, and I would like to take this opportunity now to introduce to everyone Professor Levitin.

It is my pleasure to introduce Adam Levitin. Mr. Levitin is a professor at the Georgetown University Law Center in Washington, D.C., where he teaches courses on bankruptcy, commercial law, and

consumer finance. He has previously served as a scholar in residence at the American Bankruptcy Institute and is a special counsel to the Congressional Oversight Panel supervising TARP. Before joining the Georgetown faculty, Professor Levitin practiced law at Weil, Gotshal and Manges, and served as a law clerk for the U.S. Court of Appeals in the Third Circuit. Professor Levitin holds a J.D. from Harvard Law School and degrees from Columbia University and Harvard College. I would like to welcome Professor Levitin.

STATEMENT OF ADAM J. LEVITIN

Mr. LEVITIN. Good morning, Chairman Schweikert, Ranking Member Clarke, members of the Committee, and Representative Luetkemeyer. Thank you for inviting me to testify today. I want to emphasize that I am testifying today solely as an academic, not as a member of the Consumer Financial Protection Bureau's Consumer Advisory Board or on behalf of the CFPB.

There have been lots of new financial regulations since 2008, and not all of it is perfect, but a lot of it, much of it was long overdue, especially for mortgages, credit cards, and bank capital regulation. The implementation of this new regulation is still in process, and I think that makes it really too early to judge the regulation at this point. That said, I think it is possible to offer some early observations.

First, there obviously are some compliance costs with new regulation, and these costs are going to be harder for small businesses to amortize over their operations than for large banks. But it is important that we remember to weigh the compliance costs against regulatory benefits, and those benefits include more transparent and efficient markets, and more transparent and efficient markets can result in cheaper capital for small businesses of all sorts and for greater spending power for consumers who are the customers of small businesses.

It is also hard to see the new regulations materially affecting the competitive landscape. We hear quite a bit about increased compliance costs for small businesses and small financial institutions, and I do not doubt that for a second, but I would note that we have no hard data about the actual extent of the changes and compliance costs. And I think that is an important thing that we would want to know before proceeding with any changes in regulation, particularly because some of the regulations actually help level the playing field between large institutions and small institutions. Right now, large financial institutions have a major advantage in the financial services marketplace. In part, this is because they have this too big to fail benefit that they are understood as being guaranteed implicitly by the United States Government, and I do not think that is a function of Dodd-Frank in any way; that is a function that neither this Congress nor any other Congress is every going to let the financial system collapse. This is just a reality we have to work with.

But we can try and level the playing field between small institutions and large institutions. And some of the recent regulations actually have that effect. The recent regulations, like the Credit Card Act, Dodd-Frank Act, and the new capital requirements under

Basel III, they actually put most of the burden on big banks. And this makes sense because while we have around 14,000 depositories and credit unions in the United States, most of the assets in the financial services space are controlled by about 100 banks. So we have lots of very, very small financial institutions but most of the action is happening with large banks. The small banks play a very important role in their communities, particularly with sources of small business credit, but it is important not to lose sight of the big picture on them.

So let me just take you through the impact of a few of the recent regulations.

The Credit Card Act of 2009. Well, 85 percent of credit cards are issued by 10 banks. Most banks do not issue credit cards. Only about half of credit unions issue credit cards of any sort. So most of the regulatory burden of the Credit Card Act is falling on a very small number of banks.

The Durbin Amendment to the Dodd-Frank Act, dealing with interchange fees on debit cards only applies to—the key provision of the Durbin Amendment only applies to banks with over 10 billion in assets at the holding company level. That is just over 100 banks. Most banks are not subject to the key provision of the Durbin Amendment.

The Consumer Financial Protection Bureau has examination authority only over the largest banks in the country, only over about 100 banks. Again, banks with over 10 billion in assets. Smaller financial institutions, be they banks or community banks or credit unions, continue to be examined by their regular prudential examiners.

And the CFPB has actually been very solicitous about taking care of small banks and understanding that there are special concerns there. So, for example, the qualified mortgage rulemaking creates a safe harbor to the Dodd-Frank ability to repay rule. It has several carve-outs for smaller financial institutions, and the result of this is that at least in the current market, about 95 percent of mortgages that are being made today would comply with the QM requirement. Similarly, the Basel III capital requirements, 95 percent of financial institutions already apply with those according to the FDIC. So all in all, I think it is too early to judge the effect of recent financial regulatory reforms, but at least at first glance I think there is good reason to think that the costs do not outweigh the benefits and I think we should wait and see until we have more information before trying to change the regulatory scheme that we have in place now. Thank you.

Chairman SCHWEIKERT. Thank you, Professor.

I am going to actually go to Mr. Rice first, then back to the ranking member because I have a whole diatribe of questions. So, Mr. Rice, five minutes.

Mr. RICE. Let me get my glasses here.

Professor Levitin, does Dodd-Frank solve the problem that caused the financial collapse?

Mr. LEVITIN. I am not sure we would agree on what the problem is. I think there are kind of two problems that are key, and I think Dodd-Frank goes a long way to addressing them but maybe does not do everything. The two key problems were one, just too

much leverage in the financial system as a whole; and secondly, the spark, that is the powder keg, and then the spark that lit it was with mortgages.

Dodd-Frank, I think, solves the mortgage problem. The ability to repay requirement in Title XIV of Dodd-Frank means that we really should not see mortgages as a systemic problem in the future.

Mr. RICE. When does that take effect?

Mr. LEVITIN. That takes effect in January 2014, I believe is the effective date. I think January 22nd maybe.

Mr. RICE. Yeah.

Mr. Mitchell, that requirement that he is speaking of, this mortgage requirement where all mortgages are under this microscope, how is that going to affect your lending practices?

Mr. MITCHELL. Actually, it will probably decrease. It will decrease the amount of mortgages that we will make. We hold some mortgages in portfolio. It takes away a lot of flexibility of mortgage banks to look at individual circumstances, and we have to strictly standardize. If you have a 44 percent debt-to-income ratio and not a 43 percent debt-to-income ratio, then we will not make the loan. And there will be a lot of people that will not get home mortgage financing.

Mr. RICE. Okay. So you are saying that a loan that you would have made prior to this new regulation taking into effect you will no longer make?

Mr. MITCHELL. Quite a few. Yes.

Mr. RICE. And what people, what borrowers are affected by that? Is this the wealthy people that are affected by that or is this the middle income people?

Mr. MITCHELL. No, sir. No, sir. It is probably lower middle income and low and moderate income individuals.

Mr. RICE. So what you are doing is you are preventing access to capital to lower and middle income people?

Mr. MITCHELL. There is no question about it. And the end effect is that it will have a negative effect on the rebounding housing market itself.

Mr. RICE. How is Dodd-Frank going to affect your business lending?

Mr. MITCHELL. Well, you know, Dodd-Frank, all in all, has added quite a few costs to our bank, particularly in man-hours. We have not had necessarily to hire more individuals, although you do spend more money on consultants to help you decipher all the new regulations. But the man-hours have gone through the roof. And that is a lot of time not spent with our clients—our small business clients and our retail clients.

Mr. RICE. Ms. Sweet, I want to ask you the same questions I asked him.

This new mortgage requirement, how is this going to affect your day-to-day lending?

Ms. SWEET. It is the same as what he is speaking of. We have done mortgages for probably 25 years. Our membership is used to us where we know them, we are able to provide all of those loans and services to them. Under this new rule we are going to be passing most of our loans to a third party. We have started doing that and the feedback that we are getting is why can we not stay with

you? Our fees were much lower on our last home loan and we do not have the loan with you any longer. That becomes an issue for us. It is a difficult situation to put our membership in. To put the consumer into another mortgage lender is very difficult.

Mr. RICE. Did you portfolio lend? Did you keep loans?

Ms. SWEET. We did.

Mr. RICE. Did you keep that more for the higher income people or more for the lower income people?

Ms. SWEET. I would say a little of both. We have sold loans about 10 years ago but we portfolioed most of them. Under the new act it is difficult because the debt-to-income ratio, we were very much able to look at the member individually. Under this, the set of rules are very specific.

Mr. RICE. Okay. Is this going to hurt more people borrowing if they are high income people or low income people?

Ms. SWEET. If they are low income people.

Mr. RICE. So there is going to be more competition for the high income, high net worth borrower and the low income people are going to be shot out by this law?

Ms. SWEET. Yes. In fact, as a good example, we could have done a mortgage loan around $350,000 mortgage loan, and in California that is reasonable for about $2,500 in fees and costs. And that included everything.

Mr. RICE. I am confused. I thought we were trying to protect the middle class here.

Thank you very much, Ms. Sweet. My time has expired.

Chairman SCHWEIKERT. Thank you, Mr. Rice.

Ranking Member Clarke.

Ms. CLARKE. Thank you, Mr. Chairman. I would like to yield to Ms. Chu at this time.

Chairman SCHWEIKERT. Ms. Chu.

Ms. CHU. Thank you so much.

The Consumer Financial Protection Bureau is one of the few agencies that is required to conduct small business review panels, and so Professor Levitin, in your testimony you stated that CFPB's outreach to smaller financial institutions is particularly important. How did CFPB engage with the small entities as it was formulating these new mortgage disclosure regulations?

Mr. LEVITIN. Well, I want to emphasize I am speaking on only my own behalf. I do not know the full extent of the Agency's contact with small institutions, but what I have seen when the CFPB has advisory board meetings in various locations, top CFPB staff attends these meetings and they make a point when they are in places like Jackson, Mississippi or St. Louis, Missouri, to go and meet with the local bankers on their own time. They make a point that they are going to have breakfast with the community bankers and the credit unions in that area and talk face-to-face. The officers of these financial institutions with the very top leadership of the CFPB, not intermediated by any trade associations, and find out what are their concerns. And they are listening to them, that when they come back from these meetings and they are talking with the advisory board, it is very clear that they have been listening and they want to understand what the concerns are of small financial institutions. It is not that they are going to agree with them at

every point, but they are going to listen to them. And the CFPBs see small financial institutions as really being very important within the U.S. financial system.

Ms. CHU. In fact, let us talk specifically about the qualified mortgage rule that was made earlier this year. The CFPBs created four different pathways for a mortgage to quality to gain this QM status. Can you talk about these four pathways, including the small creditor definition and how they result in a broad qualified mortgage definition? Was the CFPB required to create a small creditor definition?

Mr. LEVITIN. Absolutely not. The CFPB was directed by Congress on a fixed time table to adopt regulations implementing the statutory ability to repay requirement. The CFPB in its implementing regulation, this QM regulation, included a safe harbor for small financial institutions that have no more than $2 billion of assets—and that is actually not that small of an institution—and originate no more than 500 first lien mortgage loans in a year. There is also now, more recently this October, the CFPB added another exception, a time limited exception for balloon mortgages that applies to I believe—I cannot remember the exact scope of who it applies to, but it is for smaller financial institutions on a broader definition, giving them two years more transition time for balloon mortgages.

Ms. CHU. In fact, the Bureau estimates that more than 95 percent of the mortgage loans being made in the current market will be qualified mortgages. What is your opinion about how the market will react given that 95 percent of mortgages would be considered qualified mortgages as of January 2014?

Mr. LEVITIN. I think that there has been a lot of unnecessary panic in the market about QM. As you stated, in both the Bureau's estimate and private estimates, such as Mark Zandi of Economy.com, who was one of Senator McCain's campaign advisors in 2008, they estimate that 95 percent of mortgages being originated today would qualify as QM. If that is correct, I do not think that we are going to see very much of a change in the availability of credit in the market. And let me emphasize, it is possible to make a mortgage loan that is not QM. It is not illegal. Actually, the penalty for having a non-QM loan is very, very limited. It creates a limited defense in a foreclosure. It is not a defense to foreclosure, so it creates a set-off right in foreclosure and it is a set-off right that may actually only be for about $1,000, depending on how one interprets the statute. It may also include legal fees.

Ms. CHU. A moment ago you referred to this two-year transition for balloon loans to gain qualified mortgage status. Was the CFPB required to put in place this two-year transition period?

Mr. LEVITIN. No. This was something the CFPB did on its own volition because the CFPB was concerned about the effect of the ability to repay requirement on small financial institutions. It has not given small financial institutions everything that they have wanted, but the CFPB has really been thinking about the needs of small financial institutions and trying to be accommodating to small financial institutions while still being faithful to its legal duty to implement the statute as Congress wrote it.

Ms. CHU. Okay, thank you. I see my time has come back and I yield back.

Chairman SCHWEIKERT. Thank you, Ms. Chu.

Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

It is kind of interesting. This morning in the Wall Street Journal, the story below the fold, tally of U.S. banks sinks to record low. And it is a great article that talks about a number of small banks that have gone down now to below 7,000 in this country. It talks about the one bank in the last three years that has actually had a new charter; otherwise, all new charters are basically stopped as a result of—in this article it talks about the regulatory burden that a lot of small institutions are facing. One example was United Southern Bank of Kentucky that had to hire 15 different people while basically maintaining its same size just to be able to comply with the extra cost. As a result of that it is interesting to hear some of the comments this morning.

Mr. Mitchell, I appreciate you being here. I missed some of your testimony. Also, you mentioned the FDIC study that came out last fall, and that study talked about banks under 100 million probably would not be able to survive any longer because of the increased cost and being unable to spread it out. I think Mr. Levitin and Ms. Sweet, Ms. Peirce, all made that comment, unable to spread those costs out over a smaller amount of people.

So can you talk just a little bit this morning about the amount of costs? You mentioned a while ago you did not hire any people, but you did have a percentage of cost, the number of hours that it cost you to comply?

Mr. MITCHELL. Well, let me first of all say that $360, $370 million in total assets, I am having a lot of conversations with a number of my peers that are also feeling that at our size we may be too small to survive. And so there is a lot of merger and acquisition conversation going on among institutions our size, not just at the $100 million and lower thresholds.

Our cost is probably measured in man-hours, and I do not have exact figures in that. I do know it is over 200 man-hours that we have spent probably this year, additional man-hours on compliance and coming up to speed with new compliance regulations and so forth. And we do not rely just on ourselves; we rely on consultants and so forth. So the pressure on revenues in projecting for next year and the increase in man-hours just takes away an inordinate amount of time from what we would really like to be doing.

Mr. LUETKEMEYER. You know, the title of the hearing today is "Regulatory landscape: burdens on small financial institutions." There has been some discussion already about the QM situation, but something has not been discussed about that yet and that is the liability exposure that if you make the loan or if you do not make the loan—I know that Mr. Levitin made the comment a while ago that 95 percent of the loans that are processed are going to be made. In the Financial Services Committee, a couple months ago, that number was 50 percent of the loans were being made. And I think that is probably closer if you talk to the small banks of this country about the effect of QM and what it is going to be because not only because of the rules and the way it is structured, but be-

cause of the liability exposure. Will you make or will you not make that loan? Can you talk a little bit about the lateral exposure that you look at and that you see with the QM situation and making loans?

Mr. MITCHELL. Most community banks, until they are absolutely sure, and that takes a team of lawyers to be able to tell you as far as certainty what your liability exposure is going to be, are not going to make those loans until we are absolutely certain exactly what the exposure is. We would just tend to stay away from it. That is why it makes sense to extend the review period before it is implemented so everybody can understand exactly what it is. I question that 95 percent of the loans are going to be made, and in particular, we serve underserved markets, and I can assure you that number is going to be much lower in underserved markets.

Mr. LUETKEMEYER. Well, again, that number was given in testimony in the Financial Services Committee a couple months ago, so it is not my number; it is somebody else's number.

Mr. MITCHELL. Yes.

Mr. LUETKEMEYER. From the Committee.

So just a quick comment with regards to—I know you are a small business with 370 employees.

Mr. MITCHELL. One twenty.

Mr. LUETKEMEYER. One twenty, excuse me, 120. You have $370 billion in assets. There we go.

Healthcare plan. Obamacare is still a concern, even for you. What are you doing to implement that? How is that costing out your program?

Mr. MITCHELL. Well, from what I was told by the HR department, it does not affect us right now. I think we are over the threshold of number of employees limit.

Mr. LUETKEMEYER. Okay. You have your own. Are you self-insured?

Mr. MITCHELL. No, we are not self-insured but we do offer healthcare benefits to our employees.

Mr. LUETKEMEYER. Okay, all right. Well, I have some other questions with regards to that. I think it is important to understand that you are dealing with an environment with which you are not the problem. As a small business, as a small bank, you are not systemically important. Although you are important to the community that you are in, you are not systemically important from the standpoint that the overall financial risk to the whole system, yet you are now a part of the solution which you fall under these rules and regulations. And so it is frustrating for me to see that the CFPB is making some rules and regulations.

I had a group of bankers come to my office about a month or two ago and they had been to CFPB to talk about rules and regulations, and the CFPB told them they were the 42nd group to be there to complain about these rules and regulations, and yet nothing is being done and they are not listened to. So it is disappointing to hear that from them. Hopefully, CFPB will get on board.

I appreciate your testimony this morning. Thank you very much. I yield back.

Chairman SCHWEIKERT. Thank you, Mr. Luetkemeyer.

Ranking Member Clarke.

Ms. CLARKE. Thank you, Mr. Chairman.

Mr. Mitchell, as I stated in my opening statement, Dodd-Frank was necessary because we came to the verge of a complete economic collapse three years ago. That said, very few things in this world are perfect, especially legislation. There are always unintended consequences, including federal regulations upon introduction. However, federal regulations can be tweaked and improved to adjust for these imperfections.

What would you recommend as a perfecting tweak, and if there was a potential small business institution carve-out, what would you suggest? Or is it your opinion that we should return to the deregulated era that caused the financial collapse?

Mr. MITCHELL. Well, I think we are on the same page in many respects. However, I have been in the banking industry since 1984. I have been president for 20 years. And even before Dodd-Frank, you had bankers in our industry complaining that there was already too much regulation, particularly on community banks. While Dodd-Frank may have been targeted towards large banks, it actually applies to all of us. And that is the difficulty and the frustration the community banks and particularly minority banks share.

My tweak would be that community banks should be exempt from Dodd-Frank overall. In particular, if there is another opportunity, then I think H.R. 1750 is a great start.

Ms. CLARKE. Let me open that question to the rest of the panel and get your take on it. Professor Levitin, Ms. Sweet, Ms. Peirce.

Mr. LEVITIN. Again, I think it is a little too early to tell, and I agree with you. We cannot assume that legislation is perfect but the implementing regulations for Dodd-Frank, many of them have not even gone into effect yet. It is just too early to tell what the effects are going to be. I want to address in particular that 50 percent number that Mr. Luetkemeyer cited. That comes out of core logic and they were basing that on 2011 mortgage origination activity. A lot of that activity in 2011 would not have qualified for QM because it was streamlined refinancing. In other words, without full documentation. That is a cheap thing, a relatively cheap thing to fix. It was not about debt-to-income ratios. If you carve out even in 2011 the streamlined refinancing, you get up to around 75 percent of 2011. The market has shifted again and the 95 percent number is based on what is going on in 2012–2013, but I think again it is just too early to be stepping away from regulatory implementations that we do not even know what their effect is.

Ms. CLARKE. Ms. Sweet, do you agree that it is too early to step away and we do not know what the effect would be particularly for small institutions?

Ms. SWEET. I think we have already felt an enormous amount of effect from the regulation. And I do not think it is too soon to tell. We also do not have the funds, the resources, the budget to make sure whether we comply with the regulation or not, so it takes an enormous amount of my time away from our members, especially the ones that are underserved, the ones who are confused and scared and need me. Often, I am behind closed doors trying to read piles of regulations to see if, in fact, we are exempt or if we are not, what is necessary to comply with that regulation. The cost

also that we do hire consultants for these regulations, it is impossible to know specifically all the answers once I read them. We hire attorneys for their opinions, and who is hurt is our members. And I know that was the reason for the regulation, was to protect. I do understand why many of these regulations were put into place, to protect the underserved or protect the person who has no idea and they are signing contracts they do not know what they are doing. And it is very important to have those regulations. However, when you see an organization such as credit unions that have never had those kinds of problems, it just seems so unnecessary to spend that kind of money and put it toward the regulation when it could be put toward the minority groups, to the underserved, to the immigration groups that are in California.

And I can give you an example. Just a few weeks ago, and I believe part of the underserved, is the senior citizens. They are afraid are they going to lose their medical care? Is their social security going to be decreased? Can they survive? And often they have one of their family members that are ill that they are trying to deal with an enormous amount of problems. I see that they do need us as an entity that they have trusted for 40, 50 years.

And as I said, a few weeks ago, a lady came into our office saying, "I have one of your members. I have driven her here. She needs your help. Someone took all of her money." My staff went to the car, pulled me up a history of the account, and in six months her whole account had been drained. I looked through that history and found through an investigation that she put her granddaughter on with the agreement that her granddaughter would drive her car to help her to doctors' appointments, use her ATM card for doctor appointment costs, and for food. Her granddaughter took all of that. The car. We saw hotel bills, pizza parlors, an excessive amount of costs, $11,000 was drained from her account and she was on social security. Had I not had the time to spend with her in the car, this could not have been even noticed. And that is a bit of the underserved. It is not just a minority group. It is often seniors who have nowhere else to turn. And luckily, the end of that story is we turned it over to the Elder Financial Abuse Department. They found the car. We closed the ATM card and we have helped the woman to a positive result.

Ms. CLARKE. Ms. Peirce, did you want to add anything to what has been said?

Ms. PEIRCE. I think that Ms. Sweet and Mr. Mitchell tell the story very powerfully, but I do think that we should reopen Dodd-Frank, because while the intentions were good, the philosophy behind it is bad. It is taking away lending decisions from local institutions that know their customers and giving it to folks at the CFPB whose intentions are good but who do not know the circumstances on the ground.

Ms. CLARKE. Thank you.

Mr. Chairman, I want to ask just one more question.

Professor Levitin, considering the hundreds of smaller banks that have failed since the near collapse five years ago, do you believe that Basel III capital requirements are sufficient to prevent future failures and help shore up vulnerable institutions?

Mr. LEVITIN. Basel III is a mess. I think that is the polite way to address it. It is overly complicated. It is still gameable. And I think the critical problem with Basel III is it just basically does not get capital levels high enough. It is very complicated to implement and yet in the end the capital levels really do not go high enough under Basel III. So I do not think Basel III really makes our financial system that much stronger.

I would note though that we have lots of smaller financial institutions failing well before any of the current regulations when in place. We have an incremental change but there is a fundamental problem in the economics of smaller financial institutions which is they do not have the economies of scale necessary to compete in a lot of areas with larger financial institutions, particularly credit cards. That is just an economy of scale business. You cannot compete if you are small. And it is easy to point the finger at regulations as being the problem, but regulations are really not the key problem. The key problem is one of the economic model. And we like to celebrate that we have lots of small financial institutions in the United States, but it is also notable that no other country has anywhere close to 14,000 financial institutions. Even 1,000 would be a huge number for any other country.

Ms. CLARKE. Thank you, Mr. Chairman. I yield back.

Chairman SCHWEIKERT. Thank you, Ms. Clarke.

Ms. CLARKE. And I thank our panelists.

Chairman SCHWEIKERT. A handful of questions for myself.

Mr. Luetkemeyer, I would actually like to put this article from last night's Wall Street Journal into the record just sort of as a benchmark for discussion.

So without objections, it is placed for the record.

I would like to do actually a handful of quick discussions and make sure I am doing some follow up here.

Ms. Sweet, you had started to discuss your credit union and your history of actually doing home loans, home mortgage loans.

Ms. SWEET. Yes.

Chairman SCHWEIKERT. So first, you are in California, so it would be first deeds of trust?

Ms. SWEET. It would be. Or second mortgages and home equity lines of credit.

Chairman SCHWEIKERT. Now, your cost structure, because a lot of your historic population for your credit union where grocery store workers. If it were a couple years ago, I walk in and I am going to get my $350,000 loan, which for those of us in Arizona seems appallingly high, but you are in California. What was my cost of that loan and what happens to me today if I walk in today and ask for that same loan? What is my cost?

Ms. SWEET. A couple of years ago that probably would have cost you around $2,500 and that would have covered your appraisal, your title search, credit report, and all the fees, all the hard costs that go into that loan. Today that is going to cost our members about $6,000 to $6,200. Many of our members are not getting those loans. Also, the qualifications, some of them do not comply with the regulations and the mortgage companies or the banks, they are very tight. They are very set within their standards, and the cost

of that loan is just astronomical for these people, our members who cannot afford that. So most of them have decided to rent.

Chairman SCHWEIKERT. And just to make sure, give me what would be an average, or typical demographic of your clients, your customers, actually your members because as a credit union, who would that be? Who are you serving on that loan?

Ms. SWEET. As far as their positions, most of our members have been there for many, many years. So you have the elderly. We know their children, their children's children, and they may have started out to be either family members of or worked for Safeway either as a checker, a bagger, in the Milk department, unionized workers often. And the demographics now I see a huge portion, maybe it is the baby boomers, a huge portion of senior citizens. We are also seeing a very large portion of minorities, California being very close to Mexico. We have a great deal of Hispanic groups. We would like to serve that group more and their needs are being underserved. It is very costly and the remittance rule is one of the things that we were going to and we are ready to implement, and we are very happy to implement.

Chairman SCHWEIKERT. And none of us has actually spoken of some of those costs of the mechanics of, as you refer to it, the remittances rule, which is a function of Dodd-Frank and what that is doing. And that may be a whole another discussion and a whole another hearing.

Professor Levitin, first off, you get a gold star from me on your comments about Basel III. I tried to become an expert on Basel 2-½ and Basel III and partially coming from sort of a financial world, I can find places where I can run a freight train through it. I wanted to touch two things. One, part of your testimony is we do not actually have enough data of actual experience of regulatory environment affecting small institutions, fully enforced to truly understand them. Am I treating that fairly?

Mr. LEVITIN. I think so.

Chairman SCHWEIKERT. Second of all, on your QM comment, my concern is that we have passing information. Mr. Mitchell's institution can do a non-QM loan if he keeps it on his books, but if he needs to manage certain capital calls, where is the secondary market for a non-QM loan? Where does he take those packages of loans and sell them today?

Mr. LEVITIN. It is not clear. Well, right now we just do not know because QM is not in place, but at this point it does not appear that there is a secondary market for non-QM loans. That may change.

Chairman SCHWEIKERT. So one of our solutions here is on the positive side is do we have to come back and rebuild a more robust, private secondary market to package inquire? Because right now it would almost be a level of misfeasance if Mr. Mitchell's institution produces those loans, puts them on the books.

Mr. LEVITIN. He can get stuck in a liquidity bind very easily. And certainly, there is the whole related issue of GSE reform. I am happy——

Chairman SCHWEIKERT. God forbid we go there because we will spend all day.

Mr. LEVITIN. I am happy to talk at length about that. I have another testimony but it is not an easy issue.

Chairman SCHWEIKERT. Thank you, Professor.

Ms. Peirce, we were actually back and forth in testimony. I would like to try to help everyone sort of understand what you see from your research of rules that are in effect, rules that are coming, rules that we are not sure of because right now it is call your lawyer. Just as an example here of would an institution write a non-QM loan and put it on their books for fear of what happens tomorrow? From some of your research, what are you finding out there in sort of the command and control regulatory environment we are putting on small institutions today?

Ms. PEIRCE. Well, I think that you are right to kind of segregate it between what is happening and what is coming down the road, but I think a lot of what is the problem is that there are mortgage regulations that are coming in place in January. People have been saying, look, we are not ready. So even if we might be able to adjust to these, we need more time and they are not getting the time. So there is that problem. And then there is the problem of the uncertainty about what is going to happen down the road. The Consumer Bureau has been focused on putting rules in place that they had to put in place, but what is going to come after that, I think people have a lot of uncertainty about that. And then there is just the existence of the change in the regulators' kind of state of mind and the examination change which is already affecting small banks. And I think they are already feeling the change in the way that examiners are coming in and looking at what they are doing.

Chairman SCHWEIKERT. Okay. Thank you, Ms. Peirce.

Mr. Mitchell, I had a couple of questions for you, just because I do not think we have communicated it much. Tell me about your institution here in D.C. What would be the typical demographic of the customers you serve?

Mr. MITCHELL. Typically, it is in low and moderate income neighborhoods. We are a CDFI under the Treasury Department, mostly African-Americans. That is changing a lot by virtue of the fact that we are doing more commercial real estate lending and the demographics of Washington are changing.

Chairman SCHWEIKERT. Now, also, you were the president of the Association of the Smaller Banks.

Mr. MITCHELL. Chairman of the National Bankers Association, which makes up a lot of minority owned and specialty institutions and just small, minority and women-owned institutions.

Chairman SCHWEIKERT. Because Professor Levitin actually touched on it, I am curious from your chairmanship there, your presidency. Do you see any Cascade effect in sort of a Basel III environment which was really meant for I truly believe more money center banks getting down to our neighborhood and community institutions?

Mr. MITCHELL. It definitely is cascading down to community banks like ours, but Basel III, just by the nature of the Committee itself is really for international banks, multinational and international institutions and much larger institutions.

Chairman SCHWEIKERT. If you had to talk right now and share, saying the staff difference in time. So if it were a couple of years ago you were making the argument that your employees were working with customers; today they are doing regulatory compliance. How much of that is also them having to reach out to consultants and outside to try to find out if you are operating in the proper manner?

Mr. MITCHELL. Well, it depends on the employee, but if I had to average it out among 120 employees, I would probably say everybody is probably spending 10 percent more time on regulatory and legislative issues. And that is a lot when you talk about 120 employees.

Chairman SCHWEIKERT. Ms. Sweet, you actually touched on something very similar of what has happened to some of your cost structure of how many outside lawyers and consultants you are now using. Can you give us a window into what that is and that cost?

Ms. SWEET. I would say just on the CFPB, for our consultants and legal opinions and other costs that are associated with that compliance is close to $50,000. To us that is enormous. Attorney fees is just astronomical. Our legal staff, it is a legal firm for credit unions. They now have a complete segment of their attorneys dealing with regulatory compliance. When I started with that firm 25 years ago, regulatory compliance was never what we would contact them for. So it is an enormous amount of money just from us that could have gone to our membership, that could have lowered those interest rates on loans and given higher dividends on savings accounts.

Chairman SCHWEIKERT. Ms. Sweet, as sort of a neighborhood credit union, let us say I am an employee at the auto parts manufacturer, or Safeway, I do not have a lot of credit history. I would have been able to come and open my account at the neighborhood credit union and have you issue me a debit card, credit card, and begin to become what many of us refer to as bankable. I will share to anyone that cares, this is one of my fixations ever since I was county treasurer in Maricopa, of the amount of my population that was underbanked, almost unbankable because of lack of credit history, not because they were dodging a collection issue from an ex-wife.

I know, there are always giggles on that one but it is the data.

Ms. SWEET. Yes.

Chairman SCHWEIKERT. Today is there more of a barrier for you to work with that underbanked individual? I am trying to understand my cost structure of how do I take in some communities 20, 25 percent of my population that is underbanked, how do I make that more robust? Is this cost structure, regulatory structure we are talking about now hurting that population?

Ms. SWEET. It is enormously hurting the population. The time and resources that are spent trying to either identify the intent of the regulation. That time and money could be spent on education. We have very young people coming into financial institutions that have no credit whatsoever and they have never had a checking account. Our staff needs to take time with them and educate them, help them through the process and help them understand what is

important to get them started and what is it going to take to get that credit report, because some day they may get married, have families, want the home, want the new car. It is important to educate all of our members so that their finances are set in place. And there are glitches in that, whether it is divorce or death or something, that we are there for them. Credit unions, community banks often are the people that we are willing and able outside of a lot of these regulatory timeframes to sit down with people and help them through their concerns.

Chairman SCHWEIKERT. Thank you.

And last one—and I appreciate your patience.

Professor, and this may not be the place to do it, this may be something you and I should talk about over a cup of coffee.

If I came to you and said you could have an A and a B regulatory environment—A is what we are doing and B would be one where we approach Mr. Mitchell's institution and say, if you hold 15 percent true equity capital—not operating but equity capital—at that point all we ask from you is a single touch audited financials. Because if we look back at multiple financial events over the last century, it was small institutions that had equity, had capital on their books, survived. My father's favorite saying was "for every complicated problem there is a simple solution that is absolutely wrong." In this case, is holding equity capital the ultimate buffer?

Mr. LEVITIN. There is really no replacement for capital if you are worried about an institution's solvency. And the Basel rules, the existing ones and the ones that are coming in place, both play games. But if you just went with a very simple, just plain common equity, I do not know what the right percentage is. I cannot say that it is 15 percent, but if you went with just a simple plain common equity level, yeah, I think that would be an easy way to figure out. It would be easy to implement and if you put it high enough that I think would——

Chairman SCHWEIKERT. So there may be an elegant solution that is sort of an A and a B?

Mr. LEVITIN. Well, it will have effects on what kind of assets financial institutions hold. Because if you are not doing risk-weighted assets, that is going to really change what kind of lending is done.

Chairman SCHWEIKERT. Liquidity score. All right. Professor, thank you.

Ranking Member Clarke.

Ms. CLARKE. Mr. Mitchell, section 1070 of Dodd-Frank requires information gathering regarding loans made to women and minority-owned businesses. Critics have cited this section as being prohibitively expensive and an undue burden to small financial institutions.

So I have a two-part question for you. How is this a prohibitively expensive burden, and in a cost benefit analysis, does this regulation not give us a better idea of how we can assist these small businesses gain capital access?

Mr. MITCHELL. I think it does have a benefit. However, if you look at HMDA regulations, which is pretty much the same thing as it applies to mortgages, the number of different data points and the number of different fields that have to be compiled and accu-

rately compiled, many institutions even now get it wrong and the penalties are very high. So it can be very expensive. It is definitely very expensive.

Ms. CLARKE. So then I am going to apply another question to that.

What would you see as probably an alternative to be able to get at the goal of trying to basically preserve this space in banking for these institutions?

Mr. MITCHELL. Well, number one in the community banking space, we care about our customers. I mean, all over the country, not just urban community banks, but rural community banks. We are there because we know the community, we want to serve the community, we want to see the community developed, we want to provide access to capital in the community. We are part of those communities. So we just do business differently. And I do not think you see discrimination problems at community banks. That is really the long and short of it. And I think larger institutions, they operate in ways that larger institutions operate. I think there is evidence that they have been discriminatory but I do not think that is necessarily true across all the board for large institutions. They do what they do and they focus on larger customers and larger deals. And so the individuals fall through the cracks for one reason or another, and that is exactly why they tend to standardize a lot of their credit processes for smaller businesses and individuals.

Ms. CLARKE. I want to open up the question to the other members of the panel.

We are just trying to figure out if Section 1070 of Dodd-Frank is prohibitively expensive and burdensome, and in terms of cost-benefit analysis, is it worth it? Does anyone else have a take on that? Professor Levitin?

Mr. LEVITIN. Well, if you are concerned about discriminatory lending, if you want to make sure that there really is equal credit opportunity in the United States, the only way that we can really police that is if there is data available. The Home Mortgage Disclosure Act creates that data for mortgage lending but we do not have comparable data for other types of lending. There is a cost to gathering that data, and it is really just a question of do you think that the costs of gathering that data are worth the benefits of being able to police discriminatory lending? In my mind it is an easy question but I imagine someone could disagree on that.

Ms. PEIRCE. Yeah. I would be one of those people who would disagree.

My concern is that data collection often sounds like an easy thing but it does end up being a really big cost on the institutions that have to do it. I think the best thing that we can do in terms of preventing discriminatory lending is to make sure that we have that diversity in our financial system, and that is the concern that I have. You know, when these smaller institutions decide I am not a banker anymore. I am just a regulatory compliance person so I am going to shut my institution down, that is when we are going to see people who we would want to be able to get loans not be able to get the loans that they would otherwise have gotten.

Ms. CLARKE. Did you want to add anything, Ms. Sweet?

Ms. SWEET. I do. I believe that there is an area of this that we need to look at. We have, as credit unions we have our NCUA, which is our regulatory examination process. And during that there are all types of compiling of information and reporting to them on a quarterly basis and then annually them coming in and examining us which takes about now through all the regulations through the years about 90 days to get through that. So there is already in place—I do not believe we need new regulators. I do not believe we need new regulations. We are compiling that data and have for quite some time and it is examined already.

Ms. CLARKE. So I am just wondering, part of the challenges that we face as a legislative body is sort of working from the outside in. It always amazes me the level of consultation. In other words, living vicariously through institutions like yours. That ought to take place so that we have an informed process. It does not take place often enough. And so I just wanted to just to share with colleagues that I think it benefits us in the long run. These "one size fits all" solutions, the unintended consequences oftentimes are not really worth it. Even if there is the fear that these regulations will be burdensome and it shocks the culture of the institutions that we are trying to preserve, then we are defeating the purpose that we are all seeking.

I am rambling right now but it just amazes me that we would not have done a fear analysis and have a strong and robust conversation with the diversity of institutions that we are trying to regulate here so that we do not create a crisis by trying to avert a crisis.

With that, Mr. Chairman, I yield back.

Chairman SCHWEIKERT. Thank you, Ms. Clarke.

Mr. Rice?

Mr. RICE. Thank you, Mr. Chairman. And I would certainly like to associate myself with the comments Ms. Clarke just made. I do believe that we need to take a very close look at this law.

Mr. Mitchell, something you said earlier peaked my curiosity. You were talking about discriminatory lending practices and you indicated, I think, that the standardization of lending criteria by big banks led to some of that. Is that right?

Mr. MITCHELL. No, not necessarily. I just think that there was discrimination with some of the larger institutions. The point I was trying to make is that community banks by nature is we do a lot of creative personalization in trying to make loans.

Mr. RICE. And why do you do that? Why do you have to do creative personalization?

Mr. MITCHELL. Because you know, I think we more so want to make loans then we want to decline them.

Mr. RICE. And does not this law—in an effort to standardize these loans, does it not take away your ability to do exactly that?

Mr. MITCHELL. Absolutely.

Mr. RICE. And that disproportionately affects who?

Mr. MITCHELL. Low and moderate income individuals

Mr. RICE. Right. So what we are doing is we are actually, probably expanding income disparity, expanding access to capital—disbanding incomes and access to capital with this law. And is this not exactly the opposite of what this law was supposed to do?

Mr. MITCHELL. I believe so.

Mr. RICE. I think this law is fundamentally flawed. Perhaps more so. I think it threatens our economy perhaps more than most because I believe America is built on innovation and competitiveness, and we complete with people around the world, not just in this country. And everybody is trying to complete. And we needed if we are better by small degrees. It is not vast things. It is small degrees. And I think that this law makes us let competitive. One of the big things that American has had as an advantage is access to capital.

A disproportionate amount of the jobs in this country are created by small businesses. And a disproportionate amount of those jobs are created by startup businesses. Now, when you are looking to make a loan, I am going to go to Mrs. Peirce now because I have not picked on you yet.

Do you think when a small bank is looking to make a loan to a small business startup, is it going to be easier to more complicated under Dodd-Frank?

Ms. PEIRCE. Certainly more complicated. It is definitely more complicated. Of course, I mean, the regulators are coming and they are looking more closely, and so what I had one small banker say to me is look, I can know that a business is going to pay back a loan, but I will not make that loan because I know that I am going to have to explain it to a regulator later and I will not be able to because I will not be able to say—the regulator is not going to meet the small businessman and is not going to know the same things I know about that person. And so it is impossible to justify it so I just will not do it.

Mr. RICE. All right. And I guess this is not an area where you are really qualified, but in small businesses, the jobs that are created, are those jobs, do you think, going to higher income people or lower income people?

Ms. PEIRCE. Well, you are right to say that I am probably not qualified to answer that but my guess is that those would mostly be lower income people.

Mr. RICE. So that is another aspect of this law that attacks the middle class.

Ms. PEIRCE. Yeah. I mean, when you put constraints on the ability of people to get capital, it has follow-on effects in the economy.

Mr. RICE. If you look at areas where America has succeeded in competing worldwide, and we have for decades, but if you look at our infrastructure which is other countries are coming up and our infrastructure I would argue is declining or perhaps crumbling. When you look at our educational system, certainly other countries have lifted themselves, and perhaps we have been stagnant or fallen behind. And now you look at our access to capital which is just one more area where we are making this country less competitive. I think this law, the federal regulatory environment does more to stifle innovation and job creation than anything else, and I think this is a huge addition to the federal regulatory environment and I certainly think we need to rethink the entire law, but if not that, as much of it as we can. Thank you very much.

Chairman SCHWEIKERT. Sorry, Mr. Rice.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I appreciate the deference to allow me to be here today and to participate in this hearing. I certainly appreciate everybody's great testimony.

I just have a few comments. Ms. Sweet, in your testimony this morning, written testimony, you made the comment that one of every two dollars lent to small businesses comes from community banks. And I think that is a very, very significant figure. I think that is important that we understand the role that the banks play in the communities that they are in.

We talked about that a little bit at length here in the last couple of minutes but I think it needs to be reinforced that this is a tremendous role that they have. They are the hands-on, if you will, institutions within the communities that they serve.

Mr. Mitchell made the comment a few minutes ago about—and I noticed in your testimony also you made comments to the effect that the small community banks tailor the products to fit their individual needs, and I thought Mr. Mitchell did a good job explaining it. They have the ability to do that where the big banks sometimes, that is where they get themselves in compliance problems, have a standardized way of looking at things and if it does not fit, you do not get the loan, where the other institutions seem to be able to make those adjustments on the fly.

Would you like to comment just a little bit more and elaborate? I know you went into it a little bit just now but I think it is important to reinforce that point.

Ms. PEIRCE. Certainly. I think that is one of the beauties of the system that we have. There is nothing wrong if a big bank wants to make only standardized loans, that is fine as long as we have a system that allows these smaller institutions to come in and fill the gap. And that is the situation that we have had, but I think the more that you put in a regulatory framework that is designed with these big banks in mind, you leave out the smaller institutions. And what we are seeing in the survey that the Mercatus Center conducted is that a lot of people are saying we are just going to try to stay away from the consumer business altogether because it is too dangerous for us to be there. So while we would like to make those loans, we just will not make them anymore.

Mr. LUETKEMEYER. Did you say in your survey that there was an intimidation factor by the regulators with regards to how punitive they are sometimes with the way that they enforce the rules?

Ms. PEIRCE. Yeah. I think one of the comments that sort of struck me was that you can be trying to do everything right and you make a mistake and the consequences are so high of that mistake. And so because there are so many rules to keep track of it is really difficult to stay on the right side of the line.

Mr. LUETKEMEYER. I think this is one of the comments that was made and I had a long discussion with the FDIC chairman with regards to this. Mr. Mitchell, you made comment in your testimony to the FDIC study last fall, and you made the comment with regards to HMDA. This has been just a nightmare for the institutions to comply with. I think Ms. Sweet made a comment about it a minute ago as well. What has been your experience with regards to regulators and HMDA? I mean, all this is, for those who do not know what is going on is just box-checking. You check a box to

make sure that you total individual this statement. You hand them this piece of paper. You make sure—if you go down the list there are about 25 different things, and if you miss one box the whole loan, the whole loan is considered in violation versus one boxed fail check. What is your experience with that?

Mr. MITCHELL. Well, first of all, I think HMDA could be simplified, and I think there are small business reporting requirements that need to be something that can be complied with and be relatively simple to achieve the objectives with not much expense.

But with respect to HMDA, I speak to bankers all the time and all bankers have problems with HMDA because it is a lot of box-checking. And if you make a mistake with one field, you know, there could be 16 or 20 different fields just for one loan, and if you make a mistake with one field, you have made a mistake for that entire loan. We are administratively pretty well run when it comes to compliance and we continue to struggle with HMDA.

Mr. LUETKEMEYER. From my experience in talking with security bankers, you are not alone. It seems like everybody—and this is something I have talked with the regulators about is having some deference here with regards to trying to comply with all these things. And I will give you a quick example.

In Missouri, over about a two and a half year period, FDIC had civil penalties for 160 to 180 violations. And during the same period of time, the fail/uncomfortable had a total I think of five. So we had a long discussion of "look, what is going on here?"

Now, he used to be a regulator himself. This is not the way that this is supposed to be enforced. Tell us what is going on. I think they are trying to take a look at this but the point I am trying to make is it seems to be an intimidation factor. Sometimes also with regulators it makes it very difficult for these kinds of banks to exist because they do not have the power to back. Would that be a fair statement?

Mr. MITCHELL. There is no question about it.

Mr. LUETKEMEYER. Thank you.

And again, Mr. Chairman, I appreciate your deference and I appreciate the opportunity to be with you. Thank you.

Chairman SCHWEIKERT. Mr. Luetkemeyer, it was fun having you on the Committee with your background.

Ms. Clarke, okay to close up?

Chairman SCHWEIKERT. I am going to share just the old danger of when they hand me a microphone and there is no clock on me. This is a Small Business Oversight Subcommittee But the reality for all of you, what you do, whether it be helping organize the regulatory environment as a community banker, as a community credit union, as someone trying to work on public policy? The access to capital is the lubricant that runs this engine of an economy. We spend a lot of time talking about you as small businesses and your clients and the cost of the clients. But there is that next tier out and that is when your clients are those small businesses. The person coming in, trying to buy a piece of real estate and the cascade effect that has. Or trying to find access to capital. Ranking Member Clarke and I were just kibitzing a bit on the ideas of the flexibility for our small community banks and neighborhood credit unions to be able to also be the alternative to a check-cashing store

or a title loan or those things, but that is a very different view in a regulatory environment. There has got to be a way to create lots of competition, lots of access to capital for things that grow our economy. And it is helping that part of our population that is underbanked, but also the person who is starting a business. For many of us we keep saying access to capital is going to be very different by the end of this decade, if we do not screw it up. But yet I see what is coming out of the regulatory environment on equity crowdfunding and it breaks my heart because this egalitarian idea is going to be crushed if the rule moves forward where it is. I see that happening in our community banks and our credit unions of you are just going to move up the food chain and income and status. And once again, we were going to leave more and more of our brothers and sisters there underbanked and left in the cold.

So I appreciate this discussion, it is a big discussion. My fear is we do not spend enough time trying to also come up with a mechanical solution. There is also a lot of folklore about what we went through in 2008, what caused the cascade. We discuss community banks. Well, if community banks' real estate portfolios had not collapsed in value, how many of them would be here today? And was that from their poor underwriting or was it at the top of the pyramid that collapsed that came down through much larger institutions.

So there is lots of data, and a lot of bad data out there that we make these decisions on.

So as we wrap up today—I think I make senior staff nervous when I go off script like that—but with that I ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record. Also, as witnesses, do be prepared that there may be some questions that come your way that we will ask you to respond to.

And without objection, this hearing is adjourned.

[Whereupon, at 11:41 p.m., the Subcommittee was adjourned.]

APPENDIX

MERCATUS CENTER
George Mason University

Bridging the gap between academic ideas and real-world problems

TESTIMONY

REGULATORY LANDSCAPE: BURDENS ON SMALL FINANCIAL INSTITUTIONS

BY HESTER PEIRCE

House Committee on Small Business
Subcommittee on Investigations, Oversight, and Regulations

December 3, 2013

Chairman Schweikert, Ranking Member Clarke, and members of the Subcommittee, thank you for the opportunity to be part of today's hearing on regulatory burdens on small financial institutions.[1]

In financial services, as in every other sector, the United States is not a one-size-fits-all nation. Financial institutions of all different sizes coexist, and customers choose among them based upon their needs. A regulatory environment that is increasingly unwelcoming to small financial institutions may curtail customer choice.

Increasingly burdensome regulation is not the only challenge facing small banks and credit unions. They are also confronting slow economic growth, declining populations in rural areas, the increasing technological sophistication of banking, the sustained low-interest-rate environment, competition from new types of financial services providers, and difficult capital markets. Small financial institutions can adapt and excel in the face of such challenges, but not if regulation stands in the way and absorbs resources and managerial attention that would otherwise be devoted to dealing with them.

Today I will briefly discuss the importance of small financial institutions and then talk about three ways in which regulation or regulators are threatening their future prospects. First, the regulatory framework accommodates

1. The definition of "small financial institution" is open to debate. I favor a cutoff of $10 billion in assets, which is also used by others, such as the Federal Reserve Board of Governors, in defining community banks. See, for example, "Supervisory Policy and Guidance Topics: Community Banks," Board of Governors of the Federal Reserve System, last modified August 2, 2013 (noting that "in general, community banks can be defined as those owned by organizations with less than $10 billion in assets"), http://www.federalreserve.gov/bankinforeg/topics/community_banking.htm. The $10 billion threshold is also used in Dodd-Frank to demarcate banks and credit unions over which the Bureau of Consumer Financial Protection has primary consumer protection-related examination and enforcement authority from those over which it does not. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No.111-203, 124 Stat. 1376, §§1025 & 1026 (2010). Although using such a high threshold aggregates financial institutions with very different profiles, it also recognizes that even financial institutions with billions of dollars in assets are experiencing substantial regulatory overload. It is important to acknowledge, however, that the smallest financial institutions feel these strains far more intensely than the banks and credit unions at the top end of the range. As of December 2012, the median asset size was $21 million for credit unions and $168 million for banks. Mike Schenk, Economics and Statistics Department, Credit Union National Association, "Commercial Banks and Credit Unions: Facts, Fallacies, and Recent Trends Year-End 2012," 3, accessed November 21, 2013, http://www.cuna.org/Research-And-Strategy/Credit-Union-Data-And-Statistics/ (scroll to bottom for link to pdf).

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large financial institutions better than it does small ones. Second, the increased regulatory and compliance burden is felt most heavily by the smallest financial institutions. Finally, regulators' lackluster commitment to fundamental administrative process protections takes a particular toll on small financial institutions.

THE IMPORTANCE OF SMALL FINANCIAL INSTITUTIONS

With one-fifth of one percent of the banking industry controlling two-thirds of its assets,[2] it is easy to forget the important role that the remaining financial institutions—most of which are small—play. Many have served their communities for decades and continue to serve the financial needs of millions of retail customers and small businesses. Community banks are particularly important in rural areas. The FDIC reported that community banks serve "more than 1,200 US counties (out of a total of 3,238), encompassing 16.3 million people, who would have limited physical access to mainstream banking services without the presence of community banks."[3] They are also key providers of small business loans. By one measure, "$1 out of every $2 lent to small businesses comes from community banks."[4] Federal Reserve Governor Jerome Powell has noted that "as auto, mortgage, and credit card loans have become increasingly standardized, community banks have had to focus to a greater extent on small business and commercial real estate lending—products where community banks' advantages in forming relationships with local borrowers are still important."[5] Credit unions are also an increasingly important source of small business loans.[6] More generally, credit-union lending expanded by thirteen percent between the end of 2007 and the end of 2012.[7]

Community-based financial institutions are able to distinguish themselves from larger competitors by developing firsthand knowledge about their customers. This enables them to provide personalized service and meet the needs of the local residents and businesses in ways that a larger, nonlocal bank, which does not know the unique characteristics of the community, cannot. The Government Accountability Office explained:

> Despite the decline in their number, community banks and credit unions have maintained their relationship-banking model, relying on their relationships with customers and local knowledge to make loans. Such institutions can use their relationship-based information to make loans to small businesses and other borrowers that larger banks may not make because of their general reliance on more automated processes.[8]

Federal Reserve Governor Elizabeth Duke likewise cited the following "natural advantages" of community banks: "deep community ties, daily interaction between senior managers of banks and their customers, and the dexterity to customize financial solutions."[9]

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2. *Hearing on "Examining How the Dodd–Frank Act Could Result in More Taxpayer-Funded Bailouts," Before the Committee on Financial Services*, 113th Cong. (2013) (statement of Richard W. Fisher, president and CEO, Federal Reserve Bank of Dallas), 3, http://www.dallasfed.org/assets/documents/news/speeches/fisher/2013/fs130626.pdf.
3. See Federal Deposit Insurance Corporation, *FDIC Community Banking Study* (December 2012), 3–5, http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf. See also *Nominations Hearing, Before the Senate Committee on Banking, Housing, and Urban Affairs*, 113th Cong., 1st Sess. 39 (2013) (statement of Richard T. Metsger, Nominee for Board Member, National Credit Union Administration) ("A large portion of our Nation is dominated by small communities that rely on the services of equally small credit unions and community banks as their economic lifeblood.").
4. Tanya D. Marsh and Joseph W. Norman, *The Impact of Dodd-Frank on Community Banks*, 12 (Washington, DC: American Enterprise Institute, 2013).
5. Jerome Powell, Governor, Board of Governors of the Federal Reserve System, "Community Banking: Connecting Research and Policy" (speech at the Federal Reserve/Conference of State Bank Supervisors, Community Banking Research Conference, St. Louis, MO, October 3, 2013), http://www.federalreserve.gov/newsevents/speech/powell20131003a.htm.
6. James A. Wilcox, *The Increasing Importance of Credit Unions in Small Bank Lending* (Sept. 2011), http://www.sba.gov/sites/default/files/files/rs387tot.pdf. The study was prepared for the Small Business Administration.
7. Schenk, "Commercial Banks and Credit Unions," 9–10,
8. Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rulemakings* (Sept. 2012), i, http://www.gao.gov/assets/650/648210.pdf. See also "Community Banks and Credit Unions," Consumer Financial Protection Bureau, accessed November 18, 2013, http://www.consumerfinance.gov/small-financial-services-providers/ ("Community banks and credit unions . . . generally base their businesses on building personal, long-term customer relationships.").
9. Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System, "The Future of Community Banking" (speech at the Southe-

Firsthand knowledge of customers provides useful information for making sound lending decisions. Credit unions report that delinquent loans peaked in 2009 at 1.82 percent of credit unions' loan portfolios and were down to 1.15 percent at the end of 2012.[10] Community banks' loans tend to default at lower rates than loans made by bigger institutions. The rate of loans in default for the first quarter of 2013 on loans secured by residential properties was 3.47 percent for banks with less than $1 billion and 10.42 percent for banks with more than $1 billion in assets.[11] Community banks that are closest to their borrowers may fare best.[12] As one study of the rural banking landscape found, "community banks, as a group, remain competitive with larger banking organizations, at least in markets where informationally opaque borrowers are most prevalent."[13] Small financial institutions thrive when they use what they know about retail and small business borrowers to make well-tailored, sound loans.

REGULATORY FRAMEWORK IS DESIGNED FOR LARGE FINANCIAL INSTITUTIONS

The regulatory framework is not well suited to the kind of lending that distinguishes small financial institutions from their large bank counterparts.[14] A recent survey of community bankers found that "many bankers felt that the move toward standardized products and a 'one-size-fits-all' supervisory approach were taking away one of the strongest advantages of community banks: the ability to tailor products to fit individualized needs."[15]

A prime example of this is Dodd-Frank's approach to consumer financial protection that allows the new Bureau of Consumer Financial Protection ("CFPB") effectively to delineate the products that are safe for consumers. This model works better for large institutions than it does for small ones. Marsh and Norman explain:

> A recurring theme in Dodd-Frank . . . is that the standardization of financial products and forms will protect consumers. This is implicitly a reaction to the narrative that one of the causes of the financial crisis was the inability of parties to understand and appreciate the risks of innovative financial products. But the focus on standardization of consumer financial products, like home loans and checking accounts, fails to recognize the value to consumers of the community banking model, which emphasizes relationship banking, personalized underwriting, and customization of financial products to meet the specific needs of customers and communities.[16]

While the needs of homogenous consumers can be met with homogenous products, the fundamental assumption that consumers are homogenous is wrong. Community-based financial institutions' practice of getting to know their customers and tailoring products to their needs is at odds with the Dodd-Frank version of one-size-fits-all consumer protection.

Rules adopted by the CFPB under Dodd-Frank leave insufficient room for the consideration of the "soft infor-

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astern Bank Management and Directors Conference, Duluth, GA, February 5, 2013), http://www.federalreserve.gov/newsevents/speech/duke20130205a.htm.

10. Schenk, "Commercial Banks and Credit Unions," 11.

11. See *FDIC Statistics on Depository Institutions*, accessed July 16, 2013, http://www2.fdic.gov/sdi/main.asp. Loans in default are defined as nonaccrual loans or loans past due 30 or more days. These data include one to four family residential properties.

12. See, e.g., Robert DeYoung, Dennis Glennon, Peter Nigro, and Kenneth Spong, "Small Business Lending and Social Capital: Are Rural Relationships Different?" (Center for Banking Excellence Research Paper No. 2012-1, 2012), http://www.business.ku.edu/sites/businessdev.drupal.ku.edu/files/docs/CBE%20WP%202012-1%20DeYoung%20Glennon%20Nigro%20Spong.pdf. The authors found that small business loans originated by rural community banks defaulted at a lower rate than loans originated by their urban counterparts.

13. R. Alton Gilbert and David C. Wheelock, "Big Banks in Small Places: Are Community Banks Being Driven Out of Rural Markets?," Federal Reserve Bank of St. Louis Review 95, no. 3 (May/June 2013): 216, http://research.stlouisfed.org/publications/review/article/9723.

14. Even some well-intentioned regulatory changes may have the effect of decreasing small financial institutions' reliance on soft information. See, e.g., John R. Walter, "Not Your Father's Credit Union," *Federal Reserve Bank of Richmond Economic Quarterly* 92, no. 4 (2006): 369–70 (noting the role that such factors as the introduction of deposit insurance and the loosening of the common bond mandate have played in lessening credit unions' focus on relationship lending). Nonregulatory trends are also relevant. See, e.g., David C. Wheelock and Paul W. Wilson, "Are Credit Unions Too Small?," *Review of Economics and Statistics* 93, no. 4 (2011): 1343 ("recent advances in information processing and communications technology have lowered the cost of acquiring hard information about potential borrowers, and thereby have eroded some of the advantages of small scale and common bond that traditionally enabled credit unions to provide financial services at low cost to their members").

15. Conference of State Bank Supervisors, *Community Banking in the 21st Century: Opportunities, Challenges and Perspectives* (2013), 15, http://www.stlouisfed.org/CBRC2013/town-hall.pdf.

16. Marsh and Norman, *Impact of Dodd-Frank*, 39.

mation" that community banks and credit unions have profited from using in the past. Credit unions, which are limited-membership organizations, have their origins in relationship lending, although the intensely personal nature of credit union lending has diminished over time.[17] Likewise, as Marsh and Norman explain, "in contrast to the complex financial modeling large banks use, community bankers' specialized knowledge of the customer and their local market presence allows underwriting decisions to be based on nonstandard soft data like the customer's character and ability to manage in the local economy."[18] The CFPB's one-size-fits-all regulatory approach tends to thus disadvantage those banks that compete on margins such as customer service while favoring those with the lowest costs, big banks that offer economies of scale and lower capital-market costs."[19]

As one example, the new qualified mortgage rules specify parameters for mortgages that satisfy Dodd-Frank's ability-to-repay requirement. Nonqualified mortgages can be offered, but the associated legal risk is high. The CFPB defined qualified mortgages so that they could not include features the CFPB believes to be inherently risky. Mortgages that fall outside the CFPB's parameters may work well for certain borrowers identifiable by using non-standardized eligibility criteria. The CFPB made some helpful accommodations for small lenders, but the qualified mortgage rules will still operate as a constraint on small financial institutions' participation in the mortgage market. As the Independent Community Bankers of America has pointed out:

> many community banks do not have the bandwidth to constantly learn and absorb frequent changes and update their business practices to comply. Recent feedback from our members indicates that approximately one third will not be able to comply with all of the new mortgage rules by January 2014 for various reasons such as not having enough time to change policies and procedures or train their staff, or their vendors and suppliers will not be ready in time to complete preparations.[20]

A recent survey of credit unions found that sixty percent will "discontinue, delay or reduce their mortgage loan product offerings" because of CFPB mortgage regulations.[21] Preliminary results of a survey of small banks that I and my colleagues at the Mercatus Center conducted found that approximately ten percent of banks with less than $200 million in assets have discontinued offering residential mortgages and another fourteen percent anticipate doing so.

If community banks and credit unions are unduly constrained in their ability to offer traditional products and services, they may feel pushed to go into lines of business with which they are not familiar. This could pose a risk to the viability of the banks, credit unions, and ultimately to the government deposit insurance funds that back them. The FDIC, in its recent report on community banking, concluded that the banks that stuck to traditional lending strategies fared much better than their counterparts that "abandoned those lending specialties for the small bit of extra yield."[22] Likewise, the Government Accountability Office found that failed small banks "had often pursued aggressive growth strategies using nontraditional, riskier funding sources and exhibited weak underwriting and credit administration practices."[23] It would be unfortunate if government regulations encouraged small financial institutions to abandon what they are good at in favor of lines of business with which they are less familiar.

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17. Walter, "Not Your Father's Credit Union," 92 (discussing how credit union "members knew one another, and failure to repay a loan harmed fellow members and damaged the defaulting member's reputation in the group, there was social pressure to repay, thus reducing the likelihood of default, and consequently providing another explanation for low interest rates on loans from credit unions").
18. Marsh and Norman, "Impact of Dodd-Frank," 11.
19. Todd J. Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?" (Working Paper No. 12-25, Mercatus Center at George Mason University, Arlington, VA, October 2012), 31–2, http://mercatus.org/sites/default/files/CFPB_Zywicki_v1-0_0_1.pdf.
20. Camden R. Fine, President and CEO, Independent Community Bankers of America, to Richard Cordray, Director, CFPB , 9 October 2013, 2.
21. Credit Union National Association, "Many Credit Unions Will Reduce or Discontinue Mortgage Loans as a Result of CFPB Regulations," news release, October 21, 2013, http://www.cuna.org/Stay-Informed/Press-Room/Press-Releases/2013-Press-Releases/Survey-Reveals-Mortgage-Lending-Regulations-May-Hurt-Consumers/.
22. FDIC, *Community Banking Study*, 5-22.
23. *Hearing on the State of Community Banking in the Current Regulatory Environment, Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services*, 113th Cong. ii (March 20, 2013) (statement of Lawrence L. Evans, Director, Financial Markets and Community Investment, Government Accountability Office).

Regulations are often written with big financial institutions in mind. The Basel III capital rules are one such example. As the American Bankers Association notes, "even though Basel standards are held out to be designed and intended for large, internationally active banks, US regulators are increasingly applying them to even the smallest banks."[24] American regulators worked with their international counterparts to develop a framework designed for big banks. The proposed rules, which clearly targeted larger institutions, generated considerable push-back from community banks.[25] The final rules better accommodate community banks, but fundamental questions about the utility of a risk-based approach for these institutions remain.[26] The complexity of the capital rules and the implications for investors, regulators, and banks also have raised cost and efficacy concerns.[27]

Regulations explicitly crafted to preserve large financial institutions—such as systemic designations under Title I of Dodd-Frank—can have a deleterious effect on small financial institutions. These kinds of regulations lead to market perceptions that regulators will not let large financial firms fail. Institutions that are perceived to be too big to fail enjoy a subsidy, [28] the size of which and degree to which it is offset by increased regulatory costs are hotly debated.[29] Although not typically competing directly with designated financial companies in the capital markets,[30] small banks are at a funding disadvantage, particularly in a time of widespread crisis, when banks are most likely to need to raise money to survive. Large banks that enjoy explicit or implicit government backing will find it a lot easier to attract private capital than community banks. Large banks with a systemic designation are also likely to find it easier than other financial institutions to obtain and retain customers, for whom the government's designation functions as a perceived guarantee of the financial institution's longevity.

INCREASED REGULATORY BURDEN FALLS MOST HEAVILY ON SMALL FINANCIAL INSTITUTIONS

Contrary to a popular misconception, the financial services industry is not lightly regulated and was not prior to the crisis, either.[31] Regulatory costs imposed on financial institutions are passed on, in whole or in part, to the customers that rely on these institutions. The increasing burden of regulations is a reality across the entire financial

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24. High C. Carney, Senior Counsel, American Bankers Association, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, 12 November 2013, 2, http://www.aba.com/Advocacy/commentletters/Documents/11-12-13CommentLettertoFDICreBaselIII.pdf.

25. For a discussion of comments related to community banks, see *Revised Memorandum from Staff to Board of Governors of the Federal Reserve System re Draft Final Regulatory Capital Rule and Market Risk Notice of Proposed Rulemaking* (July 1, 2013), http://www.federalreserve.gov/aboutthefed/boardmeetings/20130702__Basel__III_Board__Memo.pdf.

26. See Thomas L. Hogan, Neil Meredith, and Xuhao Phan, "Evaluating Risk-Based Capital Regulation" (Working Paper No. 13-02, Mercatus Center at George Mason University, January 2013), http://mercatus.org/sites/default/files/Hogan_EvaluatingRBC_v2_1.pdf.

27. See, e.g., Eric S. Rosengren, President & CEO, Federal Reserve Bank of Boston, "Simplicity and Complexity in Regulation" (speech before the Financial Stability Institute of the Bank for International Settlements: Program for Financial Sector Supervisors, Abu Dhabi, United Arab Emirates, November 18, 2013), http://www.bostonfed.org/news/speeches/rosengren/2013/111813/111813text.pdf; Basel Committee on Banking Supervision, "The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability" (Bank for International Settlements Discussion Paper 2013), http://www.bis.org/publ/bcbs258.pdf.

28. See, e.g., William C. Dudley, President, Federal Reserve Bank of New York, "Ending Too Big to Fail," (speech at the Global Economics Forum, New York, NY, November 7, 2013) ("The market's belief that a too big to fail firm is more likely to be rescued in the event of distress than other firms weakens the degree of market discipline exerted by capital providers and counterparties. Since the government does not charge for this implicit guarantee, this reduces the firm's cost of funds and incents the firm to take more risk than would be the case if there were no prospect of rescue and funding costs were higher. The fact that firms deemed by the market to be too big to fail enjoy an artificial subsidy in the form of lower funding costs distorts competition to the detriment of smaller, less complex firms. This advantage, in turn, creates an unfortunate incentive for firms to get even larger and more complex. As a result, the funding benefit of being seen to be too big to fail causes the financial system to become skewed toward larger and more complex firms in ways that are unrelated to true economies of scale and scope.").

29. For a spirited sample of that debate, compare Abby McCloskey, "Why Big Banks May Be at a Funding Disadvantage," *American Banker*, October 24, 2013, http://www.americanbanker.com/bankthink/why-big-banks-may-be-at-an-annual-fourteen-billion-dollar-disadvantage-1063111-1.html, with Camden R. Fine, "Wall Street Funding Advantage Is All Too Real," *American Banker*, October 30, 2013, http://www.americanbanker.com/bankthink/wall-street-funding-advantage-is-all-too-real-1063257-1.html.

30. For a discussion of community bank capital-raising practices, see FDIC, *Community Banking Study*, Chapter VI.

31. See, e.g., Patrick McLaughlin and Robert Greene, "Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank" (Chart, Mercatus Center at George Mason University, Arlington, VA, July 19, 2013), http://mercatus.org/publication/did-deregulation-cause-financial-crisis-examining-common-justification-dodd-frank.

industry.[32] It falls disproportionately on small financial institutions.[33] Indeed, regulatory burdens have been and are likely to be the death-knell of many of the smallest financial institutions.

With respect to regulatory compliance, small financial institutions are at a clear disadvantage. They cannot spread costs over a large portfolio of loans. They do not have their larger competitors' sophisticated legal and compliance staffs to interpret the new rules and regulations and look for effective ways to comply with those regulations without compromising their ability to serve customers and earn profits. Regulators have made some attempts to ease the burden by, for example, organizing dialogues with community banks and preparing compliance guides for community banks. [34] Nevertheless, regulation ends up giving larger financial institutions a competitive advantage over smaller ones.[35]

Regulations have built up over time, and it is difficult to pare them back.[36] As one community banker recently explained to Congress, "regulations have accreted steadily over past decades, but are rarely removed or modernized, resulting in a redundant and sometimes conflicting burden."[37] Professor Tanya Marsh, who recently conducted a study of community banks, explained that "we just react to crises and add new laws. And what we need to do is take a step back and fundamentally re-imagine what is the appropriate way to regulate a bank that is located in rural Wyoming and most of its business is farm lending."[38]

As a Federal Reserve staff study of the costs of bank regulation explains, "Higher average regulatory costs at low levels of output may inhibit the entry of new firms into banking or may stimulate consolidation of the industry into fewer, large banks."[39] A more recent effort by the Federal Reserve Bank of Minneapolis at quantifying the cost of financial regulation demonstrates the disproportionate effect of regulation on small banks by showing how the costs of hiring just two additional compliance personnel could reverse the profitability of one third of the smallest banks.[40] Small credit unions also feel regulatory burdens very keenly.[41]

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32. JPMorgan has 5,000 or more compliance staffers. Dawn Kopecki, "Dimon Tells JPMorgan to Brace for More Regulatory Woes," *Bloomberg*, September 17, 2013.
33. Tim Critchfield, Tyler Davis, Lee Davison, Heather Gratton, George Hanc, and Katherine Samolyk, "The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects," *FDIC Banking Review* 16, no. 3 (2004): 27, http://www.fdic.gov/bank/analytical/banking/2005jan/br16n34full.pdf.
34. See, e.g., Board of Governors of the Federal Reserve System, *Final Rule on Enhanced Regulatory Capital Standards—Implications for Community Banking Organizations* (2013), http://www.federalreserve.gov/newsevents/press/bcreg/commbankguide20130702.pdf; Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies Release a Regulatory Capital Estimation Tool for Community Banks," joint press release, November 19, 2013, http://www.federalreserve.gov/newsevents/press/bcreg/20131119a.htm.
35. Many of the community bankers participating in a survey in the early 2000s "voiced strong concerns that the rules of competition worked against them—namely, that state and federal regulation placed them at a disadvantage relative to their large bank and nonbank rivals." Robert DeYoung and Denise Duffy, "The Challenges Facing Community Banks: In Their Own Words," (Federal Reserve Bank of Chicago Economic Perspectives 2002), 12-13.
36. This problem is not limited to the banking industry. See, e.g., Tyler Cowen, "More Freedom on the Airplane, if Nowhere Else," *New York Times*, November 16, 2013 (discussing regulatory accretion and, given existing bureaucratic incentives, the difficulty of doing anything about it), http://www.nytimes.com/2013/11/17/business/more-freedom-on-the-airplane-if-nowhere-else.html?_r=1&.
37. *Hearing on "Examining Community Bank Regulatory Burdens," Before the Subcommittee of Financial Institutions and Consumer Credit of the House Committee on Financial Services*, 113th Cong. 2 (Apr. 16, 2013) (statement of William A. Loving, President and CEO, Pendleton Community Bank, Testimony on Behalf of the Independent Community Bankers of America), http://www.icba.org/files/ICBASites/PDFs/test041613.pdf.
38. *Regulatory Burdens: The Impact of Dodd-Frank on Community Banking, Hearing before the Subcommittee on Economic Growth, Job Creation and Regulatory Affairs of the House Committee on Oversight and Gov't Reform*, 113th Cong., 1st. Sess. 57 (2013) [hereinafter *Community Banking Hearing*] (testimony of Tanya Marsh, Assistant Professor of Law, Wake Forest University School of Law), http://www.gpo.gov/fdsys/pkg/CHRG-113hhrg82337/pdf/CHRG-113hhrg82337.pdf.
39. Gregory Elliehausen, "The Cost of Banking Regulation: A Review of the Evidence" (Federal Reserve Board Staff Studies No. 171, 1998), 29, http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss171.pdf. Elliehausen provides a helpful overview of research on regulatory costs.
40. Ron Feldman, Ken Heinecke, and Jason Schmidt, "Quantifying the Costs of Additional Regulation on Community Banks" (Federal Reserve Bank of Minneapolis Economic Policy Paper No. 13-3, 2013), http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=5102. The authors point out that their "goal is to advance quantification of additional regulatory costs rather than arguing for a specific cost estimate."
41. *Community Banking Hearing*, 67 (letter of Bill Cheney, President & CEO, Credit Union National Assoc.) ("If a smaller credit union offers a ser-

Small banks often supplement internal compliance staff with compliance advice from outside consultants and software providers. Community bankers with whom the FDIC spoke in connection with its recent study explain that "their increasing reliance on consultants is driven by their inability to understand and implement regulatory changes within required timeframes and their concern that their method of compliance may not pass regulatory scrutiny."[42]

In addition to the costs of hiring new compliance personnel and buying new software, there are less easily quantifiable compliance costs, including "psychological costs" and "dynamic changes in the risk-taking of banks" to compensate for "higher fixed costs."[43] When confronted with too many regulations, managers can lose their ability to focus on serving customers in a profitable and sustainable manner. Regulatory burdens and worries divert time and resources away from the day-to-day business. If the distraction is severe enough, there will be an increased likelihood of financial institution failures, which is a matter of concern to bank shareholders, employees, and customers, and to American taxpayers, who may ultimately be asked to pick up the tab for failed banks and credit unions.

Even when Congress or regulators create exemptions, it can be costly and time-consuming for small financial institutions to determine how to comply with the conditions for the exemption. The legal consequences of non-compliance can be very high, so small financial institutions may instead avoid certain activities altogether. A recent study found that community banks can benefit from using derivatives to hedge their business risks.[44] The authors noted, however, that, as a consequence of the Volcker Rule—which will impose disproportionately high costs on small banks—"community banks may have to reduce and even stop using derivatives for risk management due to the increased regulatory costs."[45]

New rules under Dodd-Frank aggravated the already heavy regulatory burden. In a 2012 survey of Florida community bankers and credit unions, for example, "respondents cited the confusion, complexity, and inconsistencies of the Dodd-Frank Act" as sources of "significant collateral damage on their core operations."[46] The survey found that fifty-six percent of community banks and credit unions planned to devote an additional one to three full-time employees to compliance over the next three years.[47] To gain deeper insight into how Dodd-Frank is affecting small banks, the Mercatus Center conducted an online survey of small banks and is currently in the process of compiling the results. Approximately two hundred banks participated. The average asset size of respondents was $500 million, and most serve rural or small metro markets. More than eighty percent responded that since the passage of Dodd-Frank, their costs of regulatory compliance have increased by more than five percent. Sixty-five percent responded that they expect requirements of Dodd-Frank to be "substantially more burdensome than the Bank Secrecy Act." I hope that our final results will assist Congress and regulators as they think about ways to achieve their regulatory objectives without unduly burdening small banks, their customers, the financial system, and the economy.

INADEQUATE REGULATORY PROCEDURES

Regulators have not given sufficient consideration to the costs that regulations impose on small financial institutions. Small financial institutions are less likely than bigger institutions to have policy-related interactions with

vice, it has to be concerned about complying with most of the same rules as a larger institution, but only can spread those costs over a much smaller volume of business. Not surprisingly, smaller credit unions consistently say that their number one concern is regulatory burden.").

42. FDIC, *Community Banking Study*, B-2.

43. See Feldman et al., "Quantifying the Costs," 3. The authors also point out that regulations can increase profitability. One way that regulation can do this is to act as a barrier to entry.

44. TXuan (Shelly) Shen and Valentina Hartarska, "Financial Derivatives at Community Banks," 20 (Paper Prepared for Presentation at Community Banking in the 21st Century, St. Louis Federal Reserve Bank, October 2013), http://www.stlouisfed.org/banking/community-banking-conference/PDF/Financial_Derivatives_Community_Banks_%20XS_and_VH.pdf.

45. Ibid., 2.

46. Florida Chamber Foundation, *2012 Small Business Lending Survey* (2012), 6.

47. Ibid., 10.

their regulators.[48] Regulators are making some efforts to learn about issues that affect small banks and credit unions,[49] but they can do more.

Agencies have been faulted for not adequately fulfilling their responsibilities under the Small Business Regulatory Enforcement and Fairness Act of 1996 (SBREFA). The Federal Reserve's Inspector General issued a report several months ago that found that the Federal Reserve was not providing consistent, clear, and useful small entity compliance guides and that it could "considerably improve its approach to ensure that its compliance guides consistently (1) explain the actions a small entity should take to comply with the corresponding final rules and (2) enable a small entity to know when such requirements have been satisfied."[50] The Federal Reserve's inspector general currently is conducting an evaluation of the CFPB's compliance with its obligations to take small entities' concerns into account.[51] The CFPB, one of the few agencies required to convene SBREFA panels to hear the views of small entities, has been faulted for not taking this SBREFA obligation seriously.[52]

Regulators have thus far resisted taking a more fundamental step towards understanding the implications of their regulations. Because the federal financial regulators are independent regulatory agencies, they are not subject to executive orders that require executive agencies to conduct economic analysis.[53] Even absent a requirement, however, the federal financial regulators should perform economic analysis of their own volition. It is a tool that would help them identify both the problems they are trying to solve and effective solutions that do not unduly burden financial institutions and the consumers they serve. Yet the regulators have consistently failed to conduct the kind of economic analysis that would help to elucidate unintended consequences *before* a new regulatory burden is imposed.[54] A National Credit Union Administration board member went so far as to reject cost-benefit analysis as too much trouble:

> I also do not believe we should write a report on the cost-benefit analysis of every regulation NCUA proposes. Doing so would be too burdensome, or necessitate hiring additional employees. In any event, the intended benefits are generally obvious in the regulations we propose, and, indeed, many comments point out potential costs–we need not duplicate those efforts. Like credit unions themselves, we at NCUA need to run as tight and as focused an agency as we can.[55]

While performing rigorous economic analysis is not easy, it is preferable to regulating without a complete analysis of the costs and benefits. A statutory requirement that all rulemaking by the financial regulators be informed by

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48. Nearly thirty-five percent of the respondents in our survey had been contacted by a regulator regarding the feasibility of Dodd-Frank implementation, but most of the contacts came from state regulators.

49. The Board of Governors of the Federal Reserve System, for example, has a Community Depository Institutions Advisory Council, made up of representative banks, thrifts, and credit unions. The FDIC has an Advisory Committee on Community Banking and has looked in depth at community banks. See FDIC, *Community Banking Study*. The Federal Reserve Bank of St. Louis recently held an event on community banking. See Federal Reserve Bank of St. Louis, "Community Banking in the 21st Century," accessed November 19, 2013, http://www.stlouisfed.org/banking/community-banking-conference/.

50. Office of Inspector General, Board Of Governors of the Federal Reserve System, *Evaluation Report: Board Should Enhance Compliance with Small Entity Guide Requirements Contained in the Small Business Regulatory Enforcement Fairness Act of 1996* (2013), 4, http://www.federalreserve.gov/oig/files/FRB_SBREFA_compliance_full_Jul2013.pdf.

51. Office of Inspector General, Board Of Governors of the Federal Reserve System, *Work Plan*, (November 25, 2013), 9.

52. See, e.g., Letter from Various Small Business Organizations to Sam Graves, Chairman, and Nydia Velázquez, Ranking Member, House Committee on Small Business (August 1, 2012), 1 ("we are concerned that the CFPB views SBREFA as a burden rather than as a means of improving their regulations. In some cases , CFPB chooses to skip the process altogether, and in other cases they choose to convene panels on compressed timelines, making it difficult for small companies to prepare and gather industry information.").

53. The Office of the Comptroller of the Currency used to be subject to regulatory analysis requirements, but Dodd-Frank reclassified the agency as an independent regulatory agency. See Dodd–Frank Act § 315 (amending the definition of "independent regulatory agency" in 44 U.S.C. § 3502(5) (2006) to include the OCC).

54. For a more in-depth discussion of this topic, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *Journal of Law, Economics & Policy* 9, no. 4 (2013): 569–613.

55. Michael E. Fryzel, Board Member, National Credit Union Administration, Remarks before the NASCUS State System Summit (Sept. 16, 2011), http://www.ncua.gov/News/Pages/SP20100916FryzelNASCUS.aspx.

economic analysis could assist the regulators in designing better regulations and identifying instances in which additional regulation is not necessary. This, in turn, would help to stop unnecessary regulatory burdens from being placed on small financial institutions.

CONCLUSION

Small banks and credit unions face a growing list of regulatory obligations. The discouraging reality is that many of these regulations are not working to make banks safer or to protect consumers. They are absorbing more and more of small financial institutions' time, talent, and other resources. They are preventing small financial institutions from effectively and safely playing their essential role in the financial system. Once the Mercatus Center has finalized the results of our small bank survey, we expect to have a better understanding of the nature of the challenges small financial institutions are facing and the opportunities they are seeing in the current environment. These results should help policymakers to better understand how they can ensure that the American banks and credit unions remain vibrant, competitive, efficient, and customer-focused.

Thank you again for including me in today's discussion. I would be happy to take any questions.

ABOUT THE AUTHOR

Hester Peirce is a senior research fellow at the Mercatus Center at George Mason University and coauthor of *Dodd-Frank: What It Does and Why It's Flawed* (Mercatus Center at George Mason University, 2013). She was on the staff of the Senate Banking Committee during the drafting of the Dodd-Frank Act. Prior to that, she spent eight years at the Securities and Exchange Commission.

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Testimony of

Linda Sweet
President & CEO
Big Valley Federal Credit Union

On Behalf of

The National Association of Federal Credit Unions

"Regulatory Landscape: Burdens on Small Financial Institutions"

Before the

House Small Business Subcommittee on Investigations, Oversight and Regulation

United States House of Representatives

December 3, 2013

Introduction

Good morning Chairman Schweikert, Ranking Member Clarke and Members of the Subcommittee. My name is Linda Sweet and I am testifying this morning on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as President and CEO of Big Valley Federal Credit Union in Sacramento, California. Big Valley was founded in 1953 as Safeway Sacramento Employees Federal Credit Union and serves Safeway stores as far as Nevada and most of northern California.

Over the years, Big Valley merged with four small credit unions unaffiliated with Safeway and therefore has a diverse field of membership. Three of our nine full time employees make up our management team that consists of a former branch manager of a large bank, a former employee of one of the largest credit unions in California, and the CEO of a credit union we merged with. Opening 60 years ago with only $50.00 on deposit, Big Valley has grown to $56 million in assets and serving more than 7,000 members with two branch locations. In my 40 years with Big Valley, 25 as the President/CEO, I have watched the industry go from helping people with their financial needs and life goals, to a point now where I have limited member interaction due to the unprecedented regulatory onslaught my credit union has faced since the financial crisis.

NAFCU is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU member credit unions collectively account for approximately 68 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to discuss the regulatory burden that our nation's credit unions face. The overwhelming tidal wave of new regulations in recent years is having a profound impact on credit unions and their ability to serve some 96 million member-owners nationwide.

Historically, credit unions have served a unique function in the delivery of essential financial services to American consumers. Established by an Act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom may otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche that credit unions still fill today.

Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While nearly 80 years have passed since the Federal Credit Union Act (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain wholly committed to providing their members with efficient, low-cost, personal financial service; and,

- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The nation's approximately 6,700 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. Furthermore, unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the Credit Union Membership Access Act (CUMAA - P.L. 105–219). In the "findings" section of that law, Congress declared that, "The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means ... [and it] continue[s] to fulfill this public purpose."

Credit unions have always been some of the most highly regulated of all financial institutions, facing restrictions on who they can serve and their ability to raise capital. Furthermore, there are many consumer protections already built into the Federal Credit Union Act, such as the only federal usury ceiling on financial institutions and the prohibition on prepayment penalties that other institutions have often used to bait and trap consumers into high cost products.

Despite the fact that credit unions are already heavily regulated, were not the cause of the financial crisis, and actually helped blunt the crisis by continuing to lend to credit worthy consumers during difficult times, they are still firmly within the regulatory reach of several provisions contained in the *Dodd-Frank Act,* including all rules promulgated by the Consumer Financial Protection Bureau (CFPB). The breadth and pace of CFPB rulemaking is troublesome as the unprecedented new compliance burden placed on credit unions has been immense.

The impact of this growing compliance burden is evident as the number of credit unions continues to decline, dropping by more than 800 institutions since 2009. While there are a number of reasons for this decline, a main one is the increasing cost and complexity of complying with the ever-increasing onslaught of regulations. Many smaller institutions cannot keep up with the new regulatory tide and have to merge out of business or be taken over.

Credit unions didn't cause the financial crisis and shouldn't be caught in the crosshairs of regulations aimed at those entities that did. Unfortunately, that has not been the case thus far. Accordingly, finding ways to cut-down on burdensome and unnecessary regulatory compliance costs is a chief priority of NAFCU members.

As evidenced by today's hearing, it is clearly a priority of the Subcommittee. We appreciate your focus on this important issue.

Growing Regulatory Burdens for Credit Unions

A 2011 NAFCU survey of our membership found that nearly 97% of respondents were spending more time on regulatory compliance issues than they did in 2009. A 2012 NAFCU survey of our membership found that 94% of respondents had seen their compliance burdens increase since the passage of the Dodd-Frank Act in 2010. Furthermore, a March 2013 survey of NAFCU members found that nearly 27% had increased their full-time equivalents (FTEs) for compliance personnel in 2013, as compared to 2012. That same survey found that over 70% of respondents have had non-compliance staff members take on compliance-related duties due to the increasing regulatory burden. This highlights the fact that many non-compliance staff are being forced to take time away from serving members to spend time on compliance issues.

At Big Valley FCU, I have seen our compliance costs steadily climb from year-to-year, and skyrocket over the last few. Unfortunately, this is the same at many credit unions. A recent survey of NAFCU members found that of those credit unions that are increasing their education budgets for next year, 84% cited increasing compliance burdens as the most important factor for this increase. Furthermore, it must be noted that new regulations also impact many of the vendors credit unions deal with (such as those providing forms, etc.), and the same NAFCU survey found that over 70% of responding credit unions have seen increased vendor costs stemming from new regulations.

These increased costs at Big Valley have resulted in the inability to provide the quality of service our members have grown accustomed to. Now, we are often slower to offer services that our members want and there are some services we have been forced to cut back on. For example, in many cases we are unable to offer a member a mortgage product that we were once able to. We have actually started to outsource many of our mortgages because we cannot afford a loan officer with the qualifications that new CFPB regulations require. In addition to requiring a member to turn elsewhere for a product we once offered them, they are faced with increased costs that often rise to several thousands of dollars. That certainly seems like an unintended and unnecessary cost to the consumer that the new agency was meant to protect.

The thousands of pages of new mortgage regulation and guidelines from the CFPB is a prime example of the growing compliance burden our nation's credit unions face. Covering everything from the scope of coverage under the Home Ownership and Equity Protection Act, comprehensive changes to mortgage origination and servicing, amended rules associated with the Truth in Lending Act and Financial Institutions Reform, Recovery, and Enforcement Act, changing requirements for escrow accounts and issuing rules under Dodd-Frank relative to what constitutes a "qualified mortgage"—the breadth and pace of new requirements are daunting. A time-

frame of under 12 months to implement the rules should cause serious pause for lawmakers and regulators. Even if the mortgage proposals are well intended, they come with a significant burden particularly to smaller institutions that have trouble just keeping up to be sure that they stay compliant with all of the new rules. That is why NAFCU has urged a delay in the implementation date of the new rules. Furthermore, we believe that CFPB Director Richard Cordray should be very specific about what he means when he promises flexibility for the first few months of 2014 in relation to "good faith" compliance efforts with the mortgage rules slated to take effect in January. The CFPB must work closely with the NCUA to ensure that (1) the NCUA has a clear understanding of what "good faith effort" means; and (2) the NCUA communicates with credit unions their exam expectations in regard the mortgage rules.

While some may argue that the directive aspects of the "rule" itself are far less than thousands of pages, they do not recognize the extent of what it takes to be compliant. In order to fully comprehend and comply with the "rule" a credit union employee must read the regulation in its entirety, interpret the law and its intent, write or rewrite the credit union's policies and procedures, and identify which supervisor is assigned the responsibility for monitoring, compiling and reporting back to management on the necessary information. Management then either audits or hires an outside audit firm, whichever is required by the law, to verify that the regulation is followed. Keep in mind that this is required of each and every regulation, in addition to the employee handling all other daily responsibilities. For most small credit unions, that employee is the only person handling the same regulatory issues that a megabank must comply with. While the CFPB was created under the guise of "leveling the playing field" with unregulated entities, a survey of NAFCU members this fall found that only 4% of responding credit unions have seen a positive impact from CFPB regulating the unregulated.

For small institutions who are just trying to keep up, the ever-increasing amount of time consumed by compliance is daunting. The NCUA has changed the examination process over the years, which has resulted in the transformation from 3 to 5 days of helpful input and teamwork, to a process that now requires months of preparation. The examination time at Big Valley, from start to finish, takes roughly 90 days. Regulatory requirements have also shortened the time between examinations which then condenses the time to prepare for other regulatory audits; CPA audit, BSA audit, ACH audit and Risk audit also take months to prepare for. Furthermore, it seems that these exams are taking longer due to the large number and complexity of regulations and not because of the increasing size or complexity of the credit union.

The 5300 Call Report requirements by the NCUA have increased from a few hours every 6 months to three weeks of compiling and reporting data every quarter. Each quarter's instructions must be reviewed, as there are often changes that are vague, open to interpretation, and requiring clarification. Compiling the data is mostly a manual process because the 5300 Call Report requirements

change faster than a data processor can reprogram the computer systems to search and assemble the required data.

The ever-increasing regulatory burden on credit unions stems not just from one single onerous regulation, but a compilation and compounding of numerous regulations—one on top of another—stemming from a number of federal regulators. A number of these regulations may be worthwhile and well-intentioned, but they are often issued with little coordination between regulators and without elimination or removal of outdated or unnecessary regulations that remain on the books. It was with this in mind that former NAFCU President and CEO Fred Becker wrote then Treasury Secretary Timothy Geithner in his role as Chairman of the Financial Stability Oversight Council (FSOC) in June of 2012. In this letter, NAFCU urged the FSOC to focus on its duty to facilitate regulatory coordination under the Dodd-Frank Act. A copy of this letter is attached to this testimony (Attachment A).

In testimony before a House Financial Services Subcommittee in May of 2012, NAFCU Board Member and witness, Ed Templeton noted that it is not any single regulation, but the panoply of the regulatory regime of numerous regulators, each operating "within their own lanes" and with minimal, if any, interagency coordination, that not only helps create, but also significantly magnifies today's undue regulatory burden on credit unions and other small financial institutions.

It is important to make clear that the tsunami of regulatory burden is impacting all credit unions and hampering the industry's ability to serve our nation's 96 million credit union members. NAFCU believes that any relief efforts should not bifurcate the industry by asset size and would not support such an approach. Providing broad-based relief will help credit unions of all sizes, especially smaller institutions like Big Valley FCU, as we have limited compliance resources and don't have the economy of scale of larger institutions. All credit unions need regulatory relief and we hope that this Subcommittee can help provide it.

Areas Where Credit Unions Need Regulatory Relief

In early February of this year, NAFCU was the first credit union trade association to formally call on the new Congress to adopt a comprehensive set of ideas generated by credit unions that would lead to meaningful and lasting regulatory relief for our industry. As part of that effort, NAFCU sent a five-point plan for regulatory relief to Congress to address some of the most pressing areas where credit unions need relief and assistance (Attachment B). There are number of provisions in this plan that have been introduced as part of the *Regulatory Relief for Credit Unions Act of 2013* (H.R. 2572), by Representative Gary Miller (R-CA). NAFCU and its member credit unions appreciate this opportunity to outline our ideas for meaningful and lasting regulatory relief for our industry. The five points outlined in our plan include:

1. Administrative Improvements for the Powers of the NCUA

NAFCU believes that Congress should take steps to strengthen and enhance the National Credit Union Administration (NCUA).

First, the NCUA should have authority to grant parity to a federal credit union on a broader state law, if such a shift would allow them to better serve their members and continue to protect the National Credit Union Share Insurance Fund (NCUSIF). This is a parity issue that will enable federally chartered credit unions to adequately serve their members in instances where a state law is more conducive to the lending needs and environment in that particular state. It is important to note that this does not simply mean that a federal credit union can default to a state law. The NCUA would need to approve any such shift on a case-by-case basis, ensuring that safety and soundness concerns are addressed. It also must be recognized that in many instances a federal rule addressing an issue that has arisen in a particular state or region simply does not exist. Without the ability to instead use the state law, federal credit unions could be hamstrung in trying to serve their member-owners. We are pleased that this provision was included in the *Regulatory Relief for Credit Unions Act of 2013* (H.R. 2572).

Second, the NCUA should have the authority to delay the implementation of a CFPB rule that applies to credit unions, if complying with the proposed timeline would create an undue hardship. Furthermore, given the unique nature of credit unions, the NCUA should have authority to modify a CFPB rule for credit unions, provided that the objectives of the CFPB rule continue to be met. Since the modified rule would be substantially similar to the original rule, and achieve the same goal, the argument that this would undermine the CFPB's intentions is not valid. Granting NCUA this authority would help address one major issue facing the CFPB. Unfortunately, the CFPB has been given the impossible task for writing one rule that will work well for both our nation's largest banks and the smallest credit unions. Such a provision is also included in H.R. 2572.

An example of where this is necessary is the CFPB's new remittance transfer rule. As part of a regulatory relief package in the 109th Congress (H.R. 3505 / P.L. 109–351), Congress explicitly granted all credit unions the ability to offer remittance services to anyone in their field of membership in an effort to draw the unbanked and under-banked into the system by familiarizing them with credit unions. NCUA could very likely tailor this new rule while maintaining the CFPB's intent. The NCUA has already had this type of authority in the past in conjunction with other regulators, and has this authority now with tailoring Truth in Savings to the unique nature of credit unions.

NAFCU is seriously concerned about the remittance transfer rule and has taken every opportunity to educate the CFPB on the position of credit unions and how the new rule will likely impact the marketplace. The overly broad definition of "remittance transfer" used in the rule imposes new requirements on all international electronic transfer of funds services, and not just transmissions of

money from immigrants in the U.S. to their families abroad—which are in fact conventional remittances. In fact, a September 2013 survey of NAFCU members found that nearly 25% of respondents will cease offering remittance services because of the new rule.

Third, the NCUA and the CFPB should be required to conduct a look-back cost-benefit analysis on all new rules after three years. The regulators should be required to revisit and modify any rules for which the cost of complying was underestimated by 20% or more from the original estimate at the time of issuance. Credit unions did not cause the financial crisis yet all credit unions are subject to the same CFPB rules as larger for-profit mega banks. As a result, credit unions find themselves drowning in regulatory burden stemming from the CFPB and NCUA. It should be noted that many credit unions only have one or two people dedicated full-time to compliance issues, yet they have to comply with the same CFPB rules as mega banks that have an army of lawyers to work on these issues.

There are many instances where the regulator is off base in terms of projecting the compliance cost for credit unions. While some examples may seem insignificant, it is the cumulative effect of layering requirements on top of requirements that creates an environment where a credit union simply cannot keep up. For example, the CFPB recently expanded their survey of credit card plans being offered by financial institutions to include credit unions. The survey purports that the "Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time to gather and maintain data in the required form and to review instructions and complete the information collection." Feedback from NAFCU members indicates that it takes more than 15 minutes just to read the survey instructions, so the idea that the entire process of reviewing and completing the survey could take a total of 15 minutes defies common sense.

In a March 2013 survey of NAFCU members, over 55% of respondents said that compliance cost estimates from the NCUA/CFPB were lower than the credit unions actual cost (That is, the cost was greater than the estimate from the regulator). In the instances where the compliance costs were underestimated, the costs were off by more than 25% over a quarter of the time. Relief on this matter is also an important part of H.R. 2572.

Fourth, new examination fairness provisions should be enacted to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation. NAFCU supports the bipartisan *"Financial Institutions Examination Fairness and Reform Act"* (H.R. 1553) introduced on April 15, 2013 by Representatives Shelley Moore Capito and Carolyn Maloney and is hopeful that the issues this bill seeks to address are given consideration moving forward. Credit unions must have adequate notice of and proper guidance for exams, the right to appeal to an independent administrative law judge during the appeal process, and be assured that they are protected from examiner retaliation.

Finally, the Central Liquidity Facility (CLF) should be modernized with changes such as: (1) removing the subscription require-

ment for membership, and (2) permanently removing the CLF borrowing cap so that it may meet the current needs of the industry.

II. Capital Reforms for Credit Unions

NAFCU believes that capital standards for credit unions should be modernized to reflect the realities of the 21st century financial marketplace.

First, the NCUA should, with input from the industry, study and report to Congress on the problems with the current prompt corrective action (PCA) system and recommended changes.

Second, a risk-based capital system for credit unions that more accurately reflects a credit union's risk profile should be authorized by Congress. We ask that Congress amend current law to make all credit unions subject to risk-based capital standards, and direct the National Credit Union Administration (NCUA) to consider risk standards comparable to those of FDIC-insured institutions when drafting risk-based requirements for credit unions. Credit unions need this flexibility to determine their own risk and to leverage all their resources to provide the best financial services possible to their membership. Such a proposal is a key element of H.R. 2572.

Third, the NCUA should be given the authority to allow supplemental capital accounts for credit unions that meet certain standards. NAFCU applauds Reps. Peter King and Brad Sherman for introducing bipartisan legislation, the *Capital Access for Small Businesses and Jobs Act* (H.R. 719), that would improve the ability of credit unions to serve their members by enhancing their ability to react to market conditions and meet member demands. We would urge members of this Subcommittee to consider supporting this legislation.

Under current law, a credit union's net worth ratio is determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth can dilute a credit union's regulatory capital ratio and trigger nondiscretionary supervisory actions under prompt corrective action (PCA) rules. Allowing credit unions access to supplemental capital would help address this issue.

Finally, given that very few new credit unions have been chartered over the past decade, including only 1 new credit union this year, and in order to encourage the chartering of new credit unions, the NCUA should be authorized to further establish special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

III. Structural Improvements for Credit Unions

NAFCU believes there should be improvements to the *Federal Credit Union Act* to help enhance the federal credit union charter.

First, Congress should direct the NCUA, with input from the industry, to study and report back to Congress suggested changes to outdated corporate governance provisions in the Federal Credit Union Act as several parts haven't been updated to reflect modern day corporate governance since the advent of credit unions and the Acts in 1934. Congress, upon receiving the report, should ensure this mundane yet important issue receives the consideration it deserves. For example, the FCUA currently requires a two-thirds vote to expel a member who is disruptive to the operations of the credit union, at a special meeting at which the member in question himself has the right to vote. NAFCU does not believe that this is in line with good governance practices, and feels that the FCUA should be amended to provide federal credit union boards flexibility to expel members based on just cause (such as illegal behavior, harassment or safety concerns). Given more flexibility in statute, the NCUA would be able to work with credit unions on a case-by-case basis on a number of different issues pertaining to corporate governance.

Second, a series of improvements should be made to the field of membership (FOM) restrictions that credit unions face. This should include expanding the criteria for defining "urban" and "rural" for FOM purposes and also allowing the federal credit unions that convert to community charters to retain their current select employee groups (SEGs).

Finally, Congress should clarify that all credit unions, regardless of charter type, should be allowed to add underserved areas to their field of membership.

IV. Operational Improvements for Credit Unions

Credit unions stand willing and ready to assist in our nation's economic recovery. Our industry's ability to do so, however, is severely inhibited by antiquated legislative restrictions.

First, Congress should show America that they are serious about creating jobs by modifying the arbitrary and outdated credit union member business lending (MBL) cap. This can be done by raising the current 12.25% limit to 27.5% for credit unions that meet certain criteria. We are pleased to see legislation introduced in the form of H.R. 688, the *Credit Union Small Business Jobs Creation Act,* by Representatives Ed Royce (R-CA) and Carolyn McCarthy (D-NY) which would do just that. We would urge members of this Subcommittee to consider supporting this important legislation.

An alternative approach to H.R. 688, would be raising the outdated "definition" of a MBL from last century's $50,000 to a new 21st century standard of $250,000, with indexing for inflation to prevent future erosion. Furthermore, MBLs made to non-profit religious organizations, made for certain residential mortgages (such as non-owner occupied 1–4 family residential mortgages), made to businesses in "underserved areas" or made to small businesses with fewer than 20 employees should be given special exemptions from the arbitrary cap.

Second, requirements to mail redundant and unnecessary privacy notices on an annual basis should be removed, provided that the credit union's policy has not changed and additional sharing of information with outside entities has not been undertaken since the distribution of the previous notice. At Big Valley FCU, unnecessary notices cost our institution several thousand dollars a year. NAFCU appreciates the work of Reps. Blaine Luetkemeyer (R-MO) and Brad Sherman (D-CA) in introducing the *Eliminate Privacy Notice Confusion Act* (H.R. 749) to address this issue. As you may remember, this bill passed the House under suspension of the rules on March 12. We thank the House for its support and are pleased to see that similar legislation has been introduced in the Senate in the form of S. 635.

Third, credit unions should be given greater authority and flexibility in choosing their investments, such as: allowing credit unions to invest in investment grade securities up to 10% of assets; granting credit unions the ability to purchase mortgage servicing rights for investment purposes; and raising the investment limit in Credit Union Service Organizations (CUSOs). These small steps would allow credit unions to better balance and manage their investment options. Investment relief is also included in H.R. 2572.

Fourth, the NCUA should be given greater flexibility in how it handles credit union lending, such as the ability to establish longer maturities for certain loans. Currently, most loans are statutorily capped at 15-year maturities. Allowing the NCUA to grant longer maturities for certain types of loans will allow credit unions to better offer the loan products that their members desire.

Fifth, Congress should clarify that Interest on Lawyers Trust Accounts (IOLTAs) at credit unions are fully insured. We are pleased that this proposal has also been included in H.R. 2572. Furthermore this issue has been recently addressed by legislation introduced by Representatives Ed Royce (R-CA) and Ed Perlmutter (D-CO) in the form of the *Credit Union Share Insurance Fund Parity Act* (H.R. 3468) which was unanimously reported out of the House Committee on Financial Services on November 14, 2013. To the extent the FDIC is required to fully insure IOLTA accounts, it is essential for the NCUA's share insurance fund to be treated identically in order to maintain parity between the two federal insurance programs. Congress passed a change to the Dodd-Frank law to clarify the FDIC's ability in this area, but failed to provide parity to credit unions in its last minute action. We urge Congress to correct this mistake and ensure continued parity. The Federal Credit Union Act states that funds held at a credit union are not protected by the share insurance fund unless the person or persons the funds belong to are also members of the credit union. Furthermore, many states require funds held by an attorney for clients to be held in accounts with federal insurance. In addition, IOLTA accounts often contain funds from many clients, some of whom may have funds in excess of the standard $250,000 share insurance limit. IOLTA funds are constantly withdrawn and replenished with new funds from existing and new clients. Accordingly, it is impractical to require attorneys to establish multiple IOLTAs in different credit union to ensure full share insurance coverage.

Lastly, Congress should make sure that the NCUA has practical requirements on how credit unions provide notice of their federally-insured status in any advertising.

V. 21st Century Data Security Standards

Credit unions are being adversely impacted by ongoing cyber-attacks against the United States and continued data breaches at numerous merchants. The cost of dealing with these issues hinders the ability of credit unions to serve their members. It should be noted that these breaches are often not just the national breaches that make the evening news, but often are localized breaches that can have a devastating impact on a credit union and its members. A 2011 NAFCU survey of our membership found that these local breaches are often the most costly breaches to an institution. These breaches have led to increased costs to credit unions such as higher insurance costs, higher software costs, higher security costs, higher card reissuance costs and higher staffing costs to deal with data breaches.

Congress needs to enact new 21st century data security standards that include:

- the payment of costs associated with a data breach by those entities that were breached;
- establishing national standards for the safekeeping of all financial information;
- requiring merchants to disclose their data security policies to their customers;
- requiring the timely disclosure of entities that have suffered a data breach;
- establishing enforcement standards for provisions prohibiting merchants from retaining financial data;
- requiring the timely notification of the account servicer if an account has been compromised by a data breach; and,
- requiring breached entities to prove a "lack-of-fault" if they have suffered from a data breach.

Additional Areas Where Relief is Needed

In addition to the five major areas outlined above, there are other areas where Congress should act to provide relief for credit unions and other financial institutions:

- Dodd-Frank Act Thresholds: The thresholds established in the Dodd-Frank Act should be raised and indexed. The Act established $10 billion as an arbitrary threshold for financial institutions being subject to the Durbin interchange price cap and the examination and enforcement of the CFPB. We believe that raising such a threshold would still accomplish the same objectives, while not penalizing the number of "good actors" that have found themselves above the arbitrary $10 billion line but below mega-bank status. As the very least, the $10 billion

line should be indexed for inflation on an annual basis—going back retroactively to its establishment.

• Patent Reform: Despite the enactment of the Leahy-Smith American Invents Act in 2011, many credit unions find themselves targets of patent trolls and their frivolous lawsuits and demand letters. NAFCU supports efforts to curb these practices, such as H.R. 3309, the *Innovation Act,* which was recently reported out of the House Judiciary Committee by an overwhelming bipartisan margin.

• E-SIGN Act: Passed in 2000, the E-SIGN Act requires financial institutions to receive consumer consent *electronically* before electronic disclosures can be sent to members. Credit unions cannot accept their member's consent to receive e-statements over the phone or in person, but must instead direct the member to their own personal computers to consent electronically, adding an unnecessary hurdle in this otherwise straightforward process. This outdated provisions is a burden for financial institutions and consumers and should be stricken.

• CFPB Document Access: While Dodd-Frank excludes financial institutions with $10 billion or less in assets from the examination authority of the CFPB, the new agency is provided with unlimited access to financial reports concerning covered persons issued by other regulators. Since the reports are drafted by federal agencies as part of their examination procedures, access by the CFPB to the reports essentially amounts to an examination in itself, even for those institutions with assets of $10 billion or less. NAFCU does not believe that this is the result Congress intended, and asks that this broad language be narrowed appropriately.

• Appraiser Independence: Section 1472 of the Dodd-Frank Act imposes mandatory reporting requirements on credit unions and other lenders who believe an appraiser is behaving unethically or violating applicable codes and laws, with heavy monetary penalties for failure to comply. These provisions would impose a significant burden on each credit union to essentially serve as a watchdog for appraisers violating their own professional practices, and should therefore be optional. If reporting continues to be compulsory, NAFCU asks that Congress amend the severe penalties of up to $10,000 or $20,000 per day which we believe to be excessive.

• SAFE Act Definition of "Loan Originator": The S.A.F.E. Mortgage Licensing Act of 2008 required financial institutions to register any "loan originator." While the intent was to record commissioned originators that perform underwriting, regulators have interpreted the definition very broadly to include any employee accepting a loan application, and even call center staff or credit union volunteer board members. NAFCU asks that Congress narrow the meaning of what it means to "take" an application and to "offer" or "negotiate" terms, which would help prevent credit unions from going through a burdensome process to unnecessarily register individuals not involved in underwriting loans.

- SEC Broker-Dealer Exemption: while the Gramm-Leach-Bliley Act allows for an exemption for banks from broker-dealer and investment adviser registration requirements with the SEC, no similar exception for credit unions is included, even though federal credit unions are permitted to engage in securities-related activities under the FCUA as regulated by NCUA. We ask that credit unions be treated similarly to banks under these securities laws. This would ensure they are not dissuaded from providing services that consumers demand, thereby putting their members at a disadvantage.

Conclusion

Credit unions are suffering under an ever-increasing regulatory burden. This burden is hampering their ability to serve our nation's 96 million credit union members. A NAFCU survey of our members indicates that 94% of respondents have seen this burden increase since the passage of the Dodd-Frank Act in 2010—despite the fact that everyone agreed during the financial reform debate that credit unions were good actors and did not cause the crisis. This is why, during the debate on Wall Street reform, NAFCU opposed credit unions being included under the CFPB rulemaking and why we still have concerns about them being subject to it today.

While many of the rules placed on credit unions are time consuming and burdensome, no single regulation is creating the unbearable regulatory overburden that is leading to industry consolidation, rather it is the tidal wave of new rules and regulations coming from multiple regulators—often with little or no coordination between them. The burden is compounded as old and outdated regulations are not being removed or modernized at the same pace. This regulatory tsunami has hampered all credit unions ability to serve their members and any relief effort should not attempt to split the industry.

NAFCU was the first to call on Congress to provide such relief this past February and our five-point plan, outlined in my testimony, provides a good road map to start on any relief package for credit unions.

NAFCU appreciates your time and thanks the Subcommittee for the opportunity to testify before you here today on these important issues to credit unions and ultimately our nation's economy. I welcome any questions you may have.

Attachment A: NAFCU letter to Secretary Geithner on FSOC's role to reduce regulatory compliance burden; June 27, 2012.

Attachment B: NAFCU letter to Chairman Johnson, Chairman Hensarling, Ranking Member Crapo and Ranking Member Waters calling on Congress to provide credit union regulatory relief; February 12, 2013.

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Fred R. Becker, Jr.
President and CEO

June 27, 2012

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

RE: FSOC's Role to Reduce Regulatory Compliance Burden on Credit Unions

Dear Secretary Geithner: Timothy Geithner

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's Federal credit unions (FCUs), I am writing to you in your capacity as Chairman of the Financial Stability Oversight Council (FSOC).

As you know, under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), the FSOC has a duty to facilitate regulatory coordination. This duty includes facilitating information sharing and coordination among the member agencies of domestic financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions. Through this role, the FSOC is effectively charged with ameliorating weaknesses within the regulatory structure, promoting a safer and a more stable system.

In regards to this goal, NAFCU would like to emphasize how important it is to credit unions for our industry's copious regulators to coordinate with each other to help mitigate regulatory burden. As highlighted in the testimony of NAFCU Board Member Ed Templeton before the House Financial Services Committee on May 9, 2012, it is not any single regulation, but the panoply of the regulatory regime of numerous regulators, each operating "within their own lanes" and with minimal, if any, interagency coordination, that not only helps create, but significantly magnifies, today's undue regulatory burden on credit unions and other small financial institutions.

In his testimony, Mr. Templeton, CEO of a small credit union that serves a large number of underserved Americans, emphasized the difficulties facing credit unions to

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plan ahead and keep pace with the rapid rate of regulatory changes under the Act. As Mr. Templeton testified, 96.4% of credit unions in a NAFCU survey last spring reported that they were devoting more staff time to regulatory compliance than they did in 2008. Consequently, credit unions have not been able to use their resources efficiently as they are devoting far too much time and money on regulatory compliance and related functions; they should be empowered, instead, to expend such time and resources to serving their members.

The array of regulations that are making operating a credit union more and more difficult are being fired simultaneously from multiple directions and by a host of agencies. For example, the Consumer Financial Protection Bureau (CFPB) has issued several rules and is soon expected to propose numerous major rules that would greatly impact credit unions' products and services, including savings, mortgage lending, and credit and debit card services. Concomitantly, the credit union's principle regulator, the National Credit Union Administration (NCUA), is issuing regulations on issues such as concentration and interest rate risk, loan participations, credit union service organizations and appraisal management. At the same time, the Department of Justice is issuing regulations on physical assess to ATMs, while the Department of Labor is issuing regulations on employee rights and the Financial Crimes Enforcement Network (FinCEN) is issuing regulations on currency transaction reports and suspicious activity reports.

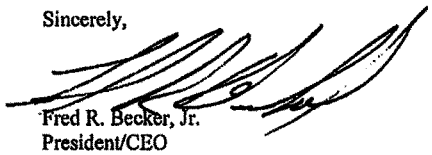
As we have approached each agency regarding the ever-increasing regulatory burden, they quickly respond that the rules being issued by other agencies are outside of their purview. NAFCU believes the FSOC is well-positioned to rectify this lack of coordination. In that regard, we ask that you establish within the FSOC robust inter-agency coordination on the issuance of rules impacting financial institutions.

NAFCU also urges the FSOC to establish policy requiring member agencies to conduct and publish a thorough cost-benefit analysis prior to issuing regulations as well as a separate cost-benefit analysis a year after each regulation the agency prescribes and every other year thereafter. Also, a cost-benefit analysis should be conducted every two years on each regulation that an agency has on its books, with the agency required to justify the regulations' continued existence. These cost analyses should be reviewed by the FSOC to assess the total impact on the financial services industry. We strongly believe that conducting such exercises would better instruct regulators of the high cost of compliance, and equip them with the information necessary to assess whether a particular regulation is effective and justifiable.

America's credit unions have long been reliable sources of financial advancement for millions of people. We believe that the FSOC, with your leadership, is in a position to help credit unions and other small financial institutions continue to achieve their mission of serving their members.

NAFCU appreciates your attention to our concerns. Should you have any questions or concerns, please feel free to contact me or Carrie Hunt, NAFCU's General Counsel and Vice President of Regulatory Affairs, at 703-842-2234.

Sincerely,



Fred R. Becker, Jr.
President/CEO

cc: Members of the Senate Banking Committee
Members of the House Financial Services Committee
The Honorable Ben Bernanke, chairman of the Federal Reserve Board
Martin J. Gruenberg, acting chairman of the Federal Deposit Insurance Corporation
The Honorable Richard Cordray, director of the Consumer Financial Protection Bureau
Edward DeMarco, acting director of the Federal Housing Finance Agency
The Honorable Debbie Matz, chairman of the National Credit Union Administration
The Honorable Karen Mills, administrator of the Small Business Administration
The Honorable Hilda Solis, secretary of the Department of Labor
The Honorable Shaun Donovan, secretary the Department of Housing and Urban Development
James H. Freis, Jr., director, Financial Crimes Enforcement Network
The Honorable Julius Genachowski, chairman of the Federal Communications Commission
The Honorable Jon Leibowitz, chairman of the Federal Trade Commission

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February 12, 2013

The Honorable Tim Johnson
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Michael Crapo
Ranking Member
Senate Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
House Financial Services Committee
United States House of Representatives
Washington, D.C. 20515

Re: NAFCU Calls on Congress to Provide Regulatory Relief for Credit Unions

Dear Chairman Johnson, Chairman Hensarling, Ranking Member Crapo and Ranking Member Waters:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, I write today to call for Congressional action during this session of the 113th Congress to enact broad-based regulatory relief that is essential to the credit union industry's ability to serve its 95 million members.

Our nation's credit unions are struggling under an ever-increasing regulatory burden that must be immediately addressed. A survey of NAFCU members late last year found that 94% have seen their regulatory burden increase since the passage of the *Dodd-Frank Act* in July 2010. The regulatory onslaught continues to compound as credit unions now have over 5,000 pages of rules from the Consumer Financial Protection Bureau (CFPB) that they must understand, interpret, and ultimately comply with – despite the fact that Congress has widely acknowledged that credit unions were not the cause of the financial crisis. Credit unions, many of which have very small compliance departments, and in some cases only one compliance officer, must comply with the same rules and regulations as our nation's largest financial institutions that employ armies of lawyers. The impact of the ever-increasing regulatory burden is even more sobering, as the number of credit unions continues to decline. There are nearly 700 fewer credit unions today than there were before the passage of the *Dodd-Frank Act*.

It is with this regulatory onslaught in mind that we call on Congress to enact meaningful regulatory reforms and provide much needed assistance to our nation's credit unions. Over the past year, we have been actively conversing with our member credit unions to identify those areas where regulatory relief is requisite.

Our ongoing discussions with our members have led us to draft a five point plan for credit union regulatory relief:

I. Administrative Improvements for the Powers of the NCUA

We believe there are changes that must be made to strengthen and enhance the National Credit Union Administration (NCUA).

First, the NCUA should have authority to grant parity to a federal credit union on a broader state rule, if such a shift would allow them to better serve their members and continue to protect the National Credit Union Share Insurance Fund.

Second, the NCUA should have the authority to delay the implementation of a CFPB rule that applies to credit unions, if complying with the proposed timeline would create an undue hardship. Furthermore, given the unique nature of credit unions, the NCUA should have authority to modify a CFPB rule for credit unions, provided that the objectives of the CFPB rule continue to be met.

Third, the NCUA and the CFPB should be required to conduct a look-back cost-benefit analysis on all new rules after three years. The regulators should be required to revisit and modify any rules for which the cost of complying was underestimated by 20% or more from the original estimate at the time of issuance.

Fourth, new examination fairness provisions should be enacted to help ensure timeliness, clear guidance and an independent appeal process free of examiner retaliation.

Finally, the Central Liquidity Facility (CLF) should be modernized with changes such as: (1) removing the subscription requirement for membership, and (2) permanently removing the CLF borrowing cap so that it may meet the current needs of the industry.

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NAFCU believes that capital standards for credit unions should be modernized to reflect the realities of the 21st century financial marketplace.

First, the NCUA should, with input from the industry, study and report to Congress on the problems with the current prompt corrective action (PCA) system and recommended changes.

Second, a risk-based capital system for credit unions that more accurately reflects a credit union's risk profile should be authorized by Congress.

Third, the NCUA should be given the authority to allow supplemental capital accounts for credit unions that meet certain standards.

Finally, given that very few new credit unions have been chartered over the past decade, and in order to encourage the chartering of new credit unions, the NCUA should be authorized to further establish special capital requirements for newly chartered federal credit unions that recognize the unique nature and challenges of starting a new credit union.

III. Structural Improvements for Credit Unions

NAFCU believes there should be improvements to the *Federal Credit Union Act* to help enhance the federal credit union charter.

First, Congress should direct the NCUA, with input from the industry, to study and report back to Congress suggested changes to outdated corporate governance provisions in the *Federal Credit Union Act*. Congress should then act upon those recommendations.

Second, a series of improvements should be made to the field of membership (FOM) restrictions that credit unions face expanding the criteria for defining "urban" and "rural"; and allowing voluntary mergers involving multiple common bond credit unions and allowing credit unions that convert to community charters to retain their current select employee groups (SEGs).

Finally, all credit unions, regardless of charter type, should be allowed to add underserved areas to their field of membership.

IV. Operational Improvements for Credit Unions

Credit unions stand willing and ready to assist in our nation's economic recovery. Our industry's ability to do so, however, is severely inhibited by antiquated legislative restrictions.

First, Congress should show America that they are serious about creating jobs by modifying the arbitrary and outdated credit union member business lending (MBL) cap. This can be done by raising the current 12.25% limit to 27.5% for credit unions that meet certain criteria or by raising the outdated "definition" of a MBL from last century's $50,000 to a new 21st century standard of $250,000, with indexing for inflation to prevent future erosion. Furthermore, MBLs made to non-profit religious organizations, businesses in "underserved areas", or small businesses with fewer than 20 employees should be given special exemptions for the arbitrary cap.

Second, requirements to mail redundant and unnecessary privacy notices on an annual basis should be removed, provided that the credit union's policy has not changed and additional sharing of information with outside entities has not been undertaken since the distribution of the previous notice.

Third, credit unions should be given greater authority and flexibility in choosing their investments.

Fourth, the NCUA should be given greater flexibility in how it handles credit union lending, such as the ability to establish longer maturities for certain loans.

Finally, Congress should clarify that Interest on Lawyers Trust Accounts (IOLTAs) at credit unions are fully insured and also that the NCUA should have practical requirements on how credit unions provide notice of their federally-insured status in any advertising.

V. 21st Century Data Security Standards

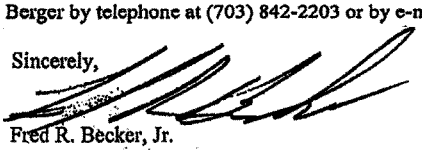
Credit unions are being adversely impacted by ongoing cyber-attacks against the United States and continued data breaches at numerous merchants. The cost of dealing with these issues hinders the ability of credit unions to serve their members. Congress needs to enact new 21st century data security standards that include: the payment of costs associated with a data breach by those entities that were breached; establishing national standards for the safekeeping of all financial information; require merchants to disclose their data security policies to their customers; requiring the timely disclosure of entities that have suffered a data breach; establishing enforcement standards for provisions prohibiting merchants from retaining financial data; requiring the timely notification of the account servicer if an account has been compromised by a data breach; and, requiring breached entities to prove a "lack-of-fault" if they have suffered from a data breach.

We have outlined a number of proposals that are necessary to providing the regulatory relief and assistance that credit unions urgently require. The number of credit unions continues to decline on a monthly basis and the ever-increasing regulatory burden the industry is facing is accelerating that decline as compliance costs become even more onerous. It is with that in mind that we call on Congress to act on any and all of these proposals, whether as a comprehensive package, or individually. Our nation's credit unions and their 95 million members desperately need this relief and we call on Congress to enact it.

Thank you for your attention to this important matter.

If you have any questions or would like further information about any of these issues, please do not hesitate to contact me or NAFCU's Executive Vice President of Government Affairs Dan Berger by telephone at (703) 842-2203 or by e-mail at dberger@nafcu.org.

Sincerely,



Fred R. Becker, Jr.
President and CEO

cc: Members of the Senate Banking Committee
Members of the House Financial Services Committee

Testimony of

B. Doyle Mitchell, Jr.

President and CEO of Industrial Bank

Washington, D.C.

On behalf of the

Independent Community Bankers of America

Before the

United States House of Representative

Committee on Small Business

Subcommittee on Investigations, Oversight and Regulations

Hearing on

"Regulatory Landscape: Burdens on Small Financial Institutions"

December 3, 2013

Washington, D.C.

Chairman Schweikert, Ranking Member Clarke, and members of the subcommittee, my name is Doyle Mitchell, and I am President and CEO of Industrial Bank, a $350 million asset bank headquartered in the District of Columbia. Industrial Bank was founded in 1934, in the depth of the Great Depression, and is the oldest and largest African American-owned commercial bank in the metropolitan Washington, D.C. area. We have over 120 employees, I testify today on behalf of the nearly 7,000 community banks represented by the Independent Community Bankers of America. Thank you for convening this hearing on the "Regulatory Landscape: Impact on Small Financial Institutions."

In addition to being a member of ICBA, I am also the Chairman of the National Bankers Association, a trade association for the nation's minority and women-owned banks. While many community banks serve rural areas and small towns, there is also an important segment of community banks like mine that serve urban areas and that were founded to serve minority communities that were historically and many times currently, ignored by other financial institutions.

America's 7,000 community banks are playing a vital role in ensuring the economic recovery is robust and broad based, reaching communities of all sizes and in every region of the country. The recent FDIC Community Banking Study showed that in one out of every five counties in the United States, the only physical banking offices are those operated by community banks.[1] Community banks provide 60 percent of all small business loans under $1 million, as well as customized mortgage and consumer loans suited to the unique characteristics of their local communities. Federal Reserve data shows that while overall small business lending contracted during the recent recession, lending by a majority of small community banks (those of less than $250 million in assets) actually increased, and small business lending by banks with asset sizes between $250 million and $1 billion declined only slightly. By contrast, small business lending by the largest banks dropped off sharply. The viability of community banks is linked to the success of our small business customers in the communities we serve, and we don't walk away from them when the economy tightens.

In order to reach their full potential as catalysts for entrepreneurship, economic growth, and job creation, community banks must have regulation that is calibrated to their size, lower-risk profile, and traditional business model. Working with community bankers from across the nation, ICBA has developed its Plan for Prosperity, a platform of legislative recommendations that will provide meaningful relief for community banks and allow them to thrive by doing what they do best—serving and growing their communities. By rebalancing unsustainable regulatory burden, the Plan, if adopted by Congress, will ensure that scarce capital and labor resources are used productively, not sunk into unnecessary compliance costs, allowing community banks to better focus on lending and investing that will directly improve the quality of life

[1] FDIC Community Banking Study, December 2012, Page 3–5. (http://www.fdic.gov/regulations/resources/cbi/study.html)

in our communities. The Plan for Prosperity is attached to this testimony, as is a list of the 23 bills that have been introduced in the House and Senate to date that incorporate Plan for Prosperity provisions.

New Rules Threaten Community Bank Mortgage Lending

A primary focus of the Plan for Prosperity is mortgage lending regulatory relief. Every aspect of mortgage lending is subject to new, complex, and expensive regulations that will upend the economics of this line of business. These regulations are being enacted in response to the worst abuses of the pre-crisis mortgage market—abuses in which community banks did not engage. In particular, community bankers are deeply concerned by the Consumer Financial Protection Bureau's (CFPB's) new "ability-to-repay" rule which will expose lenders to litigation risk unless their loans meet the definition of "qualified mortgage" or "QM." However, a staple of community bank mortgage lending, balloon loans, are explicitly excluded from QM status unless they are made in rural areas under an unreasonably narrow definition of "rural." Many community banks are not willing to assume heightened litigation risk and will exit the mortgage lending business particularly in rural markets. While ICBA supports the CFPB's amendments to the QM rule which make accommodations for community banks, they do not go far enough to preserve access to credit for community bank customers.

The "ability to repay" rule is scheduled to take effect January 10, 2014 and thousands of community banks, more than 50 percent, will not be prepared or are uncertain of their readiness to comply by that date. Even the most negligible regulatory change can require many months to change systems, update policies and procedures, revise underwriting requirements, and train staff. Bankers must ensure that vendors and suppliers are prepared as well. Changes of the magnitude of the "ability-to-repay" rule are particularly challenging for community banks given their limited staff and legal and compliance resources. Many community banks may be forced to suspend their mortgage lending until they become compliant. This would have a significant adverse impact on the recovering housing market. Other community banks may exit the mortgage business altogether. For this reason, ICBA is urging the CFPB to extend the mandatory compliance date and allow optional compliance for a period of 9 to 12 months. We hope that members of this committee will support that request.

The CLEAR Relief Act

In addition to this administrative extension request, ICBA is seeking legislative solutions, included in the Plan for Prosperity, that would simplify community bank compliance with the CFPB "ability-to-repay" rule and other new mortgage and non-mortgage rules. While, as noted above, 23 bills have been introduced that embody Plan for Prosperity provisions, I would like to use this testimony to highlight the single bill that best captures the full scope of the Plan: the Community Lending Enhancement and Regulatory

Relief Act (CLEAR Relief Act, H.R. 1750), introduced by Rep. Blaine Luetkemeyer, a former community banker and current member of the Small Business Committee as well as the Financial Services Committee. The CLEAR Relief Act has over 80 cosponsors with strong bipartisan representation. A Senate companion bill has similar bipartisan support. The CLEAR Relief Act contains eight Plan for Prosperity provisions, including:

Qualified Mortgage Status for Community Bank Portfolio Loans

The CLEAR Relief Act solution to compliance with the "ability-to-repay" rule is simple, straightforward, and will preserve community bank mortgage lending: QM status for community bank loans held in portfolio, including balloon loans in rural and non-rural areas and without regard to their pricing. This provision would apply to all lenders with less than $10 billion in assets. When a community bank holds a loan in portfolio it holds 100 percent of the credit risk and has every incentive to ensure it understands the borrower's financial condition and to work with the borrower to structure the loan properly and make sure it is affordable. Withholding safe harbor status for loans held in portfolio, and exposing the lender to litigation risk, will not make the loans safer, nor will it make underwriting more conservative. It will merely deter community banks from making such loans.

Escrow Requirement Exemption for Community Bank Portfolio Mortgages

The CLEAR Relief Act would exempt community bank loans held in portfolio from new escrow requirements for higher priced mortgages. This exemption would also apply to all lenders with less than $10 billion in assets. Again, portfolio lenders have every incentive to protect their collateral by ensuring the borrower can make tax and insurance payments. For low volume lenders in particular, an escrow requirement is expensive and impractical and, again, will only deter lending to borrowers who have no other options.

Small Servicer Exemption

The CLEAR Relief Act would raise the CFPB's small servicer exemption threshold from 5,000 loans to 20,000. Community banks are deeply concerned about the impact of servicing standards that are overly prescriptive with regard to the method and frequency of delinquent borrower contacts. These rigid standards reduce community banks' flexibility to use methods that have proved successful in holding down delinquency rates. Example of difficult and unnecessary requirements include new monthly statements; additional notices regarding interest rate adjustments on ARM loans; rigid timelines for making contacts that leave no discretion to the servicer; and restrictions on forced placed insurance. Community banks' small size and local presence in the communities we serve make many of these requirements unnecessary.

A higher exemption threshold would preserve the role of community banks in mortgage servicing, where consolidation has clearly

harmed borrowers. Community banks above the 5,000 loan threshold have a proven record of strong, personalized servicing and no record of abusive practices. To put the 20,000 threshold in perspective, consider that the five largest servicers service hold an average portfolio of 6.8 million loans[2] and employ as many as 10,000 people each in servicing alone.

Appraisal Exemption for Smaller Mortgages

The CLEAR Relief Act would reinstate the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) exemption for independent appraisals for loans of $250,000 or less. Appraisal standards have changed significantly over the past few years. First as a result of the Home Valuation Code of Conduct from Fannie Mae and Freddie Mac, and more recently as a result of the Dodd-Frank Act. These standards are well intentioned, having been designed to prevent abuses by unregulated mortgage brokers that contributed to the collapse of the housing market. However, they have made it nearly impossible for many community banks to use local appraisers and forced them to hire appraisal management companies at significant expense. The CLEAR Relief Act would provide relief from these costs, which are passed on to the borrower and increase the cost of credit.

Modernize the Federal Reserve's Small Bank Holding Company Policy Statement

The CLEAR Relief Act requires the Federal Reserve to revise the Small Bank Holding Company Policy Statement—a set of capital guidelines that have the force of law. The Policy Statement, makes it easier for small bank holding companies to raise additional capital by issuing debt, would be revised to apply to both bank and thrift holding companies and to increase the qualifying asset threshold from $500 million to $5 billion. Qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage. This will help ease capital requirements for small bank and thrift holding companies. This past November, the House Financial Services Committee passed out of committee a bill increasing to $1 billion, the Small Bank Holding Company Policy Statement. We applaud passage of this bill and urge House leaders to give this bill floor consideration.

Relief from Accounting and Auditing Expenses for Publicly Traded Community Banks and Thrifts

The CLEAR Relief Act would exempt from the internal control attestation requirements of Section 404(b) of the Sarbanes-Oxley Act banks with assets up to $10 billion. The current exemption threshold applies to companies with less than $75 million in market capitalization. Because community bank internal control systems are monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an out-

[2] Source: Office of Mortgage Settlement Oversight (www.mortgageoversight.com).

side audit firm for attestation work. This provision will substantially lower the regulatory burden and expense for small, publicly traded community banks without creating more risk for investors.

Eliminate Redundant Privacy Notices

The CLEAR Relief Act provides that a financial institution is not required to mail an annual privacy notice to its customers if it has not changed its privacy policies. Most community banks do not have the scale to automate the annual privacy notice mailings. For these banks, the mailings are a manual, labor intensive process. Eliminating this requirement when a bank has not changed it privacy policies, will conserve resources without putting consumers at risk or reducing their control over the use of their personal data.

This provision of the CLEAR Relief Act is also contained in a separate bill introduced by Rep. Luetkemeyer, the Privacy Notice Confusion Elimination Act (H.R. 749), which passed the House in March.

There are additional provisions of the CLEAR Relief Act. Together they provide a strong, clear legislative response to the threat of mistargeted regulation to the community bank charter.

Closing

I encourage you to reach out to the community bankers in your district. Ask them about the current regulatory environment and whether the CLEAR Relief Act, the Right to Lend Act, and the other Plan for Prosperity bills attached to this testimony would help them better serve their communities. We're confident that they will agree with us. Your cosponsorship of the CLEAR Relief Act and the other Plan for Prosperity bills would be greatly appreciated by community bankers and ICBA.

Thank you again for the opportunity to testify today. I hope that my testimony, while not exhaustive, gives you a sense of the sharply increasing resource demands placed on community banks by regulation and what's at stake for the future of community banking.

Left unaddressed, the increasing burden of regulation will discourage the chartering of new community banks and lead to further industry consolidation. Consolidation will lead to higher loan interest rates for borrowers, lower rates paid on deposits, and fewer product choices. A more concentrated industry, dominated by a small number of too-big-to-fail banks, will jeopardize the safety and soundness of the financial system and expose taxpayers to the risk of additional costly bailouts. That's why it's so important to enact the sensible regulatory reforms outlined above. We encourage Congress to consider ICBA's Plan for Prosperity as a guide to achieving these reforms.

Thank you again for the opportunity to testify today.

Attachments

- **Plan for Prosperity Bills**

Bills Containing ICBA Plan for Prosperity Provisions

The Community Lending Enhancement and Regulatory Relief Act of 2013 (H.R. 1750)

The Community Lending Enhancement and Regulatory Relief Act of 2013 (S. 1349)

The Protecting American Taxpayers and Homeowners Act (H.R. 2767)

The Terminating Bailouts for Taxpayer Fairness Act of 2013 (S. 798)

The Portfolio Lending and Mortgage Access Act of 2013 (H.R. 2673)

The Financial Institutions Examination Fairness and Reform Act (H.R. 1553)

The Financial Institutions Examination Fairness and Reform Act (S. 727)

The Eliminate Privacy Notice Confusion Act (H.R. 749)

The Privacy Notice Modernization Act (S. 635)

The Municipal Advisor Oversight Improvement Act (H.R. 797)

The Municipal Advisor Relief Act (S. 710)

The Consumer Financial Protection Commission Act (H.R. 2402)

The Responsible Consumer Financial Protection Regulations Act (H.R. 2446)

The Consumer Financial Protection Safety and Soundness Improvement Act (H.R. 3193)

Responsible Financial Consumer Protection Regulations Act (S. 205)

The Holding Company Registration Threshold Equalization Act (H.R. 801)

The Holding Company Registration Threshold Equalization Act (S. 872)

Mutual Community Bank Competitive Equality Act (H.R. 1603)

The Financial Regulatory Responsibility Act of 2013 (S. 450)

The SEC Regulatory Accountability Act (H.R. 1062)

The Right to Lend Act (H.R. 2323)

The S Corporation Modernization Act (H.R. 892)

To enhance the ability of community financial institutions to foster economic growth and serve their communities (H.R. 3329)

GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Professor of Law

Written Testimony of

Adam J. Levitin
Professor of Law
Georgetown University Law Center

Before the United States House of Representatives
Committee on Small Business
Subcommittee on Oversight, Investigations, and Regulation

Regulatory Landscape: Burdens on Small Financial Institutions"

October 24, 2013
10:00 am

Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, contracts, bankruptcy, and commercial law.

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin currently chairs the Mortgage Committee of the Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

Mr. Chairman Schweikert, Ranking Member Clarke, Members of the Committee:

Good morning. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in consumer finance, contracts, bankruptcy, and commercial law. I also serve on the Consumer Financial Protection Bureau's statutory Consumer Advisory Board. I am here today solely as an academic who has written extensively on consumer finance and financial regulation and am not testifying on behalf of the CFPB or its the Consumer Advisory Board.

In my testimony today, I focus on five areas where new regulatory changes affect small businesses or small financial institutions:

1. The effect of the CARD Act on small business credit;
2. The effect of the CFPB on small business credit
3. The effect of the CFPB on small financial institutions
4. The effect of the Durbin Interchange Amendment on small depositories; and
5. The effect of the US implementation of the Basel III Capital Accords on small financial institutions.

Neither the CARD Act nor CFPB nor Basel III is likely to have a major effect on smaller financial institutions; the Durbin Interchange Amendment actually makes small financial institutions more competitive vis-a-vis large banks. These changes in regulation will undoubtedly impose some compliance costs. Some of these will be one-time costs, and some will be recurring. And these costs may affect the competitive landscape in financial services. It is hard, however, to see any currently proposed regulations as having a material effect on the ability of smaller financial institutions to compete or on the availability of credit to small businesses. When weighed against the clear benefits of better consumer protection regulation, more competitive markets, and safer banks, the overall effect of the regulatory changes appears positive.

I. The Effect of the CARD Act on Small Financial Institutions and Small Business Credit

The Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the "CARD Act") is the first major statutory overhaul of the credit card market since the 1968 Truth in Lending Act. During the intervening four decades, the credit card market expanded and evolved dramatically, and the CARD Act was much needed legislation to rein in some of the more egregious billing "tricks and traps" that had emerged in the credit card market. The credit card market is one dominated by large banks—roughly 85% of credit card lines outstanding is on cards issued by just ten large banks.[1] Many smaller banks do not even offer credit cards. Accordingly, the brunt of the CARD Act's regulatory burden has been born by a handful of megabanks.

[1] NILSON REPORT, #1012, Feb. 2013, at 9.

The CARD Act applies only to consumer credit cards; small business credit cards remain virtually unregulated. Accordingly, the CARD Act cannot be held responsible for the reduction in small business credit lines. Thus, a recent statutorily mandated study by the CFPB on the impact of the CARD Act notes that:

> [N]othing in the evidence reviewed suggests that the CARD Act was responsible for the reduction in credit access—which largely preceded the Act's enactment—or that the CARD Act has retarded the pace of the recovery. The parallels between the consumer credit card market and the small business credit card market, and between the credit card market and other consumer credit markets, do not suggest that, in general, recovery in the card marketplace has been negatively impacted by the CARD Act.[2]

The CARD Act may have even helped small businesses by lowering their costs of credit and by enabling greater consumer purchasing power for goods and services. A recent study estimates that the CARD Act has saved US consumer $20.8 billion per year.[3] Similarly, the CFPB concluded that "the CARD Act likely did not raise credit card costs for consumers."[4] To the extent that the CARD Act has helped consumers by making credit markets more transparent and thus allowing markets to operate more efficiently, it also has helped small businesses in two ways. First, small businessmen are consumers themselves. And second, to the extent that better consumer protection laws result in a more competitive consumer protection market place and reduce the rents that can be extracted from consumers by financial institutions, it means that consumers will have more money left over that can be spent on goods and services in the real economy. This suggests that the CARD Act has actually had a positive impact on small businesses generally.

II. CFPB and Small Business Credit

Small businesses account for roughly half of private-sector employment and 46 percent of GDP.[5] These small businesses—like any type of commercial enterprise—require credit to operate. As an initial matter, I want to underscore that the CFPB has no almost direct regulatory authority relating to small business credit.

The CFPB's organic authority is limited to products and services "offered or provided for use by consumers primarily for personal, family, or household purposes".[6] Most statutes administered by the CFPB, such as the Truth in Lending Act are similarly restricted. The sole areas in which the CFPB has jurisdiction are a pair of seldom-invoked provisions of the Truth in Lending Act prohibiting the

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[2] CFPB, CARD Act Report: A review of the impact of the CARD Act on the consumer credit card market, Oct. 1, 2013, at 61, *at http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.*

[3] Sumit Agrawal et al., *Regulating Consumer Financial Products: Evidence from Credit Cards,* Sept. 25, 2013, *at* http://ssrn.com/abstract=2330942.

[4] CFPB, CARD Act Report: A review of the impact of the CARD Act on the consumer credit card market, Oct. 1, 2013, at 36, *at http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.*

[5] Kathryn Kobe, Small Business GDP: Update 2002–2010, Jan. 2012, *at http://www.sba.gov/sites/default/files/rs390tot_0.pdf* (the 46% figure is for 2010).

[6] 12 U.S.C. § 5481(5)(A).

issuance of unsolicited credit cards[7] and limiting liability of employees to card issuers for unauthorized business card usage[8] and the Equal Credit Opportunity Act (ECOA), which prohibits various discriminatory lending practices,[9] and which was amended by the Dodd-Frank Act to include a data collection provision on small business lending.[10] This means that the CFPB can engage in only very limited regulation of small business financial products, and then primarily to ensure against discriminatory lending, rather than to regulate the terms and conditions of financial products.

Thus, the CFBP's direct authority over small business credit is primarily to the extent that the small business credit is obtained as consumer credit. While this is commonly done, it is typically in contravention to representation made by the borrowers to their lenders. Still, many small businesses rely on consumer credit cards and home equity lines of credit for liquidity, use consumer deposit accounts, and make use of vehicles financed through consumer loans or leases.

To date, however, CFPB rulemaking and enforcement has had little impact on any of these particular financial products in a way that would affect small businesses. The CFPB has done only minor rulemakings relating to credit cards (and these loosened pre-existing regulations);[11] the CFPB's major mortgage rulemaking regarding the "qualified mortgage" or QM exemption to the statutory ability-to-repay requirement does not apply to home equity lines of credit;[12] and the CFPB has done no rulemakings in the deposit account or auto finance areas. Similarly, the CFPB has yet to engage in a rulemaking regarding data collection on small business lending, and has indicated that until such a rulemaking occurs, the reporting requirements do not go into effect.[13]

Instead, to the extent that the CFPB is affecting small business credit, it is only indirectly, to the extent that financial institutions are responding to CFPB regulation by changing their small business lending practices. To date, there is no evidence that this is occurring, much less that any such indirect effects are negative and outweigh any concomitant benefits. I make no attempt here to quantify the benefits of any particular consumer protection regulation, but note again, that small businesses benefit from such regulations both as because small businessmen are consumers them-

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[7] 15 U.S.C. § 1642.
[8] 15 U.S.C. § 1645.
[9] 15 U.S.C. § 1691 *et seq.*
[10] 15 U.S.C. § 1691o–2.
[11] 78 Fed. Reg. 25818 (May 3, 2013) (amending Regulation Z to remove the requirement that card issuers consider consumers' *independent* ability to pay for applicants who are at least 21 years old and permitting issuers to consider in ability to repay income and assets which a consumer can reasonably expect to access, such as spousal income and assets); 78 Fed. Reg. 18795 (Mar. 28, 2013) (amending Regulation Z to apply the limitation on the total amount of fees that a credit card issuer may require a consumer to pay solely to the fist year after account opening and not also prior to account opening).
[12] 12 C.F.R. § 1026.43(a)(1). Some rules, such as regulations relating to mortgage counseling, mortgage servicing, and compensation rules for arbitration and credit insurance do apply to home equity lines of credit, but the impacts are minor. Similarly, the application of the Home Owners Equity Protection Act rules (requiring additional disclosures for high-cost mortgages) also apply to high-cost equity lines of credit.
[13] Letter from Leonard J. Kennedy, General Counsel, Consumer Financial Protection Bureau to Chief Executive Officers of Financial Institutions under Section 1071 of the Dodd-Frank Act, April 11, 2011, *at* http://files.consumerfinance.gov/f/2011/04/GC-letter-re-1071.pdf.

selves and because better consumer protection laws leave more money in consumers' pockets to spend on goods and services instead of on bank fees and interest.

III. CFPB and Small Financial Institutions

The creation of the CFPB has changed the regulatory landscape for consumer protection regulation, but the CFPB's impact on small banks is limited, and the CFPB has shown a particular solicitude toward the concerns of smaller financial institutions, such as community banks and credit unions, which are the source of a disproportionate share of small business lending.[14]

The CFPB's attention to small financial institutions is partially a matter of statute. The CFPB is required to identify and address "unduly burdensome regulations," which are a particular concern of smaller financial institutions.[15] As part of these safeguards against unduly burdensome regulation, the CFPB is required to:

- Consult with prudential regulators and State bank regulators in order to minimize the regulatory burden upon lending institutions.[16]
- Consult with the prudential regulators of small banks and credit when proposing regulations.[17] The prudential regulators are permitted to formally object to the rules and their written objections must be included in the rule-making record, along with the Bureau's response to their concerns.[18]
- Evaluate the potential impact of rules on small businesses under the Regulatory Flexibility Act.[19]
- Give small businesses a preview of new proposals and receive extensive feedback from small businesses before even giving notice to the broader public (under the Small Business Regulatory Enforcement Fairness Act).[20]
- Assess possible increases in the cost of credit for small entities and consider any significant alternatives that could minimize those costs.[21]

Assess the effectiveness of each rule within five years of implementation, including soliciting public comments on whether to change or eliminate the regulations.[22]

- Finally, the CFPB also has the authority to exempt any consumer financial services provider from its rules.[23]

The CFPB's real attention to the concerns of smaller financial institutions is also a matter of agency culture. My observation from serving on the CFPB's Consumer Advisory Board is that the CFPB

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[14] 57% of small business loans by dollar amount outstanding are on the books of depositories with less than $10 billion in assets. FDIC Statistics on Depository Institutions ($335 billion of $586 billion in small business credit outstanding is from institutions with less than $10 billion in assets)

[15] 12 U.S.C. § 5511(b)(3).

[16] 12 U.S.C. § 5513(b)(2)–(3).

[17] 12 U.S.C. § 5512(b)(2)(B).

[18] 12 U.S.C. § 5512(b)(2)(C).

[19] 5 U.S.C. §§ 603, 604.

[20] 5 U.S.C. §§ 603, 609; Executive Order 12866 of September 30, 1993.

[21] 5 U.S.C. § 603.

[22] 12 U.S.C. § 5512(d).

[23] 12 U.S.C. § 5512(b)(3)(A).

is an agency that is deeply committed, from the top down, to working with small financial institutions. Institutionally, the CFPB understands that small financial institutions play an important role in consumer protection through fostering greater competition, particularly along the lines of providing better service and simpler products for consumers. Moreover, small financial institutions play a particularly important role in consumer finance in smaller and rural communities. Thus, the CFPB has created an important exemption from the ability-to-repay requirement for mortgages for smaller financial institutions.[24]

Because of the importance of small financial institutions to consumer finance, the CFPB has set up special community bank and credit union advisory boards—not required by statute—so that it gets regular feedback directly from small banks themselves, not simply from trade associations. When CFPB leadership travels outside of Washington, a routine and important part of the agenda are meetings with the officers of small financial institutions.

The CFPB's outreach to smaller financial institutions is particularly important because the CFPB does not have much formal direct contact with small depositories and credit unions. Of the roughly 14,000 depositories and credit unions in the United States, only around 111 of them (those with over $10 billion in net assets in the holding company) are subject to examination by the CFPB. The rest—all small depositories—are examined for consumer protection compliance by their prudential regulators: the FDIC, the Federal Reserve Board, the NCUA, and the OCC.

While this spares smaller institutions the burden of having to deal with two separate examinations, it also means that there is no direct communication between the CFPB and these smaller institutions. Instead, what the CFPB expects in terms of regulatory compliance is communicated indirectly through the examiners from the prudential regulators. In theory, all of the examinations should be coordinated through the Federal Financial Institutions Examination Council, but it is possible, particularly as new regulations go into effect, that the lack of a direct communication channel through the examination process has made it harder for small financial institutions to understand what is—and is not—required of them.

In short, the CFPB is an agency that is very attuned to the concerns of small institutions. This is not to say that the CFPB would or should always agree with these concerns, but it is clearly an agency that is listening with an open mind and trying to balance its statutory charges of consumer protection and access to financial services with the particular needs of smaller financial institutions.

IV. Durbin Interchange Amendment

The Durbin Interchange Amendment to the Dodd-Frank Act regulates the interchange or "swipe" fees that banks can charge on

[24] 12 C.F.R. § 1026.43(e)(5); 1026.35(b)(2)(iii)(B)–(C) (exempting from the QM debt-to-income ratio requirement loans held in portfolio and made by creditors that originate less than 500 mortgages annually and have less than $2 billion in net assets).

debit card transactions.[25] While parts of the Durbin Amendment apply to all financial institutions, depositories with less than $10 billion in net assets are exempt from the Durbin Amendment's cap on interchange fees.[26] The result is to give smaller financial institutions a significant leg up against their larger competitors.

The Durbin Amendment has also helped consumers and small businesses significantly. A recent study estimates that last year the Durbin Amendment saved consumers $5.8 billion in lower costs for goods and services and saved merchants $2.6 billion, which translates into roughly 38,000 new jobs.[27] Taken as a whole, then the Durbin Amendment seems to have benefitted consumers, small businesses, and also small financial institutions.

V. Basel III

In the wake of the financial crisis, bank regulators globally recognized the need to craft more stringent capital requirements for depositories and their holding companies. One of the most fundamental lessons of the financial crisis is that capital is key. Sufficient capital is the only real guarantee that a bank can absorb losses.

The third round of the Basel Capital Accords (Basel III) is an attempt to take this lesson to heart. Basel III creates a more detailed and demanding system of bank capital requirements for US banks and their holding companies. The Basel III rules are not perfect. They are too complex and too gameable because of a continued reliance on risk-weighting. They also still require too little capital and liquidity for banks. In particular, the leverage ratio—the bottom line and simplest measure of capital—is still far too low at 3%.

The proposed US implementation of Basel III,[28] which goes into effect as of January 1, 2015 for most banks and bank holding companies, generally requires more capital for banks. It also defines capital more stringently. These are both good things, and neither should affect financial institutions' willingness to lend. Heightened capital requirements do not limit the amount of lending a bank can do—they are not reserve requirements. Instead, capital requirements merely require that banks be less leveraged. To the extent that a bank is less leveraged, it is less risky, which means that there is less chance that the public will be asked to pick up the tab. Greater capital requirements help move us away from the faux capitalism world of privatized gains and socialized losses.

While Basel III was in reaction to the financial crisis, which was first and foremost a large bank crisis, it applies to all banks. This is the correct approach. While no individual small bank is likely to

[25] 15 U.S.C. § 1693o–2.

[26] 15 U.S.C. § 1693o–2(a)(6)(A). Smaller financial institutions are still subject to the Durbin Amendment's routing exclusivity provision, but the Federal Reserve rulemaking currently in place does not meaningfully change pre-existing routing arrangements for most debit cards.

[27] Robert J. Shapiro, *The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees,* Oct. 1, 2013, *at* http://21353cb4da875d727ald-ccea4d4b51151ba804c4b0295d8d06a4.r8.cfl.rackcdn.com/SHAPIROreport.pdf.

[28] Basel III is a non-binding set of coordinated principles agreed to by bank regulators from leading developed economies, in order to head off international arbitrage of regulatory capital standards, but there is room for variation in the actual national-level implementations, which are done via notice-and-comment rulemaking.

pose a systemic risk, small bank failures are still costly for the FDIC. Requiring greater capital makes these failures less likely.

There will certainly be one-time cost of understanding the complicated new requirements and implementing proper compliance systems. Beyond that, however, it is hard to identify any provisions that are especially onerous on small banks,[29] although it is notable that Basel III applies to small banks, but not to credit unions.

The limited impact of Basel III on small banks is partially because Basel III left intact some key features of Basel I/II: the total risk-weighted capital ratio remains at 8%, and the leverage ratio remains at 4%. And key assets categories for smaller financial institutions, such as all residential mortgage loans and most commercial real estate loans retain the same risk-weighting.

Basel III's impact on small banks is also limited because the US Basel III rules contain numerous exceptions or exemptions for smaller financial institutions. Significantly, trust preferred securities (TruPS) and cumulative preferred stock issued before May 19, 2010 may still count for Tier 1 capital for institutions with less than $15 billion in assets. Similarly, all institutions with less than $250 billion in assets may keep opt to continue their current regulatory capital treatment of accumulated other comprehensive income (AOCI), which would mean keeping available-for-sale securities on balance sheet without having to adjust regulatory capital levels based on the securities' current market value. And bank holding companies with less than $500 million in assets are entirely exempt from Basel III (their depository subsidiaries must still comply). As a result, the FDIC estimates that 95% of insured depositories already have sufficient capital to comply with the final Basel III rules.[30]

Conclusion: The Multi-Tiered Financial Regulatory System

The past five years have seen remarkable change in the regulation of the financial services industry, starting with the CARD Act of 2009 and continuing through the Dodd-Frank Act and subsequent and still on-going regulatory implementation. On the whole, this regulation addressed serious problems in our financial regulatory system, particularly in regard to consumer protection and bank safety-and-soundness.

The new financial regulations, taken as a whole, are not perfect. In some areas regulation may have gone too far, in other areas not far enough, and in yet other areas, simply taken the wrong approach. I make no claim in this testimony that all the changes in

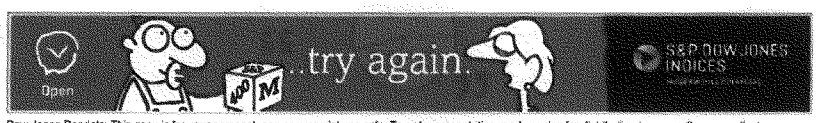
[29] Basel III did restrict the definition of what can qualify as capital and increased requirements for more finely tuned sub-ratios. In addition, Basel III creates the concept of a "capital conservation buffer" that will, after a phase in, be an additional 2.5% of risk-weighted assets. The capital conservation buffer is not a formal capital requirement—banks are not required to have a capital conservation buffer. The capital conservation buffer will function as a type of de facto capital requirement, however, because any bank that fails to have a capital conservation buffer will be subject to restrictions on dividends, share repurchases, and interest payments on preferred securities, and executive bonus payments. Basel III also caps the inclusion of mortgage servicing and deferred tax assets in capital. Both provisions are potentially burdensome, but not unduly so.

[30] 79 Fed. Reg. 55340, 55347 (Sept. 10, 2013).

the financial regulatory system have been optimal. Instead, looking at the regulatory changes as a whole, what one sees is the emergence of four-tiered financial regulatory system: big banks and big non-banks; small banks; big non-banks; and small non-banks.

In this four-tiered regulatory system, big banks are subject to stricter capital requirements; to examination and enforcement of consumer financial protection statutes by the CFPB; and to debit interchange fee caps. Small banks have looser capital requirements; have consumer protection examination and enforcement done by their prudential regulators instead of by CFPB; and are exempt from debit interchange fee caps. Small banks may also benefit from various exemptions to consumer financial protection statutes. Big non-banks may be subject to capital requirements (if systemically important) and may subject to CFPB examination (if defined by regulation as "larger participants" in their product market). Small non-banks are not subject to capital requirements or CFPB examination, although all non-banks are subject to CFPB enforcement. (Non-banks do not receive debit interchange fees.)

The multi-tiered system has the effect of tilting the competitive playing field toward smaller financial institutions; whether they are banks or non-banks. Even with a tilted regulatory playing field, however, smaller financial institutions are still often at a competitive disadvantage to larger institutions because of the economies of scale that can exist in technology-heavy areas of financial services. There will be compliance costs from any changes in regulation, and some regulations will result in lower revenue for financial institutions. Ultimately, marginal changes in regulatory compliance costs are not what will determine the viability of smaller financial institutions, and no institution's profitability should depend on being able to take advantage of consumers or the ability to gamble with federally insured deposits. Financial regulation has costs for financial institutions, but these costs should not obscure the real and valuable social benefits of consumer protection, competitive markets, and safe-and-sound banks.



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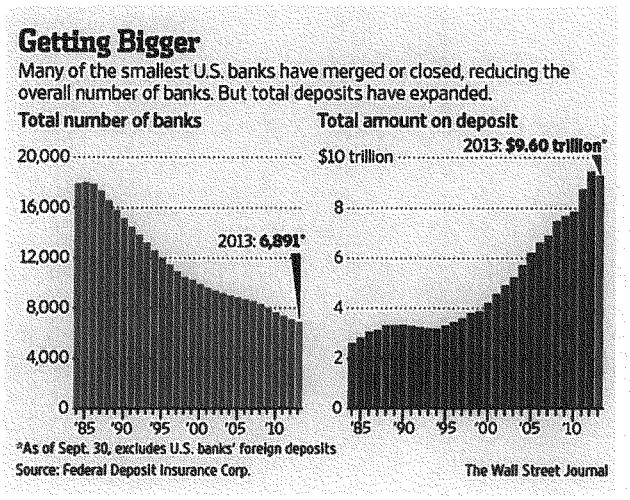
MARKETS

Tally of U.S. Banks Sinks to Record Low

Small Lenders Are Having the Hardest Time With New Rules, Weak Economy and Low Interest Rates

By RYAN TRACY

Updated Dec. 3, 2013 7:33 a.m. ET



The number of banking institutions in the U.S. has dwindled to its lowest level since at least the Great Depression, as a sluggish economy, stubbornly low interest rates and heightened regulation take their toll on the sector.

The number of federally insured institutions nationwide shrank to 6,891 in the third quarter after this summer falling below 7,000 for the first time since federal regulators began keeping track in 1934, according to the Federal Deposit Insurance Corp.

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The decline in bank numbers, from a peak of more than 18,000, has come almost entirely in the form of exits by

banks with less than $100 million in assets, with the bulk occurring between 1984 and 2011. More than 10,000 banks left the industry during that period as a result of mergers, consolidations or failures, FDIC data show. About 17% of the banks collapsed.

The consolidation could help alleviate concerns that the abundance of U.S. banks leads to difficulties in oversight or a less-efficient financial system. Meanwhile, overall bank deposits and assets have grown, despite the drop in institutions.

"Seven thousand is still an awful lot of banks," particularly in an era where brick-and-mortar branches are becoming less profitable, said David Kemper, chief executive of Commerce Bancshares Inc., a regional bank based in Missouri. "There's no reason why we need that many banks, especially if those smaller banks have a much lower return on capital. The small banks' bread and butter is just not there anymore."

Still, the falloff is raising alarms among boosters of community banks, who say such lenders—which represent the vast majority of U.S. banks—are critical to the economy because they are more likely to make small-business loans. The number of physical bank branches in the U.S. is also shrinking. From the end of 2009 through June 30 of this year, the total number of branches dropped 3.2%, according to FDIC data.

"All too often, the large banks use their models and their algorithms, and if you don't fit in their boxes, you don't get the loan," said Sheila Bair, the former FDIC chairman who is now a policy adviser at the Pew Charitable Trusts think tank.

Unlike before the financial crisis, new startup banks aren't rushing to take the place of exiting institutions. Every year from 1934 to 2009, investors in the U.S. chartered at least a few and sometimes hundreds of new banks, according to the FDIC data. The Bank of Bird-in-Hand opened in Bird-in-Hand, Penn., on Monday—it was the first new bank startup in the U.S. since December 2010.

~~The reticence stems from slim profits and rising regulatory costs as Washington tries to ensure banks won't fail en masse as they did during and after the 2008 financial crisis, bankers and industry consultants say.~~

SNL Financial, a firm that tracks bank data, said the median loan-growth rate for banks with less than $100 million in assets was about 2% during the year ending Sept. 30, well behind the roughly 3.4%-to-7% rate for midsize banks, or those with assets as high as $10 billion.

FDIC researchers, in a study of community banks released in December 2012, found that, as net interest margins—the difference between the interest charged on loans and that paid on deposits—declined across the industry in recent years as interest rates dropped, community banks suffered more than other banks. That is because their business models—traditional lending and deposit gathering—generally rely more on interest income.

And one way small banks grow, by buying branches from other banks, is also slipping. Through mid-November, there had been only 89 sales of branches this year, down 25% from the same 2012 period, according to SNL Financial. The main reason for the drop, industry experts said, is consumers' increasing reliance on mobile banking and automated teller machines.

The question for community banks is, "Can you be too small to succeed?" said Dorothy Saverese, chief executive of the Cape Cod Five Cent Savings Bank in Massachusetts, who also advises the FDIC on community-banking issues.

Last week, the Bank of Bird-in-Hand bucked the trend, announcing it had secured FDIC approval and would become the first federally approved startup bank in nearly three years. The challenges the bank faced in winning that approval help explain why many investors are opting not to charter new banks.

To convince regulators of their viability, the backers behind the Bird-in-Hand group raised about $17 million from investors. Brent Peters, chief executive of the Bank of Bird-in-Hand, estimated the group spent about $800,000 in preparing its application for a new charter, including consulting and legal fees, rent on a temporary office during the roughly seven-month application process and the salaries of top managers, four of whom were on the payroll one month before the bank won FDIC approval.

In its application, the bank had to lay out internal policies and procedures in detail and specify the systems in place to, for example, guard against cyberattacks. Paid consultants analyzed the local lending market and the feasibility of opening a bank there. The FDIC interviewed senior management and contacted banks competing nearby.

"You are talking perhaps anywhere from 8 to 16 inches of paper," the bank's attorney, Nick Bybel, said of the application.

Mr. Peters, who helped found another Pennsylvania bank in the early 1990s, said the application process this time was much more intense. "I've done this before, and it's a lot different this time around," said Mr. Peters.

Even before the financial crisis, the FDIC had begun to step up its analysis of bank applications, including testing to see how an institution would likely fare in its early years. In 2009, the agency lengthened to seven years from three years the period during which the banks it oversees face higher capital requirements and heightened scrutiny of business-plan changes.

FDIC officials say the agency's process has always been rigorous and that it has received few applications in recent years as the economy has struggled. The lack of new banks forming is similar to "a pattern we've seen following previous financial crises and the recoveries that followed," FDIC Chairman Martin Gruenberg said during a news conference last week. "We would expect to be seeing additional applications as the environment improves, and we expect to be approving them."

David Baris, a partner at law firm BuckleySandler LLP who said he has advised more than 30 new bank startups over his career, said he has been steering clients away from starting a bank. "As a result of the FDIC's policy, a [new] bank becomes a much-less-attractive investment, and it will be difficult to find sufficient capital."

Even existing small banks also report higher operational costs in the postcrisis era. Expenses include investments in cybersecurity and staffing to ensure compliance with new federal rules on mortgage lending and other matters.

United Southern Bank in Kentucky is about the same size it was in 2009, but bank President Todd Mansfield said he has hired about 15 back-office workers since then to help process loans, ensure compliance with regulations and deploy information technology. "We are literally running out of space. Probably we needed to add a few [more] people, but you know labor is the most-expensive item we have on the books," he said.

Mr. Peters said he and his partners felt starting a bank in this climate could still be profitable, in large part because the Bird-in-Hand bank will cater to a population they feel is underserved: the Amish community. The area around Bird-in-Hand, a village squeezed between farm fields in Lancaster County, Pa., had a

locally owned bank in recent years, but it was snapped up by a larger competitor in 2003. Bank of Bird-in-Hand's owners think they can provide banking services that are better tailored to the community.

While the new bank will offer online deposits and target local customers who aren't Amish, it will also operate a courier service to accommodate customers who might not be able to drive up or log on—a nod to the fact many Amish don't use cars or computers. The drive-through window of the bank's one branch accommodates a horse and buggy, and there is a shelter in the parking lot to shield horses from rain.

There is now one community-bank application pending in the U.S., according to the FDIC. It is for an institution in American Samoa.

—Saabira Chaudhuri contributed to this article.

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