Testimony of

Guy T. Williams

On behalf of the

American Bankers Association

before the

Oversight and Reform Committee

United States House of Representatives

American
Bankers
Association

Testimony of Guy T. Williams

On behalf of the

American Bankers Association

before the

Oversight and Reform Committee

United States House of Representatives

July 13, 2016

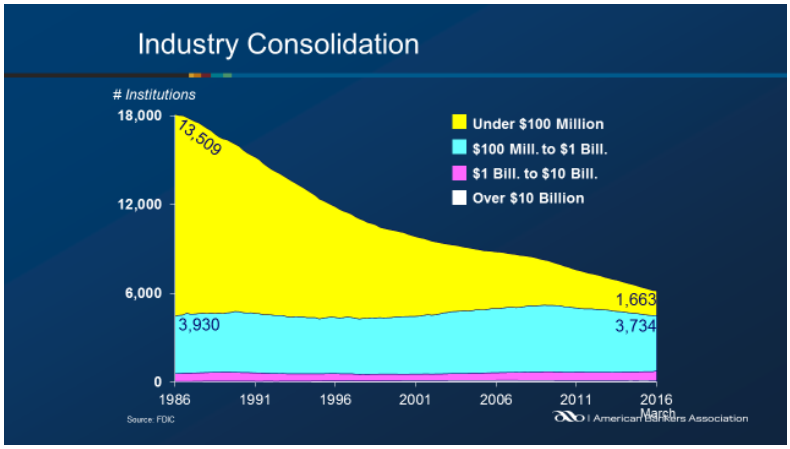
Chairman Chaffetz and Ranking Member Cummings, my name is Guy Williams and I am the President and Chief Executive Officer of Gulf Coast Bank and Trust Company in New Orleans, Louisiana. I appreciate the opportunity to be here to present the views of the American Bankers Association (ABA) regarding regulatory relief for small financial institutions. The ABA is the voice of the nation's $14 trillion banking industry, which is composed of small, mid-size, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend more than $8 trillion in loans.

Gulf Coast Bank was chartered in 1990—at the beginning of a recession—with $1.5 million in capital. Over the last 25 years, we have used that capital to grow our company into a $1.45 billion community bank, serving southeast Louisiana. We are the largest small business lender in our state, specializing in helping to establish and grow new businesses. Gulf Coast Bank is also one of the largest New Orleans metro area mortgage lenders, making roughly $500 million in residential mortgage loans each year.

ABA appreciates the opportunity to testify on the nearly complete lack of new bank start-ups (de novo banks). New entrants into any industry are a sign of growth potential and economic opportunity. New banks help fill gaps in the provision of banking services, increase competition, and ultimately strengthen the community banking sector. New banks mean consumers and businesses have more choices of competitive products and services which translates into greater economic activity and growth in local communities.

The lack of de novo activity is concerning to our industry and sadly reflects the same forces that are driving consolidation—excessive and complex regulations that are not tailored to the risks of specific institutions. This—not the local economic conditions—is often the tipping point that drives small banks to merge with banks typically many times larger. It is also a barrier to entry for

new banks. The fact remains that there are only seven de novos in the last 5 years. Even more troubling, there are 1,500 fewer community banks today than 5 years ago—a trend that will continue until rational changes are made to provide some relief to America's banks.



The FDIC has acknowledged both the vital importance of community banks as well as the need for changes to encourage de novo formations. Community banks account for 44 percent of small business loans. According to a 2012 FDIC report, there are 600 rural or micropolitan counties where a community bank is the only financial institution. If that bank disappears, there is no incentive for investors to start a new bank to serve that community (and any economic vitality will quickly disappear).

In April, the FDIC announced welcome supervisory changes, including community outreach, establishing a team of people to help prospective de novos through every stage of the process, refreshing its answers to key questions, and developing a guide to the deposit insurance application process to increase transparency. In addition, the period of heightened de novo supervision and strict adherence to the bank's original business plan—what some have referred to as the "penalty box"—was shortened from seven years to three years.

Addressing gaps in knowledge and resources is very important, but it doesn't address the underlying issues that create the barriers to entry: capital hurdles, unreasonable regulatory expectations on directors, funding constraints, an inflexible regulatory infrastructure, technology investments, and tax-favored competition from credit unions and the Farm Credit System. The 3-year penalty box, while better, still acts as a deterrent. If it does not make economic sense, no one will start a new bank. Look no further than the lack of new charters for proof of this. Fix the underlying problems and new charters will result.

Certainly the extraordinarily low interest rates over such a long period have narrowed spreads and created considerable economic stress for any existing bank or prospective de novo. But this is only part of the story. Community banks are resilient. We have found ways to meet our customers'

needs despite the ups and downs of the economy, but that job has become much more difficult due to the avalanche of new rules, new guidances and the seemingly ever-changing expectations of the regulators. Let me repeat: Fix the underlying problems and you help both existing banks and encourage new bank charters as well.

Each and every bank in this country helps fuel the U.S. economy. Each has a direct impact on job creation, economic growth and prosperity. Community banks have always prided themselves on being flexible in order to meet the unique circumstances of each customer. This is why it is imperative that Congress take steps to ensure and enhance the banking industry's capacity to serve their customers, thereby facilitating job creation and economic growth.

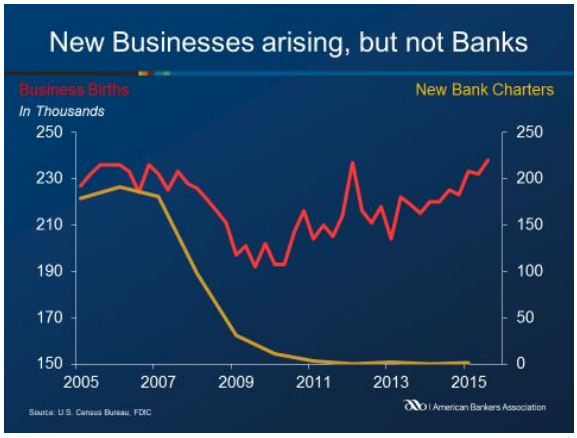
We thank House Financial Services Committee Chairman Hensarling and the members of the Committee that have worked to provide some regulatory relief. We urge members of Congress to work together— Senate and House—to pass legislation that will enhance the ability of community banks to serve our customers and help grow our economy.

In the remainder of my testimony, I would like to focus on the follow key points:

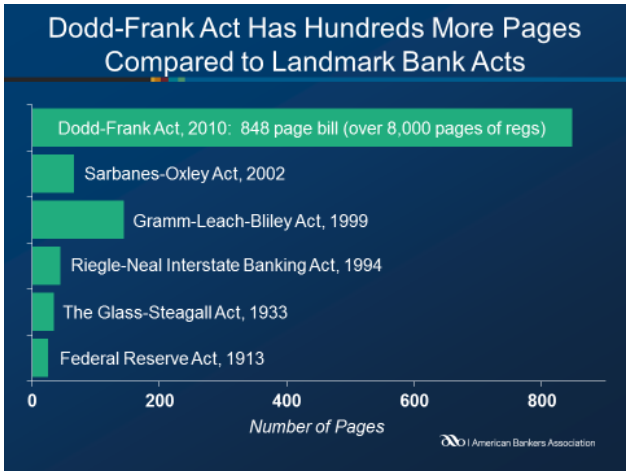
- The lack of de novos has its roots in excessive regulation,
- The constraints on assets, liabilities and capital all conspire to make new charters uneconomical, and
- In order to insure the broadest possible financial options for our communities, we must think creatively to find solutions that will stimulate new bank entrants.

1. The Lack of De Novo Banks Has Its Roots in Excessive Regulation

In these economic times, the forces that challenge banks every day are the same as those that make starting a new bank nearly impossible. Certainly, economic conditions have had an impact. The Federal Reserve did admirable work during the recession, but quantitative easing and the zero-interest-rate policies have had real, lasting consequences. The first consequence is that we as a nation now favor borrowers and penalize savers. Great if you have good credit and want a home loan; horrible if you are a saver or retiree and need to live on your interest income. For banks, quantitative easing has compressed margins and forced longer-term lending which has raised concerns by regulators about interest rate risk. The near zero-interest-rate policy is challenging enough for existing banks, but as I detail later, it makes starting a new bank much more difficult.



A common belief is that the economic cycle is the primary obstacle for new banks. This is untrue. When Gulf Coast Bank was started in 1990, it was in the middle of the so-called "S&L Crisis" and the beginning of a recession. Despite these severe conditions, there were 193 de novos that year. ***Over the next 10 years, 1,500 new banks started***! While our bank was started during a recession—in many ways not dissimilar to the Great Recession—there were opportunities and investors who were willing to risk their own money to capitalize a new bank. Contrast that with the latest cycle: it started similarly with 181 new charters in 2007 (the start of the recession) but fell off very quickly over the next two years. Since the Dodd-Frank Act was enacted in 2010, there have only been 7 de novos with three of those started only to facilitate an acquisition of a failed bank and another for a credit union to convert to a bank. ***That means only 3 real new banks in the last 5 years***. Even more stark is the contrast between the lack of de novo bank formations and the recovery of new business formations across all industries since the recession.



Not only have regulation been piled on, even more telling is the regulatory approach that a bank should never fail. This is not only an impossible standard, it is also too risk averse. It limits new activities and growth. The first chapter in every book on entrepreneurship or economics says that capitalism is built on investors putting ideas and money to work, and accepting the very real risk that they will fail in the process.

There is no question that de novos, like all new businesses, are riskier than existing institutions. They have failed at twice the rate of other banks historically. They create losses for the FDIC (which banks fund). But most bankers believe that failures are part of any dynamic industry and de novos are where new ideas are born.

When Gulf Coast Bank and Trust Company was started, we used the capital we had to buy two failing savings and loan institutions, and quickly boosted capital from the initial $1.5 million to $3 million and proceeded to create an institution that has helped our community thrive for more than 25 years. Other de novos may not have fared so well, but without the risk taking by investors, none of this would have been possible. I doubt seriously that our bank would be granted a charter today due to the capital requirements, the constraints on assets, and the restrictions on funding. Couple those factors with a suffocating regulatory blanket, and I doubt that our investors would have made the investment.

2. Constraints on Assets, Liabilities and Capital All Conspire to Make New Charters Uneconomical

On both sides of the balance sheet—assets on one side and liability plus capital on the other—there are constraints that limit the economic potential of any new bank. These are detailed below:

Earning Assets are Under Stress

Community banks typically have four broad categories of assets: cash and investments, consumer loans, mortgage loans and business loans. Each of these types is under stress. For consumer lending (non-real estate), competition from lightly regulated, untaxed credit unions combined with an overwhelming and constantly increasing regulatory burden has made these loans marginally profitable at best, if not actual loss leaders. For residential mortgage and home equity lending, new requirements from the Consumer Financial Protection Bureau with help from the other regulators has made this type of lending more risky. The risk comes from an aggressive compliance culture that attempts to criminalize minor regulatory violations, combined with an inflexible definition of qualified mortgages. This means fewer banks will offer these loans, limiting choices and options for consumers.

As I mentioned, Gulf Coast Bank is one of the largest residential mortgage lenders in our state. After the new TRID rules, we found that all of the mortgage service providers raised their costs.

The closings now take longer, and because of the TRID mandated closing resets, realtors encourage home owners to only take cash offers or offers from borrowers who have locked in financing to avoid closing delays. As a result, consumers now pay more, wait longer, and have incentives not to shop among lenders because of the delays these things are likely to create. The result is fewer options for consumers as many community banks abandon mortgage lending altogether due to the added risks and costs that make it uneconomical.

The last area of profitability for consumer banks is small business lending. This continues to be profitable, but it is now under assault from the tax-free credit unions and Fintech non-bank lenders who make loans without the same regulatory costs as community banks to remain in the business.

Every earning asset held by community banks is now less profitable than it was in years past. Some of this erosion is caused by regulations, some by the interest rate environment, some by unregulated competitors, and some by untaxed and lightly supervised competitors.

For those considering starting a new bank, these stresses combine to limit potential profitability and discourage any investment. Banks compete with all other capital options, and if returns from making good asset decisions are not sufficient to generate a reasonable return, money flows elsewhere.

Funding Constraints Limit Asset Growth

Even when there are good opportunities to lend, funding those loans is the perhaps the biggest hurdle for potential de novos. Banks are funded with deposits. Recent regulations aimed at the largest banks, which take a narrow view of “stable” funding, coupled with the FDIC’s aggressive definition of what constitutes a brokered deposit, have steered the industry into insured retail and small business deposits. While these deposits offer low cost funding, this narrow view of stable funding constrains banks, which incur a regulatory cost as compared to other types of funding. The limited array of acceptable funding sources hits de novo banks acutely because it takes time to build the customer relationships necessary to gather these deposits – and de novos can’t compete on convenience (with few branch locations) or pay high rates.

There are many other sources of funding available that have proven to be stable and cost effective. For example, as de novo institutions build their deposit base, they may need to look for funding outside of their local market by using internet-based deposit services or partnering with a third party to help market their products and generate deposits. Unfortunately, all these are

considered "brokered" by the FDIC and, as such are unlikely to be approved in the de novo's new business plan. The bottom line is that unlike most new businesses that can work every available option to gain customers and gain market share, new banks are extremely limited in their funding and product options, further detracting from the desirability of a new bank charter.

Capital Thresholds are Too High

As I mentioned, Gulf Coast Bank started with $1.5 million of investor capital—$4.4 million in today's dollars—and quickly doubled that as part of our two acquisitions. The expectation now in banking circles is that it would take $20-$30 million to start a bank. This is many multiples beyond what ***successful*** banks needed in the past. Can a bank today earn enough to cover the cost of that capital? Great investment options don't exist in today's abnormally low-rate environment. But even with more normal rates and a steeper yield curve, a new bank probably cannot grow fast enough to cover investor expectations.

The key point is that investors cannot justify illiquid investments at low yields. If de novos were a good investment that made economic sense, today there would be a lot more new banks started. Besides the enormous regulatory infrastructure that must be covered by capital (with no return, of course), the technology investment required in today's banking world is also large. Moreover, while a strong business plan for the new bank is required, there is strong resistance by the regulators to any change in that plan. A new business must adjust quickly to the rapidly changing reality of its market. But unlike most new businesses, a de novo bank must jump through regulatory hoops to chart a new course. With the 3-year penalty box and strong resistance by the regulators to any change in the business plans of a new bank, it can be nearly impossible to make the necessary adjustments quickly enough to be successful. For investors, it raises questions about success and the likelihood and timing of their potential returns.

The pressure to increase capital levels—including requirements of the Basel Capital Standards—increases the hurdle rate for any return to investors. A well-capitalized bank used to operate with 6% leverage capital. Now are being pushed to maintain 9% capital. The simple math is that earnings must increase by 50% to maintain the same return on equity. These high capital requirements mean that new banks are unlikely to make a reasonable return on equity in any reasonable time frame.

So we are back to the beginning. If investors can't see a way to make a reasonable return on investment, they won't invest. No investment means fewer new banks and slower growth for the U. S. economy.

Unreasonable Regulatory Expectations for Directors is Also an Impediment

Typically investors in a de novo institution become the first directors of the newly formed bank. This is because the capital often comes from pooled funding from leaders in the community that see a niche that could be filled by the new bank.

The significant regulatory requirements of directors in banks today—which can impose personal legal liabilities for them—make it difficult for any bank to find a good director and near-impossible for new bank. Directors are now expected to know more than can be reasonably expected, including maturity matching, hedging strategies, derivative accounting, complex asset-liability strategies, and cybersecurity risks and mitigations, to name just a few. They must then tell management how to address each of these things. Given the potential liability, the lawyers to these investors most certainly would advise against being a bank director.

3. A Creative Approach is Needed to Encourage New Bank Formations

The changes the FDIC has made are a start, but more can and needs to be done. It's time to think differently to encourage new banks—by requiring less capital, reducing the regulatory burden, permitting greater flexibility in business plans, and lifting funding restrictions. Some ideas to consider include:

- Create a fast track for new banks.
- Reduce the minimum initial capital level (e.g., to $10 million) and reduce the required capital ratio for the first three years (e.g., to 6%). The goal is enable the new bank to generate earnings and grow quickly enough to become profitable and sustainable.
- Further reduce the "penalty box" and enable changes in the bank's business plan.

- Allow a new bank to fund itself in the least-cost most efficient way without regard to the source.

- Define any mortgage loan held by the bank on its own balance sheet as a "Qualified Mortgage."

- Address the unfair competition from tax-favored providers such as credit unions and the Farm Credit System.

Simply put, Congress can help by eliminating unnecessary impediments which negatively impact every community across the United States. This will help stem the tide of community bank consolidation and create an environment conducive to new bank charters. The key to changing the consolidation trend is to stop treating all banks as if they were large and complex institutions. All too often, regulations intended for the largest institutions become the standard that is applied to every bank—Basel III capital requirements being the most egregious. (The Europeans who designed the Basel Accords are shocked that the U.S. regulators chose to apply them to community banks.) Such an approach only layers on unnecessary requirements that add little to improve safety and soundness, but add much to the cost of providing services—a cost which customers ultimately bear. A better approach to regulation is ***tailored*** bank supervision that is responsive to the charter, business model, and scope of each bank's operations. This would ensure that regulations and the exam process add value for banks of all sizes and types. By facilitating new bank charters, new capital will flow into the entire banking system as it would signal the potential for growth and success.

Conclusion

New entrants into any market reflect the promise of a better tomorrow. For banks, new entrants bring new ideas and technologies, expand the financial choices and opportunities of businesses and consumers, and fill gaps where banking services may not have fully met the needs.

The lack of de novos banks is strong evidence that the economics no longer work. Investors have plenty of choices about where to invest, and if the impediments to starting a new bank are too great, they will quickly move their money to opportunities with greater promise. The forces that

have acted to stop de novos are the same ones that have led to the dramatic consolidation of the banking industry. Fix the underlying problems and the future will be brighter for both new and existing banks.

Community banks—whether new ones or old—have a personal stake in the economic growth, health, and vitality of nearly every community. A bank's presence is a symbol of hope, a vote of confidence in a town's future. When a bank sets down roots, communities thrive. We urge Congress to act now and pass legislation to help turn the tide of community bank consolidation, create an economic environment that encourages new bank charters, and protect communities from losing a key partner supporting economic growth.