REGULATORY BURDENS: THE IMPACT OF DODD–FRANK ON COMMUNITY BANKING

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH, JOB CREATION AND REGULATORY AFFAIRS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

JULY 18, 2013

Serial No. 113–47

Printed for the use of the Committee on Oversight and Government Reform

Available via the World Wide Web: http://www.fdsys.gov
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

82–337 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

DARRELL E. ISSA, California, *Chairman*

JOHN L. MICA, Florida
MICHAEL R. TURNER, Ohio
JOHN J. DUNCAN, JR., Tennessee
PATRICK T. MCHENRY, North Carolina
JIM JORDAN, Ohio
JASON CHAFFETZ, Utah
TIM WALBERG, Michigan
JAMES LANKFORD, Oklahoma
JUSTIN AMASH, Michigan
PAUL A. GOSAR, Arizona
PATRICK MEEHAN, Pennsylvania
SCOTT DESJARLAIS, Tennessee
TREY GOWDY, South Carolina
BLAKE FARENTHOLD, Texas
DOC HASTINGS, Washington
CYNTHIA M. LUMMIS, Wyoming
ROB WOODALL, Georgia
THOMAS MASSIE, Kentucky
DOUG COLLINS, Georgia
MARK MEADOWS, North Carolina
KERRY L. BENTIVOLIO, Michigan
RON DESANTIS, Florida

ELIJAH E. CUMMINGS, Maryland, *Ranking Minority Member*
CAROLYN B. MALONEY, New York
ELEANOR HOLMES NORTON, District of Columbia
JOHN F. TIERNEY, Massachusetts
WM. LACY CLAY, Missouri
STEPHEN F. LYNCH, Massachusetts
JIM COOPER, Tennessee
GERALD E. CONNOLLY, Virginia
JACKIE SPEIER, California
MATTHEW A. CARTWRIGHT, Pennsylvania
MARK POCAN, Wisconsin
TAMMY DUCKWORTH, Illinois
ROBIN L. KELLY, Illinois
DANNY K. DAVIS, Illinois
PETER WELCH, Vermont
TONY CARDENAS, California
STEVEN A. HORSFORD, Nevada
MICHELLE LUJAN GRISHAM, New Mexico
VACANCY

LAWRENCE J. BRADY, *Staff Director*
JOHN D. CUADERES, *Deputy Staff Director*
STEPHEN CASTOR, *General Counsel*
LINDA A. GOOD, *Chief Clerk*
DAVID RAPALLO, *Minority Staff Director*

SUBCOMMITTEE ON ECONOMIC GROWTH, JOB CREATION AND REGULATORY AFFAIRS

JIM JORDAN, Ohio, *Chairman*

JOHN DUNCAN, Tennessee
PATRICK T. MCHENRY, North Carolina
PAUL GOSAR, Arizona
PATRICK MEEHAN, Pennsylvania
SCOTT DESJARLAIS, Tennessee
DOC HASTINGS, Washington
CYNTHIA LUMMIS, Wyoming
DOUG COLLINS, Georgia
MARK MEADOWS, North Carolina
KERRY BENTIVOLIO, Michigan
RON DESANTIS Florida

MATTHEW A. CARTWRIGHT, Pennsylvania, *Ranking Minority Member*
TAMMY DUCKWORTH, Illinois
GERALD E. CONNOLLY, Virginia
MARK POCAN, Wisconsin
DANNY K. DAVIS, Illinois
STEVEN A. HORSFORD, Nevada

CONTENTS

	Page
Hearing held on June 18, 2013	1

WITNESSES

Mr. Eddie Creamer, President and CEO, Prosperity Bank, ST. Augustine, Florida	
Oral Statement	5
Written Statement	7
Mr. Hester Peirce, Senior Research Fellow, Mercatus Center, George Mason University	
Oral Statement	19
Written Statement	21
Hon. R. Bradley Miller, Former Member of Congress, Senior Fellow, Center for American Progress	
Oral Statement	28
Written Statement	30
Tanya Marsh, Assistant Professor of Law, Wake forest University School of Law	
Oral Statement	33
Written Statement	35

APPENDIX

A Letter to Rep. Jordan from Bill Cheney, Credit Union National Assoc., submitted for the record by Rep. DeSantis	66

REGULATORY BURDENS: THE IMPACT OF DODD–FRANK ON COMMUNITY BANKING

Thursday, July 18, 2013

HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON ECONOMIC GROWTH, JOB CREATION, AND REGULATORY AFFAIRS
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
Washington, D.C.

The subcommittee met, pursuant to call, at 2:44 p.m., in Room 2154, Rayburn House Office Building, Hon. Jim Jordan [chairman of the subcommittee] presiding.

Present: Representatives Jordan, DeSantis, Duncan, McHenry, Lummis, Collins, Cartwright, Cummings, and Duckworth.

Staff Present: Brian Daner, Majority Counsel; Michael R. Kiko, Majority Staff Assistant; Emily Martin, Majority Counsel; Jedd Bellman, Minority Counsel; Jaron Bourke, Minority Director of Administration; Jennifer Hoffman, Minority Communications Director; Elisa LaNier, Minority Director of Operations; and Brian Quinn, Minority Counsel.

Mr. JORDAN. The subcommittee will come to order. We are going to get started.

I know Congressman—the ranking member, Congressman Cartwright is on his way. And as I think the witnesses know, we have some other hearings going on.

But I will now recognize the vice chair of the committee, Mr. DeSantis, for an opening statement.

Mr. DESANTIS. Thanks, Mr. Chairman.

Thank you to the witnesses for coming today and appreciate your flexibility. Obviously, we have a hearing downstairs that is taking quite a while.

Millions of Americans are out of work, millions are unemployed, and millions have given up looking for a job. A top priority of this Congress should be to remove barriers to job creation so Americans can get back to work, and small businesses are the key to this goal. They provide half of all employment in the United States and 42 percent of all payroll spending. Most importantly, small businesses are the leader in creating new jobs.

If small businesses are the engine of job creation, then community banks are the engine of small business because community banks are the leaders in making small business loans. At the end of 2010, community banks held $160 billion in small business loans on their books, representing almost half of all outstanding small business loans. In other words, $1 out of every $2 loaned to a small business comes from a community bank.

Community banks, characterized by local ownership, local control, and local decision-making, are best positioned to evaluate the precise business environment in a local community. Furthermore, community banks' ability to offer highly customized financial services ensures that each small business receive products that are tailored to fit that business' individual needs.

Congress has an obligation to support and promote the business model that community banks have used so successfully. Unfortunately, the regulatory regime imposed by the traditional banking regulators, as well as the Dodd-Frank Act, needlessly raise community banks' costs of doing business. There will be only one consequence from this regulatory burden, a reduction in community banks' ability to serve their communities.

Fewer services will be offered, fewer loans will be made, and those loans that are made will come at higher prices. Fewer small businesses will get off the ground. Less Americans will have a good job.

This regulation is not necessary. It seeks to solve a problem that doesn't exist. Just 2 weeks ago, the Comptroller of the Currency, one of three primary banking regulators in the U.S., emphatically stated, "Community banks and thrifts had nothing to do with bringing on the financial crisis." Yet community banks all across the country are feeling the brunt of the Federal leviathan.

This demonstrates a truism that is not unique to banking. Big, burdensome government typically gives big business a competitive advantage over existing and would-be small businesses. As J.P. Morgan CEO Jamie Dimon explained, increased regulatory burdens make it easier for large firms to gain market share because they create substantial barriers to entry for smaller competitors.

The sad thing is that much of the regulatory burden faced by community banks does not serve a compelling purpose but is simply an exercise in rote compliance. If the official position of this administration is that community banks were in no way responsible for the financial crisis, then why are we subjecting them to such onerous regulation?

The fundamental goal of this hearing is to understand just how burdensome Federal banking regulations have become on our community banks and, in turn, how that affects our small businesses.

I thank our witnesses with their individual expertise, and I thank them for being here. In particular, I would like to thank one of my constituents, Eddie Creamer from St. Augustine, Florida—he is a community banker in my district—to offer his personal experience as a community bank leader.

Mr. Chairman, thank you for having this hearing, and I yield back the balance of my time.

Mr. JORDAN. I thank the gentleman for his statement, for his hard work in Congress, and specifically for helping us put this hearing together.

I now recognize the ranking member, the gentleman from Pennsylvania, Mr. Cartwright.

Mr. CARTWRIGHT. Thank you, Mr. Chairman.

And thank you, Mr. DeSantis, for that fine opening statement as well.

Thanks to the witnesses for showing up today on this chilly day in Washington, D.C.

[Laughter.]

Mr. CARTWRIGHT. I represent northeastern Pennsylvania, a place where people rely on community banks for their banking needs. In fact, in one out of five counties in America, community banks are the exclusive source of credit. Individuals, homeowners, small business people, and farmers need community banks to be open for business in their communities.

So protecting the sustained viability of community banks is important for the quality of life in small towns and rural counties all across this Nation. But a long-term trend of consolidation in the banking industry threatens the continued existence of community banks. According to the FDIC, the decline in the number of banks with assets less than $100 million was large enough to account for all of the net decline in total banking charters between 1984 and 2011.

At the same time, banks with assets over $10 billion have expanded their share of industry assets from 27 percent in 1984 to 80 percent in 2011. In fact, just 90 banks now control $11 trillion in assets in this country.

We are still recovering from our national experience with the big banks that fail. The hearing today probes the extent to which the Wall Street Reform and Consumer Protection Act of 2010, also known as the Dodd-Frank Act, has contributed to this 30-year trend in bank consolidation.

I hope today's hearing is not just another attempt by those opposed to reforming Wall Street and protecting consumers from predatory banking practices. Unfortunately, some of the folks across the aisle from me have devoted considerable effort to stymie the law's new protections. Until just days ago, Republicans in the Senate refused to consider President Obama's nominee to head the Consumer Financial Protection Board until the Dodd-Frank Act was amended to their liking.

Members on this committee spent a week of hearings interrogating Elizabeth Warren, formerly the appointed head of the CFPB, who was trying to stand up the new agency. I wish that effort could have been spent interrogating the people who caused the financial crisis, rather than the public servants who were trying to prevent the next one from occurring.

What is clear from looking at the Dodd-Frank Act and its implementation so far is the real awareness by the law's authors and regulators of the dangers of banks that get too big and the importance of protecting small-sized community banks. In example after example, we have seen evidence that requirements imposed by the law specifically exempt small community banks, and the costs of new regulations are largely borne by the large banks. That is as it should be and I think was the intention of the law's authors.

Fortunately, today we have with us former Congressman Brad Miller, who was our participant in drafting of the bill. If the intention to protect small community banks has not been fulfilled, I want to hear about that. That is the purpose of congressional oversight.

But if the purpose of this hearing is to impede implementation of new consumer protections and to address the causes of the financial crisis, I strongly reject that. I look forward to hearing from the witnesses today, and again, I thank the chairman and Congressman DeSantis for being here today.

Thank you.

Mr. DESANTIS. [Presiding] Thank the gentleman.

And the gentlemen from Tennessee like to make an opening statement?

Mr. DUNCAN. Well, very briefly, Mr. Chairman, thank you for requesting this hearing. I think this is a very important topic.

And I will tell you that just a few weeks ago, there was a column in the Washington Times, which said that it has been 3 years since the House and Senate passed the Dodd-Frank financial reform legislation. So far, the effects are not what Washington promised.

More than 200 smaller banks have failed in the wake of Dodd-Frank. And it says, and he said, we have learned once again that whenever Washington announces new regulations, hold onto your wallets.

And very similar to that, I have a column by Louise Bennetts from the Cato Institute, an article that appeared in the American Banker. And she said this, "The Dodd-Frank Act, sold to the public as the tamer of the Wall Street titans, may well end up having a disproportionate impact on smaller institutions, thanks to the costs of capital implications? of being not too big to fail and the advent of the Consumer Financial Protection Bureau."

And that is the problem. When you overregulate something, it hurts the little guys first, then the medium size, and it ends up helping the big giants. And I can tell you, I have no problems with the regulators being very strict, very tough on the big giants. But that is not the way this law is working, and I have had many bankers in my district in east Tennessee complain about this and tell about how expensive it has been for them already.

And it is only going to get worse if we don't do something about it. So I thank you for calling this very important hearing.

Mr. DESANTIS. Thank you.

And the committee received a letter from the Credit Union National Association, explaining how credit unions are similarly burdened by onerous regulations in Dodd-Frank. Like community banks, credit unions were similarly blameless for the financial crisis of 2008.

And with unanimous consent, we will enter this letter that they sent to the committee into the record.

Members may have 7 days to submit opening statements for the record.

We will now recognize our panel. Mr. Eddie Creamer is president and CEO of Prosperity Bank of St. Augustine, Florida. Professor Tanya Marsh is assistant professor of law at Wake Forest University School of Law. The Honorable Bradley Miller is a former Member of Congress and senior fellow at the Center for American Progress. And Ms. Hester Peirce is senior research fellow at the Mercatus Center at George Mason University.

Pursuant to committee rules, all witnesses will be sworn in before they testify. Please stand. Please rise and raise your right hand.

[Witnesses sworn.]

Mr. DESANTIS. Let the record reflect that the witnesses answered in the affirmative.

Now you will each be recognized for 5 minutes. I know some of you prepared statements. You feel free to read from that or provide whatever information you would like to provide.

So, Mr. Creamer, you are up.

WITNESS STATEMENTS

STATEMENT OF EDDIE CREAMER

Mr. CREAMER. Thank you, Vice Chairman DeSantis and Ranking Member Cartwright, Ms. Duckworth, and Mr. Duncan.

I appreciate this opportunity to speak to you today. It's both an honor and a privilege for me to talk to you on behalf of my 160 employees about the sometime damaging, but always overwhelming and ever-changing regulatory environment that a community bank faces.

As my written testimony states, I've been a community banker in Florida for over 31 years. And while I understand that all banks must be regulated and the consumer must be protected, I also understand that these regulations must be clear, concise, uniformly applied to banks so they can reach their—or meet their intended purpose.

I also understand that the vast difference between community banks and very large banks, that a one-size-fits-all regulatory approach is impractical and, frankly, does not work. There is certainly more complexity and systemic risk in a $2 trillion bank than there is my $748 million bank in northeast Florida.

Today's Wall Street Journal headline reporting that one our country's largest banks will likely agree to a record fine for manipulating the electricity market is the best example I could give you of this difference today. While I do not understand how a bank could manipulate the electricity market, nor do I think I want to understand that, I do understand the crystal clear difference when contrasted to what a community bank does and the purpose it serves.

Over my 31-year career, I've experienced law after law, regulation after regulation, rule after rule—FIRREA, Gramm-Leach-Bliley, Truth-in-Lending, Truth-in-Savings, Fair Lending, Know Your Customer, and now Dodd-Frank. Dodd-Frank, by the way, which by some reports almost 63 percent is yet to be written. So I can't judge the impact of that.

All of these regulations, while well intended, had the stated purpose to protect, defend, amend, enforce, or simplify something. There are thousands and thousands of pages that a community banker must understand and attempt to comply with, and rarely, if ever, are existing regulations amended, repealed, or modernized in consideration of the new regulations.

These laws and regulations and rules are often and inconsistently—or often inconsistently interpreted and implied—applied

from exam to exam and examiner to examiner and, frankly, from agency to agency. This has created regulatory fatigue in our bank and among our employees, and the cost of compliance with these regulations skyrocketing for us.

You have seen in the written testimony here and you already know that community banks play a vital role in our economy. To continue to play this vital role, it is important that community banks have clear, concise, uniformly applied regulations commensurate to their business model and their inherent risk.

If not, I am confident there will be fewer community banks. And if there are fewer community banks, there will be fewer choices for the consumer and fewer products. Fewer choices, fewer products mean higher cost for the consumer.

Again, I'm deeply grateful for this opportunity to talk to you about my industry and my profession, of which I'm deeply passionate, and I welcome the opportunity to address your questions.

Thank you.

[Prepared statement of Mr. Creamer follows:]

PROSPERITY BANK

Testimony of

Eddie Creamer
President & CEO
Prosperity Bank
St. Augustine, Florida

Before the
Congress of the United States
House of Representatives
Committee on Government Oversight and Reform
Subcommittee on Economic Growth, Job Creation
and Regulatory Affairs

Hearing on
"Regulatory Burdens: The Impact of Dodd-Frank on Community Banking"

July 18, 2013
Washington, D.C.

Chairman Jordan, Ranking Member Cartwright, members of the Subcommittee, and especially Representative DeSantis who made this testimony possible. My name is Eddie Creamer, and I am President and CEO of Prosperity Bank (Prosperity), a $748 million bank headquartered in St. Augustine, Florida, which serves the small counties of St. Johns, Flagler, Putnam, Volusia, and Bay. Thank you for convening this hearing and allowing me to share with you my experience.

As you will quickly learn, I am not an expert on the legislative process, nor in the interpretation of regulations and their intent. However, I have been a community banker in Florida for 31 years. I have successfully managed through three recessions, one "Great" recession, and untold numbers of regulatory changes impacting lending, depository accounts, disclosures, privacy, and money laundering. And as such, I am quite knowledgeable of how the overwhelming and ever-changing regulatory burden, as interpreted and enforced by field examiners, has affected my bank, my employees, my customers, and my community.

I am not testifying before you today in regard to the broad generalities of the importance of America's 7,000 community banks. Instead, I will share how important Prosperity is to St. Augustine, Panama City, Palatka, Palm Coast, and Ormond Beach, Florida. I will not discuss how the ever-changing, overwhelming, "one size fits all" regulatory approach has damaged the way America's 7,000 community banks serve their customers and communities. Instead, I will share how the ever-changing, overwhelming, regulatory burden has damaged the way Prosperity serves its customers and communities. And, perhaps in doing so, I can help you understand, even in a small way, the stress, uncertainty, fear, and concern that these

regulations have imposed on the entire industry. I believe if you ask community bankers across this great Nation, they will share with you similar experiences.

THE TRUE ROLE OF A COMMUNITY BANK

Prosperity Bank was founded in 1984 by a group of local businessmen. It is very typical of community banks everywhere to have a board of directors made up of local business people who understand the need for community banking. These people know the value of relationships and have personal knowledge of individuals and businesses. They are people who know the local economy and the support that a strong community bank provides.

For more than 29 years, Prosperity, like all community banks, has become a central part of its communities' growth and success. I have been CEO of Prosperity for more than 13 years. During this time, our payroll totaled approximately $152 million and we made more than $4.2 million in charitable contributions. At our peak in January 2007, we employed 260 people. From 2001 to the present, Prosperity originated approximately $2.5 billion dollars of home and small business loans, and through a company-sponsored volunteer program, our employees gave back to the community 138,333 volunteer hours. I think you will agree that we significantly impacted our community in a very positive way.

As community bankers, we serve the financial needs of our towns. We are blind to race, religion, and social standing. While we do business with people and small businesses based on financial ability, we also consider relationships, personal character, and knowledge of the local market. We lend money to small businesses and individuals that the "too big to fail" banks overlook. In fact, in many rural markets, the "too big to fail" banks have no presence.

Our employees volunteer, coach, cook, teach people to read, mentor, counsel, run, walk, and ride to support many non-profit organizations. We sponsor numerous charitable events and youth teams. We are closely woven into the fabric of our small towns. Many events would not occur without the local bank's support.

THE BANK REGULATIONS

There are thousands of pages of state law and regulation and thousands more of FDIC law and regulations with which we must interpret and comply. In addition, there are The Federal Reserve regulations, commonly referred to as the "alphabet" regulations (Regulation A - YY), which address issues such as fair lending, equal credit opportunity, fair credit reporting, unfair and deceptive acts, community reinvestment, and funding of unlawful Internet gambling.[1] Furthermore, there is the Bank Secrecy Act, USA Patriot Act, and the Federal Flood Insurance Program enforced on community banks by the FDIC. And, as a small business with 165 employees, we also operate under Federal Labor Law, and of course, the Internal Revenue Code.

In response to the recession of the late 1980's, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). The purpose of this law, as stated in the Act, was "to reform, recapitalize, and consolidate the Federal Deposit Insurance system, and to enhance the regulatory and enforcement powers of federal financial regulatory agencies, and for other purposes,"[2] with the goal of preventing future banking crises. This resulted in new regulations which were imposed on all of the Country's banks regardless of size and

[1]Federal Reserve Board of Governors. "FRB: All Regulations". http://www.federalreserve.gov/bankinforeg/reglisting.htm.
[2]*Financial Institutions Reform, Recovery, and Enforcement Act of 1989.* FDIC Law.

complexity. Capital regulations were changed and the concept of risk-based capital was added. For a financial institution to be considered well-capitalized, it must maintain 5% Tier-One Capital and 10% Total Risk-Based Capital.

These capital regulations are complex, obscure, and ineffective as applied to community banks. They are applied generally in the same fashion to a $750 *million* dollar asset bank as they are to a $750 *billion* dollar asset bank. We cannot be expected to have the same capital regulations as larger banks, which do not serve the same purpose as we do. Community banks intermediate risk to foster growth in local economies. Larger banks serve a very different purpose, as they act as intermediaries to the global financial markets, providing services that are much more complex, and in most cases, have a higher risk than what community bank customers demand.

The risk ratings established by these regulations often have no correlation to actual inherent risk in a particular class of assets. For example, United States Treasury's carry the lowest risk-rating at 0%; Securities of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) are risk-weighted at 20% (including Collateralized Mortgage Obligations (CMO) and Collateralized Debt Obligations (CDO)); residential mortgage loans are risk-weighted at 50% (including non-owner occupied, investment properties, second mortgages and home equity loans); and small business loans are risk-weighted 100%. A real estate secured commercial loan to an owner-occupied orthopedic surgery practice, which is properly underwritten, should theoretically have less inherent risk than a second mortgage on an investment residential property. However, under current capital regulations, less capital would be held on the second mortgage on investment

residential property.

In 2009, Congress passed even more regulation. The Dodd-Frank Wall Street Reform and Consumer Protection Act has 1,601 sections of new rules and regulations of which 63% still remains unwritten.[3] Dodd-Frank authorized the creation of the Consumer Financial Protection Bureau whose examination manual alone is more than 900 pages. And, to the best of my knowledge, *none of the existing regulations were repealed or replaced.*

The Durbin Amendment to Dodd-Frank, was intended to affect banks of $10 billion in assets and greater. Instead, Durbin has affected the entire banking industry. To remain competitive in the marketplace, our vendors had to reduce their interchange fees. This resulted in a $150,000 annual loss of income to Prosperity, thus, further limiting our ability to provide the services needed by our customers.

Until 2007, banks maintained an allowance for losses on loans and leases (ALLL) consistent with the regulatory guidance and Financial Accounting Standards Board (FASB) pronouncements in effect at that time. Under this methodology, reserves were maintained based upon types of loans, concentrations of loan types, past due ratios, and internal loan grading systems. Individual loans showing weakness were specifically reserved for. Banks had latitude into the reserve adequacy calculations based upon their knowledge of the borrower, portfolio, and local market. Immediately prior to the "Great Recession", the FASB updated their loan loss reserve requirements, fully supported by the regulators. Under FAS 5

[3]Davis-Polk. "Dodd-Frank Progress Report, July 2013". http://www.davispolk.com/files/Publication/093bb6dd-6d24-4efb-a9fb-58b92085e252/Presentation/PublicationAttachment/974c57ea-eac4-4cc6-ae90-5d50991ca308/Jul2013_Dodd.Frank.Progress.Report.pdf

and FAS 114, loan loss reserve adequacy is now calculated using average loan losses over prior periods, loan impairment calculations, and environmental factors.[4,5]

The FAS 5 and FAS 114 pronouncements have placed additional pressure on community banks in meeting the loan needs of our customers. The calculation and methodology are flawed and not indicative of the current state of the banking industry or the economy. First, loan loss rates incurred over the past four years will very likely have no bearing on loan loss rates that will be incurred as the economy recovers. Second, loan impairment requires community banks to recognize losses based upon market values, which may not exist or are skewed before the losses are actually incurred. Finally, environmental factors such as unemployment rates, property sales, building permits, etc. are used to establish additional reserves.

EXAMINATION PROCESS

As a state-chartered non-member bank, Prosperity is examined annually by the FDIC and the State of Florida Office of Financial Regulation (OFR). These agencies are often at odds with each other on the interpretation and implementation of the regulations. Safety and soundness examinations focus on uniform bank rating standards commonly referred to as CAMELS: **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk. These CAMELS were intended to be independent measures of a bank's health at a point in time. It has always been understood that weaknesses in one of the CAMELS could be offset by strengths in others. In fact, this is how we have managed community bank balance sheets.

[4]Federal Accounting Standards Board. "Accounting for Contingencies (Issued 3/75)". http://www.fasb.org/summary/stsum5.shtml

[5]Federal Accounting Standards Board. "Accounting by Creditors for Impairment of a Loan- An Amendment of FAS Statements No.5 and 15 (Issued 5/93)". http://www.fasb.org/summary/stsum114.shtml

However, beginning in 2008, the CAMELS were no longer independent indicators of a bank's health. The examiners in the field began to use only one measure, Asset Quality, as the primary indicator of a bank's stability with no consideration of the other factors. As a result, overall bank ratings were lowered, which led to the issuance of Memorandums of Understanding, Consent Orders, and Cease and Desist Orders. These public actions by the regulatory agencies cause undue negative publicity for the Bank.

During the "Great Recession", Prosperity's asset quality deteriorated. This deterioration is not unusual considering rapidly increasing unemployment and declining real estate values. At the same time, the examination process began to focus totally on asset quality and loan grading. Asset quality was no longer about the payment performance of a loan, the past due percentages of the Bank's loan portfolio, or the ALLL. Instead, the examinations became totally about the classification of loans, i.e., substandard, doubtful, or loss, and at the discretion of the examiner, which means that it was inconsistently applied from examiner to examiner, exam to exam. These loan grades, while sometimes arbitrary, have a significant impact on the Bank's profitability, capital, ALLL, and ability to lend.

THE OVERALL EFFECT ON PROSPERITY BANK

When I began my banking career in 1982, my staff and I spent 10% to 15% of our time understanding and complying with regulation and law. Today, my senior staff and I spend in excess of 35% of our time understanding and complying with law and regulation and

responding to examination and reporting requirements. In addition, Prosperity employs a Chief Compliance Officer with a staff of five and three outside review firms to ensure compliance with law and regulation. This year, Prosperity's compliance cost will surpass $750,000. Our training budget is $90,000 annually with more than half of this amount ear-marked for compliance training. The majority of our staff are not accountants or attorneys, and it is becoming increasingly difficult to train them on the myriad of very complex regulation.

Prosperity exceeds the requirements to be considered well-capitalized. However, because of the field examiner's judgment, we currently operate under a Consent Order with the FDIC which requires Prosperity to achieve a Tier-One Leverage ratio of 8% and a Total Risk-Based Capital ratio of 12%. This is a direct result of the disconnect between the regulations and the examiners, who routinely place higher capital standards on community banks based upon asset quality without regard to the adequacy of the ALLL or other CAMELS. This impedes our ability to lend, and in doing so, will stifle the economic recovery and job creation which is desperately needed in our communities.

United States Representatives Barney Frank and Walt Minnick said as much in their letter to the Federal Bank Regulatory agency leaders (*dated October 2009*) where they stated:

"Individual examiners in some cases have unofficially moved these numbers to 8-9% and 12% respectively. The impact is that many community banks have to restrict their growth (lending activity) in order to shrink their balance sheets and meet these standards. Restricting lending activity, especially to small businesses counter-productive to helping the economy recover."[6]

[6]The Honorable Barney Frank and the Honorable Walt Minnick. "Letter to Regulators" 29 October 2009. http://online.wsj.com/public/resources/documents/pressure-frank-minnick11042009.pdf

For Prosperity Bank, the increased capital requirement equates to approximately $11,000,000. And, as a small privately traded company whose stockholders are local and few, it is impossible to raise this additional capital. Furthermore, by virtue of the Consent Order, Prosperity pays an additional $943,256 annually in FDIC insurance premiums.

The FAS 5 and FAS 114 ALLL methodologies adopted and applied to community banks by the regulators is flawed and counter-productive to community bank lending. Past performance of the Bank's loan portfolio is not an indication of future losses. Early in a recession, the weakest loans normally default and create the largest losses. Later in the recession, default rates begin to contract, the loan portfolio starts to stabilize, and losses are reduced. Once the recovery begins, the loan portfolio has seasoned and been purged of weaker loans. Banks should begin to lend, therefore allowing businesses to begin expanding and hiring. However, under FAS 5, when a new loan is made, reserves must be held against that loan based upon the bank's average losses on that type of loan during the past 2-4 years regardless of new underwriting, the strength of the borrower, or the value of the collateral. This reserve requirement can drive up the cost of a new loan, thereby making it unaffordable for the borrower.

Throughout this recession, Prosperity has been called upon by its borrowers for payment relief to help them weather the economic storm. Under FAS 114, when a borrower asks for assistance, Prosperity is required to test the loan for impairment. For a home loan or small business loan this impairment test is usually performed by obtaining a new appraisal. The reduction in value indicated by the appraisal plus approximately 10% holding and selling costs are immediately charged to earnings regardless of the ultimate disposition of the loan.

Again, I quote from the 2009 letter:

"Banks are being forced to write assets, loans and Other Real Estate Owned down to current market value. The problem is that there is virtually no market for some of the assets (developed lots for example) at present, leading to artificially low prices for those assets that have to be sold under duress. However, many of these markets are expected to recover in the future, and the forced write-downs to fire-sale values now are making the banks' capital crunch artificially and unnecessarily worse."[7]

The third part of the calculation of the methodology under FAS 5 and FAS 114 is environmental factors. Indicators such as underwriting standards, past due ratios, real estate values, unemployment percentages, building starts, etc. are considered to either add or deduct from the amount of required reserves. These are totally arbitrary and subject to open interpretation. One can easily imagine a point in the future where the economy is recovering, borrowers are performing as agreed, loan losses are minimal, and environmental factors are strong. In this scenario, FAS 5 and FAS 114 could very well require banks to carry very small ALLL. Perhaps that is why FASB is now considering a new pronouncement, which would require banks to estimate loan losses in their portfolios for the future life of the portfolio and book that reserve in the current period. I dare to imagine the catastrophic affect that would have on community banks.

As a community bank, we do business based on strong relationships and trust. We do not deceive our customers or ever attempt to take advantage of them. We can't because we live and work with them every day. We see them in local restaurants, we sit beside them in church, we coach their children, and we belong to the same civic organizations. If we don't treat our customers fairly and honestly, we have to look them in the eye and tell them why we did not.

[7] 2009 Letter

Prosperity recently agreed to merge with a larger bank. While there are many reasons for the decision, a very important consideration is the regulatory burden and the increasing cost of that burden. We simply do not believe that a bank our size can attract and maintain the resources necessary for compliance with regulation going forward. I refer to this as "regulatory fatigue." We do not have a staff of 260,000, nor the resources to spend $5 billion annually on legal fees[8] to help me interpret the regulations, such as the large banks do. And, while we are confident that we have chosen an excellent merger partner, more than 65 jobs will be lost as a result of the transaction. This will not be good for our local economy.

I will close by again thanking you for this opportunity. I am passionate about what I do and about my profession, and I could have provided many more examples than I have here. Hopefully, the examples I have provided will foster questions from this committee. I know as a 31-year community banker, that clear, concise, logical regulation consistently applied by examiners is necessary. However, I know first-hand the negative impact regulation has had on my Bank, and ultimately my community. And, I know the void that will be left when Prosperity Bank has merged into another bank. I will leave you with one last quote from the 2009 letter, because they say it much more eloquently than I could:

"Community Banks became strong and viable players in the financial services industry because they fill an important need, and it would be short-sighted to weaken that role through over-zealous regulatory actions - actions based not on wrong doing or poor management practices at these banks, but on changes in the economic environment and toughening regulatory standards."[9]

---

[8]JPMorgan Chase & Co., Annual Report Form 10-K for the Period Ending December 31, 2012 (Filed Feb. 28, 2013), From JPMorgan Chase & Co. website. http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=19617-13-221. Accessed July 15, 2013.

[9]2009 Letter

Mr. DESANTIS. Thank you for that statement.

And the chair will now recognize Ms. Peirce for her opening statement.

STATEMENT OF HESTER PEIRCE

Ms. PEIRCE. Sorry. It's an honor to be here today. I appreciate the opportunity.

One of the wonderful things about our financial system is its diversity, its flexibility, and the competition that it affords. And this is good for consumers because it allows consumers of all different types to find something that works for them.

Unfortunately, the regulatory system that we're putting in place is not consistent with that competitiveness, flexibility, and diversity. Instead, it prefers large banks over small. It imposes regulatory costs that disproportionately burden the small banks, and its consumer protection model is one that works much better for large banks than it does for small.

A lot of people say Dodd-Frank is not about community banks. It's about big financial institutions. And they're right. It's about a partnership between big financial institutions and the Government.

This manifests itself most directly in the designation of systemically important financial institutions under Dodd-Frank. And while it's true that as a designated institution, you are subject to many more regulations, but what is also true is that the Government has made a statement that they stand behind those institutions that they think they're too important to fail.

And so, when times of trouble come, when there's a liquidity crisis, customers of these institutions and also creditors are going to know that it's the large banks—that the Government has the back of the large banks. And that's a real advantage for large banks.

But there are also more subtle—more subtle disadvantages for the smaller entities, and that comes in the form of regulatory burden. The financial industry was, as we just heard, quite regulated before Dodd-Frank. But Dodd-Frank came along with almost 1,000 pages of legislative text. And then add to that 11,000 pages and counting of proposals and final rules and guidance.

For a large bank with an army of in-house lawyers, outside experts to assist them in figuring out how to comply and how to comply efficiently, it's a burden, but it's not the type of burden that it is for a community bank. For a community bank that has to hire a new compliance person or pay high-priced outside consultants to help it understand what applies to them, it could be the difference between a profitable year and not a profitable year.

But more important I think than the monetary cost is the distraction. If you think of your average community banker who got to where she is because she loved the community she serves and she wanted to figure out how to help small businesses in that community grow, how to help families buy homes, she didn't want to spend her time thinking about regulation. But now the cloud of uncertainty, of regulatory uncertainty is what's keeping her up at night, and that's not good for the consumers that she wants to serve.

And then, as far as consumer protection goes, the Dodd-Frank model of consumer protection is one in which the regulators in

Washington will figure out what works best for consumers all across the Nation. And that means designing plain vanilla products that will work for every consumer in every circumstance. And that works pretty well for large banks, which have a mechanistic approach to lending.

But for a community bank, which prides itself on getting to know its customers and its communities and tailoring products to them, it doesn't work so well. And so, this could end up leading community banks into areas that they're not—into new business lines that they're not comfortable with, into new products, and into more aggressive ways to fund themselves and more aggressive product lines.

So what can we do about this? Well, first, we can find out more. We can find out what the good, the bad, and the indifferent parts of Dodd-Frank are for community banks, which the Mercatus Center, where I work, is now trying to do that. We're conducting an online survey of small bankers, and we hope to present the information that we get from that to policymakers so that they can figure out which parts are truly the worst.

And the second thing that we can do is now we have 3 years of objective hindsight with which we can look at Dodd-Frank and say, okay, what's working and what's not? What do we need to fix? What do we need to throw out?

And then we can look at designing better exemptions for small entities. And these exemptions can't be ones that are conditioned on very complicated criteria because then that, too, becomes a regulatory burden for the small banks.

And then we can ask the regulators, ask the financial regulators to do economic analysis. This is something that they don't traditionally do, but it's not too much to ask them to look through an economic lens, figure out what the problem they're trying to solve is, look at the alternatives, and look at the costs and benefits of those alternatives.

Thank you very much, and I'd be happy to answer any questions.

[Prepared statement of Ms. Peirce follows:]

MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

TESTIMONY

REGULATORY BURDENS: THE IMPACT OF DODD-FRANK ON COMMUNITY BANKING

BY HESTER PEIRCE

House Committee on Oversight and Government Reform
Subcommittee on Economic Growth, Job Creation, and Regulatory Affairs

July 18, 2013

Chairman Jordan, Ranking Member Cartwright, and members of the Subcommittee, thank you for the opportunity to be part of today's hearing on the effect of Dodd-Frank on community banks. Dodd-Frank was the product of desperation in the face of a deeply painful financial crisis and outrage at the big financial institutions that were at the center of the trouble. Not only does Dodd-Frank fail to effectively address the problems that precipitated the crisis, but it also imposes costly burdens on many businesses that were not central causes of the crisis. Among these are community banks.

Determining how Dodd-Frank affects community banks is not easy given the statute's heft, the lengthy rulemaking process, and the many other factors influencing the number, size, and profitability of community banks. Other challenges faced by community banks include poor economic conditions, declining populations in rural areas, the increasing technological sophistication of banking, low interest rates, and difficult capital markets, as well as non-Dodd-Frank regulatory initiatives. To gain deeper insight into how Dodd-Frank is affecting small banks, the Mercatus Center at George Mason University is currently conducting an online survey of small banks. I hope that these 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.

In the meantime, it is possible to identify certain ways in which Dodd-Frank is likely to affect community banks. The aspects of Dodd-Frank that are of immediate or long-term concern to small banks include extensive new mortgage rules, the Consumer Financial Protection Bureau (CFPB), capital requirements, the new municipal advisor registration regime, data collection requirements, new conditions on the use of swaps for managing interest-rate risk, and a deepening of the too-big-to-fail status of large financial institutions. These concerns can be generalized in the following themes, each of which is discussed in more detail below:

- Increased legal and regulatory compliance burden.
- Further tilting of the regulatory playing field to the disadvantage of small banks.
- Regulatory barriers to community banks' ability to continue providing their bread-and-butter products and services.

For more information or to meet with the scholars, contact
Chad Reese, (703) 993-8921, creese@mercatus.gmu.edu
Mercatus Center at George Mason University, 3351 Fairfax Drive, 4th Floor, Arlington, VA 22201

The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

IMPORTANCE OF COMMUNITY BANKS

Community banks are a fixture across the nation.[1] Many have served their communities for decades. They are particularly important in rural areas. The FDIC reported that "more than 1,200 U.S. 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."[2] 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."[3]

Community banks are known for offering personalized service and meeting 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. In the words of Federal Reserve Governor Elizabeth Duke, community banks' "natural advantages" are "deep community ties, daily interaction between senior managers of banks and their customers, and the dexterity to customize financial solutions."[4] Community banks' first-hand knowledge of their customers provides them useful information for sound lending decisions. As a consequence, 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 one to four family 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.[5] Community banks that are closest to their borrowers may fare best.[6]

Community banks have declined in numbers and asset share for years. The number of community banks at the end of 2011 was less than half of what it was in 1984.[7] Community banks held only 14 percent of total bank assets in 2011, compared to 20 percent in 1999 and 38 percent in 1984.[8] The number of banks with less than $100 million in assets fell dramatically by more than 80 percent over the time period, but an important part of that change was attributable to small banks' growing bigger rather than failing.[9] The share of assets held by community banks is dwarfed by the top four banking organizations, which collectively held 44 percent of bank assets in 2011.[10]

The downward trend for community banks does not, however, mean that they are a relic of the past. It is not surprising that large banks play an important role in our nation's economy. Nevertheless, community banks remain an essential component of our financial system. Research suggests that well-managed community banks can continue to coexist with their larger rivals.[11] As one study of the rural banking landscape found, "community banks, as

---

1. There is not a uniform definition for "community banks." The Office of the Comptroller of the Currency uses a $1 billion threshold. The Federal Deposit Insurance Corporation (FDIC) traditionally considered banks with $1 billion or less to be community banks, but in a recent study, used a multi-factor test that allows for the inclusion of larger entities. *See* FEDERAL DEPOSIT INSURANCE CORPORATION, COMMUNITY BANKING STUDY (2012), at Table 1.1 and accompanying text, *available at* http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf. The Federal Reserve uses a $10 billion threshold. *See* Board of Governors of the Federal Reserve System, *Supervisory Policy and Guidance Topics: Community Banking* (last visited July 15, 2013), *available at* http://www.federalreserve.gov/bankinforeg/topics/community_banking.htm.
2. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 3-5.
3. TANYA D. MARSH AND JOSEPH W. NORMAN, THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS (American Enterprise Institute), May 2013, at 12.
4. Elizabeth A. Duke, Governor, Board of Governors of the Federal Reserve System, Speech at the Southeastern Bank Management and Directors Conference (Feb. 5, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/duke20130205a.htm#fn7.
5. *See* FDIC STATISTICS ON DEPOSITORY INSTITUTIONS (accessed July 16, 2013), *available at* http://www2.fdic.gov/sdi/main.asp. Loans in default are defined as nonaccrual loans or loans past due 30 or more days.
6. *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), *available at* 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.
7. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at Table 2.2.
8. *Id.* at Table 2.3
9. *Id.* at 2-3.
10. *Id.* at 2-4.
11. *See, e.g.*, 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*, 16 FDIC BANKING REVIEW 1 (2004), *available at* http://www.fdic.gov/bank/analytical/banking/2005jan/br16n34full.pdf; Robert DeYoung, William C. Hunter, and Gregory F. Udell, *The Past, Present, and Future for Community Banks*, 25 J. OF FIN. SERVICES RES. 85 (2004); R. Alton Gilbert, Andrew P. Meyer, and James W. Fuchs, *The Future of*

a group, remain competitive with larger banking organizations, at least in markets where informationally opaque borrowers are most prevalent."[12] One recent study identified the following common characteristics of "thriving banks": (1) "had a strong and localized customer service focus with high community visibility," (2) "operated in a thriving (i.e., growing) community," (3) "practiced forward-looking risk management with an eye toward long-term bank performance," (4) "demonstrated balance between growth objectives and risk level," and (5) "had patient and conservative ownership operating with the belief that returns on investment should be attractive but not necessarily spectacular."[13] As this list of healthy bank characteristics indicates, the manner in which the bank is managed is very important.

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 bank's day-to-day business. If the distraction is severe enough, there will be an increased likelihood of bank 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. As will be discussed next, Dodd-Frank's regulatory burdens are a significant source of distraction.

INCREASED REGULATORY BURDEN

One of the key ways in which Dodd-Frank affects community banks is increased regulatory burden. Regulatory compliance was already a major cost to all banks before Dodd-Frank. 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."[14] Regulatory costs "tend to be proportionately heavier for small banks."[15] The disproportionate burden on small banks can change the bank landscape. 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."[16] 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.[17]

Chairman Bernanke takes the position that "the vast majority of the provisions of the Dodd-Frank Act do not apply to community banks at all. The Dodd-Frank Act was enacted largely in response to the 'too-big-to-fail' problem, and most of its provisions apply only, or principally, to the largest, most complex, and internationally active banks."[18] Even though small banks were not the focus of Dodd-Frank, many provisions affect them directly

---

Community Banks: Lessons from Banks that Thrived During the Recent Financial Crisis, FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, Mar./Apr. 2013, at 115, *available at* http://research.stlouisfed.org/publications/review/13/02/gilbert.pdf; Ray Brastow, Bob Carpenter, Susan Maxey, and Mike Riddle, *Weathering the Storm: A Case Study of Healthy Fifth District State Member Banks Over the Recent Downturn*, FEDERAL RESERVE BANK OF RICHMOND NEWSLETTER, Summer 2012, *available at* http://www.richmondfed.org/banking/supervision_and_regulation/newsletter/2012/summer/article3.cfm?WT.si_n=Search&WT.si_x=3.

12. 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, May/June 2013, at 216, *available at* http://research.stlouisfed.org/publications/review/article/9723.

13. Gilbert et al., *supra* note 12, at 125.

14. William A. Loving, President and CEO, Pendleton Community Bank, Testimony on Behalf of the Independent Community Bankers of America Before the Subcommittee of Financial Institutions and Consumer Credit of the House Committee on Financial Services (Apr. 16, 2013), at 2.

15. Critchfield, et al., *supra* note 11, at 27.

16. GREGORY ELLIEHAUSEN, THE COST OF BANKING REGULATION: A REVIEW OF THE EVIDENCE (Federal Reserve Board Staff Studies No. 171, 1998), at 29, *available at* http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss171.pdf. Elliehausen provides a helpful overview of research on regulatory costs.

17. 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), *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=5102. It is important to note, that he authors point out that their "goal is to advance quantification of additional regulatory costs rather than arguing for a specific cost estimate."

18. *The Importance of Community Banking: A Conversation with Chairman Bernanke*, COMMUNITY BANKING CONNECTIONS (2012), *available at* http://www.communitybankingconnections.org/articles/2012/Q3/conversation-with-Bernanke.cfm.

or indirectly. Among the provisions in Dodd-Frank that directly affect small banks are new mortgage rules, rules governing municipal advisors, changes in capital requirements, new rules from the CFPB, and the transfer of regulatory responsibilities for savings and loans from the now extinct Office of Thrift Supervision to the Office of the Comptroller of the Currency.

The mere task of determining which pieces of Dodd-Frank apply is a daunting one given that the statute is nearly a thousand pages long and many implementing rules are equally long. The complex interactions among the many statutory and regulatory mandates make the analysis even more difficult. Moreover, because only about forty percent of Dodd-Frank rules have been completed,[19] many questions remain about how the statute will change the financial landscape. The uncertainty is particularly pronounced because of the degree to which critical decisions were left to the implementing regulators. Even if the statute includes or regulators create exemptions specifically for small banks, banks may find that determining how to comply with the conditions for exemption is a time-consuming and—because of the legal consequences of getting it wrong—stressful process. Even something like the Volcker Rule, which is aimed at larger, more complex financial institutions, depending on how it is ultimately implemented, could engender compliance costs for small banks trying to avoid running afoul of it.

Banks are citing increased regulatory costs as a concern. As one community banker recently warned, "the business of banking can't just be an exercise in meeting regulatory requirements."[20] 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."[21] The survey found that 56 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.[22] In addition to hiring compliance staff, small banks seek compliance advice from outside consultants. 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."[23] Compliance costs may already be causing some banks to stop offering certain products and services or to decide to not expand their businesses.[24]

In addition to the costs of hiring new compliance personnel and buying new software, compliance costs include less easily quantifiable costs. These include "psychological costs" and "dynamic changes in the risk-taking of banks" to compensate for "higher fixed costs."[25] They could also include the legal costs associated with regulatory enforcement actions, actions brought by state attorneys general or consumer lawsuits facilitated by Dodd-Frank and its implementing regulations.

With respect to compliance, community banks are at a disadvantage because they do not have their larger competitors' sophisticated legal and compliance staffs to interpret the new rules and regulations and look for effective

---

19. Davis-Polk, *Dodd-Frank Progress Report* , July 2013, at 2, *available at* http://www.davispolk.com/files/Publication/093bb6dd-6d24 -4efb -a9fb-58b92085e252/Presentation/PublicationAttachment/974c57ea-eac4-4cc6-ae90-5d50991ca308/Jul2013_Dodd.Frank.Progress .Report.pdf.
20. Preston Pinket III, President and CEO, City National Bancshares, Testimony Before the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee (Apr. 16, 2013), at 4, *available at* http://financialservices.house.gov/uploadedfiles/hhrg -113-ba15-wstate-ppreston-20130416.pdf.
21. Florida Chamber Foundation, 2012 Small Business Lending Survey 6 (2012).
22. *Id*. at 10.
23. FDIC Community Bank Study, *supra* note 1, at B-2.
24. *See, e.g.*, Kenneth L. Burgess, Jr., Chairman, FirstCapital Bank of Texas, Testimony on Behalf of the American Bankers Association Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services (Apr. 16, 2003), at 7. Mr. Burgess reported the results of an American Bankers Association survey, which found that 45 percent of banks had stopped "offering loan or deposit accounts" and 43 percent had chosen not to "launch a new product, delivery channel, or enter a geographic market because of the expected compliance cost or risk." *Id*. at 7.
25. *See* Federal Reserve Bank of Minnesota Economic Policy Paper 13-3, *supra* note 17, at 3. The authors also point out that regulations can increase profitability. *Id*. at 3. One way that regulation can do this is to act as a barrier to entry, something that will be discussed below.

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.[26]

Regardless of these efforts, regulatory costs are likely to work against smaller financial institutions as they attempt to compete with larger banks. 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."[27] As will be discussed next, there are other features of Dodd-Frank that tilt the competitive landscape in favor of larger competitors.

UNBALANCED COMPETITIVE LANDSCAPE

Community banks face competition from many sides. Large interstate banks compete for their customers. In addition, community banks face competition from credit unions, which do not pay taxes. Competition also comes from other financial services providers, such as securities firms, and other investment options, such as money market funds. Community banks also compete with larger rivals that Dodd-Frank deems systemically important—banks with $50 billion or more in assets and other nonbank financial firms designated by the Financial Stability Oversight Council.

The implicit seal of government approval that the systemic designation conveys on large banks gives them a competitive edge. These financial institutions are often not direct competitors of community banks in the capital markets, because community banks tend to fund themselves very differently than larger firms.[28] Nevertheless, when community banks decide to go to the capital markets, not having the government designation will make it harder for them to raise capital. Particularly in a time of crisis, when banks are most likely to need to raise money to survive, the large bank with government backing will find it a lot easier to do so than the community bank that the government has not deemed to be systemic. Large banks with a systemic designation are also likely to find it easier to obtain and retain customers, who will perceive the systemically important status as a guarantee of the financial institution's longevity.

Community banks have not been active users of derivatives to hedge their interest-rate risk.[29] To the extent Dodd-Frank's clearing and execution requirements make the use of derivatives more costly, it is possible that Dodd-Frank will further limit their hedging activity. As a result, small banks could be more vulnerable to interest-rate changes than their larger competitors, who routinely use derivatives to hedge interest-rate risk.

Large banks offer products and services that smaller financial institutions cannot. The system as a whole is better served by a variety of institutions offering a variety of products and services.[30] Dodd-Frank, however, enforces homogeneity.

---

26. See, e.g., Board of Governors of the Federal Reserve System, Final Rule on enhanced Regulatory Capital Standards—Implications for Community Banking Organizations (2013), available at http://www.federalreserve.gov/commbankguide20130702.pdf.
27. Robert DeYoung and Denise Duffy, *The Challenges Facing Community Banks: In Their Own Words*, (Federal Reserve Bank of Chicago Economic Perspectives 2002), at 12–13.
28. For a discussion of community bank capital-raising practices, *see* FDIC COMMUNITY BANK STUDY, *supra* note 1, at Chapter VI.
29. *See, e.g.*, DeYoung and Duffy, *supra* note 27, at 10.
30. For a discussion of how to achieve a Talebian "antifragile" banking system by letting "a thousand flowers bloom, but [not letting] even one of them be artificially preserved," *see* Lawrence H. White, *Antifragile Banking and Monetary Systems* (paper presented at Cato Institute's 30th Annual Monetary Conference, Nov. 30, 2012).

REGULATORY BARRIERS TO THE PROVISION OF TRADITIONAL COMMUNITY BANK PRODUCTS AND SERVICES

One of Dodd-Frank's main features was the creation of the CFPB, which is charged with protecting consumers. Underlying Dodd-Frank's approach to consumer financial protection is a reliance on regulators to define safe products for consumers. This model works better for large banks than it does for small banks. Wake Forest law professor Tanya Marsh and American Enterprise Institute scholar Joseph 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 one 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.[31]

The needs of homogenous consumers can be met with homogenous products, but the assumption that consumers are homogenous is wrong. Community banks' practice of getting to know their customers and tailoring products to their needs is at odds with the Dodd-Frank version of customer protection.

Community banks have profited from using "soft information" not available to their larger counterparts. 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."[32] Rules adopted by the CFPB under Dodd-Frank do not leave much room for the consideration of such soft information. As George Mason University economics professor Todd Zywicki explains, 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."[33]

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. Some of those features are standard in commonly offered community bank loans. Although the CFPB accommodations for certain community bank loans, the qualified mortgage rules will still constrain community banks' ability to lend. The qualified residential mortgage rule, which is now being drafted by regulators, exempts mortgages that fit within its parameters from Dodd-Frank's risk retention requirement. Along with the qualified mortgage rule, the qualified residential mortgage rule will interfere with customer-specific underwriting.

If community banks are unduly constrained in their ability to offer traditional products and services, they may feel pushed to go into business lines with which they are not familiar. This could pose a risk to the viability of the banks and ultimately to the FDIC's Deposit Insurance Fund. 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."[34] 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."[35] It

---

31. Tanya D. Marsh and Joseph W. Norman, THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 39 (American Enterprise Institute 2013).
32. Tanya D. Marsh and Joseph W. Norman, THE IMPACT OF DODD-FRANK ON COMMUNITY BANKS 11 (American Enterprise Institute 2013).
33. Todd J. Zywicki, The Consumer Financial Protection Bureau: Savior or Menace (Mercatus Center Working Paper No. 12-25, 2012), at 31-32, *available at* http://mercatus.org/sites/default/files/CFPB_Zywicki_v1-0_0_1.pdf.
34. FDIC COMMUNITY BANKING STUDY, *supra* note 1, at 5-22.
35. Lawrence L. Evans, Director, Financial Markets and Community Investment, Government Accountability Office, Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, at ii (Mar. 20, 2013).

would be unfortunate if government regulations encouraged community banks to abandon what they are good at in favor of riskier lines of business.

CONCLUSION

It is difficult to understand with precision the degree to which Dodd-Frank affects community banks and their potential to survive and thrive, but it is clear that the regulatory burden is weighing heavily on small banks. Some might argue that regulatory costs could be offset with subsidies for community banks, which could be used, for example, to make loans to small businesses. A better approach is to take steps to relieve the regulatory burden so that community bankers can make loans that will serve their customers and earn profits for bank owners. Certain problematic provisions of Dodd-Frank—such as the risk retention requirement—could simply be eliminated. Others—such as the unaccountable structure of the CFPB—could be reformed. Opportunities for creating new appropriate exemptions for small banks or expanding existing ones should be explored and implementation deadlines could be extended. More generally, a requirement that all rulemaking by the financial regulators be informed by economic analysis could assist the regulators in designing better regulations and identifying instances in which additional regulation is not necessary.

As mentioned above, the Mercatus Center is conducting a survey of small bankers to better understand the nature of the challenges they are facing and opportunities they are seeing as Dodd-Frank implementation progresses. I encourage community bankers to take the survey. The results will help policymakers to better understand how they can ensure that the American banking sector remains vibrant, competitive, efficient, and customer-focused.

Thank you again for inviting me here today. I would be happy to answer any questions.

ABOUT THE AUTHOR

Hester Peirce is a senior research fellow at the Mercatus Center at George Mason University. 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.

ABOUT THE MERCATUS CENTER

The Mercatus Center at George Mason University is the world's premier university source for market-oriented ideas—bridging the gap between academic ideas and real-world problems.

A university-based research center, Mercatus advances knowledge about how markets work to improve people's lives by training graduate students, conducting research, and applying economics to offer solutions to society's most pressing problems.

Our mission is to generate knowledge and understanding of the institutions that affect the freedom to prosper and to find sustainable solutions that overcome the barriers preventing individuals from living free, prosperous, and peaceful lives.

Founded in 1980, the Mercatus Center is located on George Mason University's Arlington campus.

www.mercatus.org

Mr. DESANTIS. Appreciate that statement.

Mr. Miller, thank you for joining us. You are up for 5 minutes.

STATEMENT OF HON. R. BRADLEY MILLER

Mr. MILLER. Thank you, Mr. Chairman.

I'm Brad Miller. I've served for a decade as a Member of the House and left at the beginning of the year. I'm now of counsel to the law firm of Grais & Ellsworth and a senior fellow at the Center for American Progress.

The consolidation of the banking industry has largely reduced the role of community banks to a niche in the economy, but it is an important niche, as almost everyone who has spoken has noted. Community banks still hold a majority of deposits in rural and small town America. One out of five rural and micropolitan counties—that's small towns—the only physical banking offices are those of community banks.

Community banks are locally owned and controlled. They gather deposits locally, and they make lending decisions locally. As of 2011, 46 percent of the banking industry's small loans to farms and businesses were by community banks, and community banks just had 14 percent of banking assets.

Congress and regulators should recognize real differences between community banks and too big to fail institutions. Avoid needless compliance costs because compliance costs are largely a fixed cost rather than a variable cost. Avoid giving large institutions an unfair competitive advantage. Allowing examination of smaller banks for CFPB compliance by existing safety and soundness regulators, rather than having too disruptive regulations, is a sensible recognition the differences between community banks and bigger banks. I got some grief at the time from some of my usual allies on financial reform for leading that compromise. But I thought then, and I still think, that different compliance examination rules made sense.

Similarly, the CFPB created a sensible, limited exception from the qualified mortgage, or QM, rule for portfolio mortgages by community banks and credit unions with less than $2 billion in assets that make fewer than 500 first lien mortgages a year. The Dodd-Frank Act was the most significant set of financial reforms since the New Deal, and the financial crisis was the most significant financial crisis since the Great Depression.

A GAO study last fall concluded that some provisions will help community banks, such as supervision by the CFPB of nonbank lenders that competed unfairly with responsible community banks in the past and changes in the calculation of deposit insurance premiums.

Other visions inevitably will result in some compliance costs for community banks, the GAO found. But how much will depend upon the implementing regulations. So this is all kind of a guess in what compliance costs may be.

Regulators should certainly make sensible exceptions, like CFPB's exemption from the QM rule for some portfolio mortgages by community banks. But other provisions really should apply equally to all lenders. Community bank lending may be more relationship based than lending by bigger banks, but no one walks into

a community bank with a legal pad or a laptop and says, "I need a loan. Do you want to be the party of the first part, or do you want me to be the party of the first part?"

They all use standard forms. They use the same forms for all of their lending. No lender's standard form should include predatory, equity-stripping provisions. Community banks were generally not guilty of some of the worst abuses of the last decade, and community banks remain more constrained by reputational concerns than are the biggest banks.

But community banks are not incapable of bad conduct. In the movie, "It's a Wonderful Life," George Bailey was a community banker, but so was Mr. Potter. I know that I've just made a reference that no one under the age of 30 caught.

[Laughter.]

Mr. MILLER. Which is—which means 97 percent of congressional staffers.

There is litigation pending now against a New York community bank for mortgages that the banks made to homeowners with lots of equity but problem credit. The mortgages had an interest rate that adjusted to almost 10 percent.

If a mortgager—if a homeowner was late with a payment, the rate went to 18 percent and stayed at 18 percent until the homeowner got completely current. Almost half of the 5,000 mortgages, 5,000 homeowners who got those mortgages are losing their home.

If Congress is serious about helping community banks compete, there are a lot of things Congress can do. Congress can limit ATM charges that are unrelated to the cost of transactions. There is a Bank of America cash machine just two blocks from here on Pennsylvania Avenue. Good luck with finding one for Prosperity Bank.

Most important, Congress should end the implicit subsidy of too big to fail banks. The ICBA has joined in the chorus calling for ending too big to fail because of the unfair competitive advantage it gives too big to fail banks over community banks, and Congress should pay attention.

Again, Mr. Chairman, thank you for this opportunity to testify.

[Prepared statement of Mr. Miller follows:]

Good afternoon. I'm Brad Miller. I served for a decade as a member of the House and left at the beginning of the year. I am now of counsel to the law firm of Grais & Ellsworth LLP and a Senior Fellow at the Center for American Progress. The views I express today are my own, although generally consistent with the views of CAP. I certainly am not representing a client. I am advised by House ethics that my testimony today does not constitute prohibited lobbying within my one-year cooling off period.

The consolidation of the banking industry has largely reduced the role of community banks to a niche in the economy, but it is an important niche. According to the FDIC, the number of federally insured banks fell from 17,901 in 1984 to 7,357 in 2011. During the same period, bank assets held by community banks declined from 38 percent to 14 percent. Most of the growth in bigger banks has been in American cities, while community banks still hold a majority of deposits in rural and small town America. In one out of five rural and "micropolitan" counties, the only physical banking offices are those of community banks. Community banks are locally owned and controlled, they gather deposits locally, and they make lending decisions locally. As of 2011, 46 percent of the banking industry's small loans to farms and businesses were by community banks. According to the GAO, about 20 percent of community bank lending is small business lending, as opposed to about five percent for bigger banks.

Any given community bank is small enough to fail, and no community bank is going to get into trouble by going "long in belly tranches" or trying to "monetize volatility" in a "synthetic credit portfolio," whatever that means. In the past, however, a lot of small institutions have gotten into about the same kind of trouble for about the same reason at about the same time, with severe economic consequences. The problem wasn't too big to fail, but too many to fail. There were 9,000 bank failures in the nineteen-thirties, the Great Depression. And in the Savings and Loan crisis in the 1980s, almost a quarter of all thrifts failed, 747 out of 3,234. Even with the concentration in banking we now have, a similar extinction event for community banks would do great economic damage, especially for small businesses and in small town and rural America.

Congress and regulators should recognize real differences between community banks and too-big-to-fail institutions; avoid needless compliance costs; and because compliance costs are largely a fixed cost rather than a variable cost, avoid giving large institutions an unfair competitive advantage. Allowing examination of smaller banks for CFPB compliance by existing safety-and-soundness regulators, rather than having two disruptive examinations, is a sensible recognition of the difference between community banks and bigger banks. I got some grief at the time from some of my usual allies on financial reform for leading that compromise, but I thought at the time and still think that different compliance examination rules made sense.

Similarly, the CFPB created a sensible, limited exemption from the "qualified mortgage" or "QM" rule for portfolio mortgages by community banks and credit unions with less than $2 billion in assets that make fewer than 500 first-lien mortgages a year. If a community bank assumes all of the risk of default, then there will be strong incentive to decide correctly if the borrower has the ability to repay without a debt-to-income requirement.

The Dodd-Frank Act was the most significant set of financial reforms since the New Deal. Many of the provisions are aimed at large, complex, systemically important financial institutions, and will not affect community banks at all. Other provisions will affect community banks. A GAO study last fall concluded that some provisions will help community banks, such as the supervision by the CFPB of certain nonbank lenders that competed unfairly with responsible community banks in the past, and changes to the calculation of deposit insurance premiums. Other provisions will inevitably result in some compliance costs for community banks, the GAO found, but how much will depend on the implementing regulations. Regulators should certainly make sensible exceptions, like the CFPB's exception from the QM rule for some portfolio mortgages by community banks. The regulators should also recognize, however, than a patchwork of different rules for different lenders will inevitably be confusing to consumers, and is contrary to the intent that some rules should apply to all lenders.

Other provisions should apply equally to community banks. Community bank lending may be more "relationship lending" than lending by bigger banks, but no one walks into a community bank with a legal pad or a lap top and says "I need a loan. Do you want to be the party of the first part, or do you want me to be." Community bank lending may be more tailored to the borrower, but no one's lending is that tailored. All lenders use standard forms, and no lender's standard forms should include predatory, equity-stripping provisions like what we saw in the last decade. Community banks were generally not guilty of some of the worst abuses of the last decade, and community banks remain more constrained by reputational concerns than are the biggest banks. But community bankers are not incapable of bad conduct. In the movie "It's A Wonderful Life," George Bailey was a community banker, but so was Mr. Potter.

There is litigation pending now against a New York community bank for mortgages the banks made to homeowners with lots of equity but problem credit. The mortgages had an interest rate that adjusted to almost ten percent. If a homeowner was late with a payment, the rate went to 18 percent and stayed at 18 percent until the homeowner got completely caught up. Since an interest rate of 18 percent almost doubled the monthly payment, many homeowners found it hard to catch up. Almost have of the 5,000 homeowners who got the mortgages are losing their home.

The consolidation in the banking industry was not the result of onerous regulation of community banks, but of the deregulation of big banks by submissive politicians and regulators. More of the consolidation was the result of bigger banks buying smaller banks after interstate banking restrictions were relaxed than was the result of small bank failures.

Much of the advantage community banks have had in the past is their knowledge of local laws. The largest banks have succeeded in excusing themselves from many local or states laws they find inconvenient. Legislation introduced last week would exempt mortgages even from the requirements of state land title laws.

There are several ways Congress could help community banks compete with the biggest banks. For instance, Congress could limit ATM charges that are unrelated to the cost of transactions. Fees for using an ATM that is not your bank's own may be four or five dollars, which is pretty stiff if you just need

$40.00 in cash. ATM fees are unjustifiably profitable, and are a barrier for community banks in competing for customers. There's a Bank of America cash machine just two blocks from here on Pennsylvania Avenue. Good luck with finding one for Prosperity Bank.

Most important, Congress should end the implicit subsidy for borrowing by too-big-to-fail banks. The ICBA has joined the chorus calling for ending too-big-to-fail because of the unfair competitive advantage too-big-to-fail banks have over community banks. Congress should pay attention.

Thank you for this opportunity to testify.

Mr. DESANTIS. Thank you for your attendance.

And Ms. Marsh, thank you for attending as well, and you are up for 5 minutes.

STATEMENT OF TANYA MARSH

Ms. MARSH. Thank you, Chairman, members of the subcommittee.

I appreciate you convening this hearing today and for inviting me to testify.

My name is Tanya Marsh. I'm an associate professor at the Wake Forest University School of Law in Winston-Salem, North Carolina, and I'm an adjunct scholar with the American Enterprise Institute.

In May, I coauthored a research paper for AEI, entitled "The Impact of Dodd-Frank on Community Banks." A copy of that paper is included in my written testimony, but I just wanted to highlight a couple of key points from it for you today.

The purpose of Dodd-Frank, as everyone has noted, is to prevent another financial crisis by enhancing consumer protection and ending the era of too big to fail. But the regulatory burden imposed by Dodd-Frank on community banks I believe undermines both goals, and ultimately, it will harm both consumers and the economy by first forcing community banks to consolidate or go out of business, furthering the concentration of assets in too big to fail institutions, and, second, encouraging standardization of financial products, which potentially will leave millions of vulnerable borrowers without meaningful access to credit or banking services.

The American system of banking regulation is really a system of regulation by accretion. And what I mean by that is it's a result of about 200 years of very well-meaning legislative responses to financial and banking crises. But the net effect of all of these policies is a one-size-fits-all system that is fundamentally flawed.

My key message today is I think we need to take a step back and rethink our regulatory approach to banking in general, to target our resources on the real risks to the American consumer and the American economy, rather than doubling down on a regulatory approach that represents more of a historical accident than a deliberate policy choice.

It's a simple fact that a depository institution with $165 million in assets, the median American bank, poses different risks to consumers and the economy than a $2 trillion bank. And I think we should take a more tailored approach to regulating them both.

We need to remember that financial services sector is not a free market. It's a highly regulated market. Therefore, our policy choices can have a substantial impact on the ability of institutions to compete within that market. Although few would argue, and no one is arguing here today, that community banks caused the financial crisis, 7 of the 16 titles of Dodd-Frank are expected to impact community banks in some way.

Hundreds of regulations are anticipated to be promulgated. Most of these rules are very complex, and the stakes for understanding and following them are high. It is not an insignificant cost to have an expert read the new regulations as they're proposed and determine whether or not they are applicable, let alone implement them.

As the Federal Reserve determined in 1998, a small bank is less able to absorb this regulatory burden than a large bank. So by imposing unnecessary regulation on smaller institutions, we are awarding the larger banks a further competitive advantage.

A recurring theme in Dodd-Frank, particularly with respect to the Consumer Financial Protection Bureau, is that the standardization of financial products and forms will protect consumers. But this focus on standardization fails to recognize the challenges posed by—posed by borrowers who lack the deep credit history or documentation necessary for the model-based lending that's used by the larger banks.

The self-employed, seasonal workers, farmers, people transitioning to work are particularly at risk, I believe, by increased standardization. Financial activities that are fundamental to the average American are only really worth the time of a megabank if they involve a completely standardized product and if the borrower is a completely standardized borrower. You either fit in the box, or you don't.

And as a result, millions of Americans are left out of the box altogether. According to the FDIC, one in four American households is unbanked or underbanked. These households interact with nonbank financial service providers who have been largely unregulated prior to Dodd-Frank, and they typically bear far higher costs than those households that are fully served by banks.

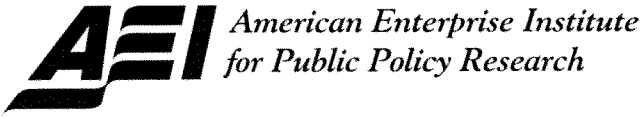
So if regulators push the entire banking industry in lockstep toward standardization, many small businesses and individuals that are currently served by community banks may be denied credit and swell the ranks of the unbanked or underbanked. In addition, because of their higher operating costs relative to larger banks, if community banks become forced through standardization into just small versions of large financial institutions, they will be at a severe competitive disadvantage.

So, as a result, credit and banking services will be eliminated or become more expensive for millions of American consumers, especially those living in rural communities and small businesses.

For these reasons, I ask the subcommittee to consider taking an overall fresh look at the Federal regulation of banks to determine how to more appropriately regulate both community banks and large financial institutions.

Thank you again for the opportunity to testify today.

[Prepared statement of Ms. Marsh follows:]



Statement before the House Committee on Oversight and Government Reform

Subcommittee on Economic Growth, Job Creation and Regulatory Affairs

Hearing on Regulatory Burdens: The Impact of Dodd Frank on Community Banking

Regulatory Burdens: The Impact of Dodd Frank on Community Banking

Tanya D. Marsh

Associate Professor of Law
Wake Forest University School of Law

-And-

Adjunct Scholar
American Enterprise Institute

July 18, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of Wake Forest University or the American Enterprise Institute.

Chairman Jordan, Ranking Member Cartwright, and members of the Subcommittee, thank you for convening this hearing today to examine the regulatory burden on community banks, and for inviting me to testify. My name is Tanya Marsh and I am an Associate Professor at the Wake Forest University School of Law in Winston-Salem, North Carolina, and an Adjunct Scholar with the American Enterprise Institute. In May 2013 I co-authored a research paper for the American Enterprise Institute entitled "The Impact of Dodd Frank on Community Banks." A copy of that paper is attached and included in my written testimony.

Any discussion of regulatory burden is incomplete without examining both the costs and the benefits of the specific regulation. It is my position that the regulatory framework for financial institutions in the United States, including many provisions of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), impose significant costs on community banks without providing benefits to consumers or the economy that justify those costs. The stated purpose of the Dodd-Frank Act was to prevent another financial crisis by enhancing consumer protection and ending the era of "too big to fail." However, the application of Dodd-Frank to community banks is misplaced. Community banks did not cause the financial crisis. The relationship-banking business model and market forces protect the customers of community banks without the need for additional regulation. Dodd-Frank builds on decades of "one size fits all" regulation of financial institutions, an ill-conceived regulatory framework that puts community banks at a competitive disadvantage to their larger, more complex competitors. The imposition of regulatory burdens on community banks without attendant benefits ultimately harms both consumers and the economy by: (1) forcing community banks to consolidate or go out of business, furthering the concentration of assets in a small number of mega-financial institutions; and (2) encouraging standardization of financial products, leaving millions of vulnerable borrowers without meaningful access to credit.

Who are the Community Banks?

Before turning to the impact of Dodd-Frank on community banks, it is useful to understand the general landscape of American banking. There are roughly 7,000 banks in the United States, of which 92.4 percent are classified as community banks. Although

numerically dominant, community banks hold only 14.2 percent of all banking institution assets. The 5,000 members of the Independent Community Bankers of America collectively hold $1.2 trillion in assets. That's about half of the assets held by a single financial institution – JP Morgan Chase. The median American bank has $165 million in assets and 39 employees. Nearly 3,000 banks have fewer than 30 employees. Most community banks are small businesses.

Generally speaking, community banks offer traditional depository, loan, and trust services, operate in limited geographic areas, and are often located in rural areas. For example, 82 percent of community banks operated within three or fewer counties. Community banks make up more than 70 percent of banking offices in rural areas. In fact, community banks operate in 1,200 U.S. counties that have no other bank, fully one-third of American counties.

Community banks are different from larger banks, which must treat the average American as a commodity in order to maintain a profitable relationship. Because their banking activities are directed toward small businesses, farmers, and consumers, community banks are considered "relationship" banks. Community banks use personal knowledge of a customer's financial situation and local business conditions to make lending decisions.

In contrast to the complex financial modeling used by large banks, 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. For example, the president of a $250 million bank in the upper Midwest explained to me that his customers face challenges that larger banks unfamiliar with the area would not understand. The community served by his bank relies on timber and mining, both seasonal activities. As a result, cash flows for consumer and business customers vary throughout the year. He described a pattern of successful loans where the borrower had uneven income or other characteristics that would lead a person from outside the community to conclude that person was a poor credit risk. But, the banker continued, he knew those loans would be repaid. He knew the borrower's family. He saw the borrower every Sunday at church, in the grocery store, at Little League. Because of the community banker's individual confidence an individual borrower, that borrower had access to valuable credit. Large

banks simply can't think that way – they are unable to profitably underwrite and structure loans for borrowers who don't fit the standard mold. But through relationship banking, through community banks, access to credit is more broadly available.

The other main characteristic of relationship banking is that it is based on *relationships.* Community banks operate in small geographic areas. They cannot afford to alienate their consumer base through predatory lending or poor customer service. They depend upon the good will of the community and repeat customers to continue in business. In other words, market forces are a powerful means of ensuring good behavior from smaller banks. Regulation that intends to do the same thing is duplicative and unnecessary.

Community banks hold approximately 14 percent of banking assets. But they play an outsized role in most categories of financial services that matter to individual consumers. Community banks provide 48.1 percent of small-business loans issued by U.S. banks, 15.7 percent of residential mortgage lending, 43.8 percent of lending secured by farmland, 42.8 percent of farm operations lending, and 34.7 percent of commercial real estate loans. In addition, they hold 20 percent of all retail deposits at U.S. banks.

Before I joined the faculty at Wake Forest, I practiced commercial real estate in Indianapolis for ten years. I know from the experience of representing my clients that when they had a smaller project, or a project outside of the heart of a highly dense metropolitan area, their main financial option was to go to a community bank. They simply would not be able to finance that project through an insurance company, a large financial institution, or the commercial mortgage backed securities (CMBS) market.

A "One Size Fits All" Regulatory Approach

The American system of banking regulation is a system of regulation by accretion – it is the result of legislative responses to particular crises, from the need to create a market for U.S. national bonds to help finance the Civil War, which led to the creation of national bank charters, the creation of the Federal Reserve after the monetary panic of 1907, the creation of the FDIC following the stock market crash of 1929, and Dodd-Frank after the 2007 financial crisis.

Each of these legislative efforts was a well-meaning attempt to deal with the perceived problems that led to each crisis. But the net effect of these policies is a federal regulatory system for banking that is fundamentally flawed and imposes unintended negative consequences on community banks, consumers, and the economy.

The major flaw of the federal banking regulatory system is that it treats a community bank with $165 million in assets, the median-sized American bank, as the same essential creature as JP Morgan Chase or Bank of America. A bank with $165 million in assets and a bank with $2 trillion in assets may both take deposits and make loans, but the similarities end there. Since the 1999 Gramm-Leach-Bliley Act, which reduced barriers between depository banks and investment banks, the gap between community banks and large, complex financial institutions has grown. It simply is not a principled policy choice to regulate them both under a "one size fits all" approach. It is an accident of history that we do so. Dodd-Frank continues the historical trend of regulating small, traditional banks and large, complex financial institutions under the same rubric and will have an impact on shaping the market in ways that I believe are counterproductive to the stated purposes of Dodd-Frank and which are against our common interests.

The Impact of Dodd-Frank

The narrative that emerged immediately after the 2007 financial crisis was that the regulatory framework for American banking was broken and that government intervention must fix it. Dodd-Frank is a massive and complicated piece of legislation with two main goals – (1) end the era of "too big to fail" without actually breaking up the largest financial institutions; and (2) strengthen consumer protection. It is my contention that the net effect of federal regulation on community banks undermines both key goals.

More fundamentally, the application of Dodd-Frank to community banks is misguided because community banks did not participate in the perceived sins that led to the financial crisis. They did not engage in subprime lending that was sold into residential mortgage backed securities (RMBS) – they originate loans and generally hold them on their books until repayment, which leads to much more conservative underwriting and an alignment of incentives. They did not participate in securitization

activity. They do not participate in the derivatives market. Nonetheless, seven of the 16 titles of Dodd-Frank are anticipated to impact community banks. Two years after Dodd-Frank, it is remains unclear to what extent these provisions will impact community banks because of the Act's heavy reliance on agency rulemaking. As of July 1, 2013, one-third of the 398 rulemaking requirements in Dodd-Frank had been satisfied with finalized rules. Rules have been proposed to meet an additional one-third, and the remaining third have not been addressed.

The attached paper details the seven titles of Dodd-Frank that are expected to have an impact on community banks and the anticipated effect. There will be two meta-outcomes. First, the regulatory burdens of Dodd-Frank will further the recent trends of consolidation and merger in the American banking sector, leading to a higher concentration of assets in the mega-financial institutions that were the original target of Dodd-Frank. Second, the focus on standardization as a means of consumer protection will undermine the relationship banking model of community banks and make it more difficult for millions of Americans and small businesses to access credit. Neither of these outcomes will fulfill the purposes of Dodd-Frank or advance our common interests.

Compliance Costs and Consolidation

As a result of Dodd-Frank, community banks will incur significant compliance costs that will place them at a further competitive disadvantage to large banks. This is a cumulative cost that has arisen over time, with the accretion of federal regulation. The number of community banks will continue to shrink, through failure and merger, leading to increased consolidation and continued growth of the "too big to fail" institutions.

Community bankers have repeatedly expressed concern that Dodd-Frank will impose new and costly regulatory compliance burdens on community banks. Both the GAO and FDIC, in reports released in September 2012 and December 2012, respectively, concluded that it is impossible at this time to quantify the costs that community banks will incur as a result of Dodd-Frank. Anecdotal information, however, suggests that compliance costs at small banks have already significantly increased in recent years.

Although they are largely unable to quantify the expected costs, community banks are focused on the rules contemplated by Dodd-Frank, particularly with respect to the Basel III capital rules, data gathering and reporting mandated by the CFPB, and the qualified mortgage provisions. All of these provisions are complex, and the stakes for understanding and following them are high. The chief executive of a small North Carolina institution summarized the impact: "For a little bank like ours with 19 people, [it] could be a full-time job for somebody to make sure we comply with the provisions of [Dodd-Frank]."

The Bureau of Labor Statistics expects that Dodd-Frank will significantly increase the regulatory burden on banks. The "financial examiners" job category, which includes compliance officers, is projected to grow 27 percent from 2010 to 2020, faster than average for all occupations. But community banks, particularly small institutions located in rural areas, may have difficulty recruiting and retaining qualified personnel.

Although the regulatory costs associated with Dodd-Frank will annoy the large banks, they will constitute a blip on their balance sheets. These costs will have a far greater impact on community banks. Basic economic theory supports the presumption that smaller banks are disproportionately affected by the costs of regulatory compliance. Research on this point was conducted by Federal Reserve staff in 1998. That study found evidence that smaller banks are at a cost disadvantage compared to larger banks. That cost disadvantage will intensify with further investments in compliance staff, technology, lawyers, and consultants.

For some community banks, the regulatory burdens imposed by Dodd-Frank will be the straw that breaks the camel's back, forcing them out of business. This will further the trend toward "too big to fail" because it will lead to greater asset concentration in a smaller number of financial institutions. Over the past several decades, bank consolidation and asset concentration has increased dramatically in the American banking sector. Between 1982 and 2013, the number of commercial banks in the United States decreased by more than 57 percent. Both mergers and bank failures account for this decrease. Except in the years following the savings and loan crisis of the late 1980s and early 1990s, and the years since the financial crisis, bank failures have been relatively rare.

Failures and mergers both disproportionately impact smaller banks. The number of banks with assets of less than $100 million decreased by more than 80 percent from 1985 to 2010, while the number of banks with assets greater than $10 billion nearly tripled over the same period. Meanwhile, the concentration of capital in those large banks increased. A mere 7.6 percent of banks currently hold about 86 percent of all banking assets in the United States. There is anecdotal evidence that the cumulative regulatory burden imposed by Dodd-Frank is already exacerbating this problem by pushing community banks to pursue mergers.

Increased Standardization

The second impact of Dodd-Frank is on consumers. A recurring theme in Dodd-Frank, particularly with respect to the Consumer Financial Protection Bureau (CFPB), 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. One of the chief advantages of community banks is their ability to successfully lend to borrowers who do not have the deep credit history or documentation necessary for the model-based lending used by large financial institutions. The self-employed, seasonal workers, farmers, and people transitioning to work will be particularly at risk.

Financial institutions with assets of more than $100 billion constitute 0.3 percent of all U.S. financial institutions. Banks in this category are behemoths, employing thousands of workers in their complex organizational and operational structures. JPMorgan Chase alone has more than $2 trillion in assets under supervision. Large financial institutions play a valuable role in the American economy – through their size and influence, they can help facilitate economic activity on a large scale. But they don't do everything well. Financial activities that are fundamental to the average American, such as taking deposits, and making residential mortgages, small business

loans, and farm loans, are only worth the time of a mega financial institution if they involve a completely standardized product and if the borrower is a completely standardized borrower. There is no negotiation of terms, there is little room for explanation for why a particular borrower has a unique profile. You either fit in the box or you don't. As a result, millions of Americans are left out of that box altogether. One in four American households are either "unbanked," meaning they lack a checking or savings account, or "underbanked," meaning they rely on alternative financial services like payday loans in addition to a traditional bank account. The unbanked and underbanked typically bear far higher costs than those fully served by banks and find it much more challenging to meaningfully participate in the economy.

If regulators push the entire financial services industry in lockstep towards standardization—of underwriting, financial products, and applications—then many small businesses and individuals currently served by the community bank model may be denied credit, joining the ranks of the unbanked or underbanked. In addition, because of their higher operating costs relative to larger banks based on economies of scale, if community banks become forced through standardization into small versions of large financial institutions, they will be at a severe competitive disadvantage. As a result, credit and banking services will be eliminated or become more expensive for small businesses, those living in rural communities, and millions of American consumers and businesses that are challenging or less profitable for large banks to serve.

Conclusion

The purpose of Dodd-Frank was to protect consumers and the stability of the financial system. Community banks provide vital services to millions of Americans, many of whom would be underserved if the community bank model were broken or if community banks abandon lines of service. If community banks are forced to merge, consolidate, or go out of business as a result of Dodd-Frank, one result will be an even greater concentration of assets on the books of the "too big to fail" banks. Another result will be that small businesses and individuals who do not fit neatly into standardized financial modeling or who live outside of metropolitan areas served by larger banks will find it more difficult to obtain credit. Neither of these outcomes will protect consumers, the financial system, or the recovery of the American economy.

More broadly, Dodd-Frank exacerbates the broken model of American financial regulation that fails to differentiate between small banks engaged in traditional relationship banking and modern, complex financial services firms. Meaningful reform of the financial regulatory system, reform that would actually reduce systemic risk and protect consumers, would establish a two-tiered regulatory framework. Community banks operating on the traditional model would be subject to less stringent regulation and examination. This is appropriate because the success of their business model depends on the quality of their underwriting and their long-term relationships with repeat customers. Freed of unnecessary regulatory burden, and allowed by examiners to engage in true relationship banking without fear of criticism, community banks would strengthen their ability to serve their customers. The largest financial institutions would be subject to regulations and examinations appropriate to their size, complexity, and role in the American economy. Staff of existing regulatory agencies could more appropriately and efficiently address the unique challenges that these large banks pose to the stability of the financial system if they could focus less on community banks.

As an intermediate step, key provisions of Dodd-Frank could be modified or repealed with respect to community banks. For example, loans originated and held in portfolio by community banks should be given safe harbor status under the "qualified mortgage" rules. The qualified mortgage regulations adopted by the CFPB are a perfect example of the kind of "check the box" standardization that will degrade the relationship banking model. The qualified mortgage rules are designed to prevent the reckless subprime lending that took place before the financial crisis by aligning underwriting and default risk. But again, community banks did not participate in that activity in the first place. If a community bank originates a loan and holds it in portfolio for the life of the loan, its underwriting and incentives are already aligned. Additional regulations are not only unnecessary, they will reduce the availability of credit to non-traditional, creditworthy borrowers who do not fit in the CFPB's box by penalizing the community banks which lend to them.

Two-thirds of the regulations contemplated by Dodd-Frank have not been finalized. That means that much remains to be settled, and there is still opportunity to reassert the value of community banks and to work to maintain the viability of the community banking model within the Dodd-Frank framework. But more meaningful

reform consistent with the goals of Dodd-Frank and the best interests of the American consumer and American economy would ultimately require the implementation of a two-tiered regulatory system.

Mr. DESANTIS. Well, thank you for your statement and for your attendance.

And the chair will recognize himself for the first 5 minutes of questions. You know, it is interesting. I saw an estimate about once all the Dodd-Frank rules are implemented, that compliance economy wide is going to be about 24 million man-hours. And by way of comparison, 20 million man-hours was sufficient to build the Panama Canal.

So this is a huge diversion of energy into compliance. And I think today we want to figure out is all this compliance necessarily a good thing, particularly for institutions who are not too big to fail and did not cause the financial crisis.

Mr. Creamer, do you have unlimited resources at your bank?

Mr. CREAMER. No, sir. I do not.

Mr. DESANTIS. So as you face more burdens from the regulatory apparatus, do you basically have to just diverted existing resources into meeting that compliance, the compliance requirements?

Mr. CREAMER. We diverted existing resources. In addition to that, over the past 4 years in a very difficult economy when, as a small business, a bank or any other business had to watch every cost, every paper clip, every piece of paper to make sure that we retained the core profitability that we needed to survive, those limited resources were strained even further as we moved away from customer-facing personnel to compliance and audit-related personnel.

In fact, coming out of the recession now, I went into the recession with 260 employees. I came out of the recession with 165 employees. I now have more compliance staff than I do small business lenders.

Mr. DESANTIS. And does that have—I would imagine that would have an effect on how broad you can lend throughout the community, given those numbers?

Mr. CREAMER. It has a negative effect. Obviously, I mean, first of all, during the recession, there was not a lot of demand for new loans. But there was a lot of demand from existing customers for help with existing loans.

As we have seen in northeast Florida now, the economy is beginning to recover, and there is a demand for new loans. But resources are still limited. And so, having the compliance and audit staff and the costs we spend in addition to that for training and three outside firms we employ for compliance review, it will cost us in excess of $750,000 this year just for compliance. That's resources that I cannot devote back into production people, calling officers, and that sort of thing.

Mr. DESANTIS. Now just as an experienced community banker, does your bank or any community bank that you have seen pose a systemic risk to the national or world economy?

Mr. CREAMER. I don't believe we pose a systemic risk to the national or world economy. In fact, I'm not sure we pose a systemic risk to St. Augustine and Palatka, frankly. We perform a very important function in those markets, but I do not believe the economy would stop functioning if we ceased to exist.

Mr. DESANTIS. Now I guess one of the—and Mr. Miller suggested, hey, well, you can cap some fees or do this. Now you and

I talked in the district about some of the purported consumer protection regulations that come out, and you serve a lot of low-income people. And you told me the issue you are having with some of the folks who have this overdraft protection and how you are basically, in response to the regulation that is supposed to be pro-consumer, they are now actually going to probably have less choices.

Can you explain that?

Mr. CREAMER. Well, we are a—we are a business like most other businesses. We are a for-profit business. In fact, our regulators want to make sure we are a for-profit business because, obviously, one of the ways we build capital, which is very important, is through our net profit.

When our profit is strained or our costs are increased, we have to pass that on, to some extent, to the consumer. We can only cut costs so much within our organization. And I think, more specifically, what you and I talked about was in relation to the overdraft protections, we are—we serve a very blue collar market. In fact, to a large extent, we serve what I call a "no collar" market—a lot of contractors, a lot of people who are working for a living.

There is a misconception about banks and overdrafts. Customers who use overdrafts are normally not customers that are being abused by the financial institution. They are using those because they are making a conscious choice. Because it's 2 days before payday, and I'm a schoolteacher. I work for the city, and I have to pay my rent or I have to buy my groceries. That's a fact of life in our economy.

I have two choices. I can write a check that I know my bank is going to pay, which has very little stigma to me, and I will cover that check later. Or I can go to the payday lender, which has a huge stigma and a large cost to the consumer.

So in many cases what is represented as being terribly problematic is more so serving a demand for that individual customer that is making a choice.

Mr. DESANTIS. And as a result of some of the new rules, you basically are going to be in a situation where they are going to have less options in that respect?

Mr. CREAMER. They already have significantly less options.

Mr. DESANTIS. Okay. Ms. Peirce, you kind of hit on this. But with the advantages that some of the heavy regulatory burden provides to some of the large banks, obviously, they can comply with this much easier. They have huge staffs, all this.

Are there funding costs? And you said there is an implicit taxpayer guarantee here. So does that reflect itself in them having lower funding costs than small and medium-sized competitors?

Ms. PEIRCE. I think it does. Now they don't always compete in the same capital markets, the small banks and the bigger banks. But I will say that especially during a time of crisis, we're going to see that funding gap really spread. And so, that's when it really matters, when you really—you need to have liquidity to survive. It's going to really matter, and the bigger institutions will have a hands-down advantage then.

So I do believe they have a funding advantage now, but it's even more critical in times of crisis.

Mr. DESANTIS. Great. Thank you.

My time has expired, and I will recognize the gentlewoman from Illinois.

Ms. DUCKWORTH. Thank you, Mr. Chairman.

Thank you to all the witnesses for being here.

I am deeply concerned about the well-being about community banks. I feel that they are absolutely critical to the success and economic well-being of our communities. They provide close to half of the small business loans, at least in my district, and I think that may be nationwide. And they also provide something around 16 to 20 percent range of residential mortgages, mortgage lending.

Community banks operate on a very different business model than the large banks, and I think it is really critical that we ensure that any financial regulations that we put into place respect those differences and don't put our community banks at a disadvantage.

The last thing I want is more consolidation in the market and for the big—too big to fail banks to get even bigger. The housing market in Illinois was particularly hard hit, and as it recovers, I want to make sure that we are not harming the ability of families in my State to achieve the American dream of buying a home.

The CFPB has requested public comments on the proposal to adjust the qualified mortgage rules for the community banks. Could each of you provide me with your thoughts on the impact of this proposed adjustment to the qualified mortgage rule will have on residential mortgages—residential mortgage lending, particularly for community banks?

Mr. CREAMER. Yes, ma'am. And thank you.

I can speak from my standpoint. I'm not comfortable with the CFPB defining a qualified mortgage. I think that's the purview of the bank and its underwriting practices and the customer individually at the time.

As an example, the definition now, as I understand it, is if a mortgage loan is made in excess of a 90 percent loan to value, it may not be a qualified mortgage, and the borrower could have a rebuttable presumption to put the loan back if there is a default.

Unfortunately, in our market, that will have the effect of eliminating a huge segment of needed mortgage loans. I know a number of people, and I will speak for my son and my daughter-in-law, who are both college graduates, who are both gainfully employed, who are both renting an apartment. And at some point, they'll want to buy a home. And in our market, to buy an affordable home, it would probably be $175,000, and there will be closing costs in that.

For them to put 20 percent down on that home would probably be somewhere around $40,000. Well, not only do they not have $40,000 saved, they haven't sold a home and made $40,000. Most Americans have a hard time saving $40,000.

And even though they would fully qualify for the loan, they would be prohibited from getting the loan because of the down payment requirement, even though the monthly payment at today's interest rates would be less than their rent payment.

Ms. DUCKWORTH. Great point.

Ms. Peirce?

Ms. PEIRCE. Yes, I mean, I just want to echo what Mr. Creamer said in the sense that it should be the bank's responsibility to figure out what sound underwriting is for a loan. It's very difficult

to—I think the CFPB has a very difficult task to try to set underwriting requirements for all the loans across the country, and that's really what they're trying to do in the qualified mortgage rulemaking.

And there are exceptions, but the exceptions, from my understanding, aren't broad enough to cover some of the normal lending practices of community banks.

Ms. DUCKWORTH. Congressman Miller?

Mr. MILLER. I understood your question about QRM rather than QM.

Ms. DUCKWORTH. Okay.

Mr. MILLER. One of the criticisms that we heard of what went wrong before the financial crisis, leading up to the financial crisis, was that the origination of mortgages was an originate to distribute, and the originator, which were often not community banks, were often mortgage companies with essentially no assets, sold those immediately to Wall Street, which immediately put them in a pool and sold mortgage-backed securities based upon them.

And so, the phrase we used, we heard so much at the time was "skin in the game." That if the originator had some skin in the game, they would, in fact, apply underwriting standards. But if they could get somebody to buy 100 percent of the risk, they didn't care.

So the object of qualified—but then the idea was they had to keep at least 5 percent. But we heard from a lot of the financial industry that if we did that, it really would constrict liquidity, and there should be some kind of obviously safe mortgages that should not be subject to that 5 percent retained risk, skin in the game requirement.

Now I have thought that the QRM rules do go too far. I don't think that they need—we need to go back to Ozzie and Harriet loans of the 1960s. I don't think we need to have 20 percent prime, you know, all the rest. But I do think that as an exception to the risk retention rules, the QRM, a QRM exception does make sense, and leaving it entirely to the banks just puts us back where we were in the middle part of the last decade.

Ms. DUCKWORTH. I am out of time, Mr. Chairman.

Mr. DESANTIS. Ms. Marsh, if you weigh in on that, give you ——

Ms. MARSH. If I could just briefly? I think that the qualified mortgage rule is a great example of the standardization issue that I mentioned in my testimony. So when I was doing research for my paper, I talked to a community banker in the upper Midwest, where the economy is very reliant on timber and mining, seasonal activity. So most people don't have any cash flow during the winter months.

He structures residential mortgages so they only have to make payments for 9 out of the 12 months because that matches their income stream. Under the qualified mortgage rules, he can't do that.

That's not the kind of activity that we're trying to clamp down on. We're trying to align underwriting risk with skin in the game, as Congressman Miller mentioned. And I think exempting loans that are held in portfolio can accomplish that.

Mr. DESANTIS. Thank you.

The chair now recognizes the gentleman from Tennessee.

Mr. MILLER. Loans held in portfolio are 100 percent skin the game.

Ms. MARSH. Right.

Mr. MILLER. Okay.

Mr. DUNCAN. Well, thank you, Mr. Chairman.

The staff asked, I didn't know what the up-to-date statistics were. So I asked the staff a few minutes ago what was the average size of a typical bank in this country, and they tell me the median size, bank size is $165 million, that 80 percent of the 7,100 banks have less than $1 billion. The average size of the 10 largest banks is $717 billion, and so there is quite a discrepancy between the very largest.

And I started this hearing saying that I don't have any objection to going to these trillion dollar banks or these mega-billion dollar banks because they can handle it. But the problem is, is that this is—as those quotes I gave, this is most harmful to the little banks.

In fact, this one article says, thanks to Dodd-Frank, community banks are too small to survive. We talked about too big to fail, too small to survive is what we are looking at in the over 200 that has run out of business since we started Dodd-Frank.

And Ms. Peirce, I was under the impression—you know, I remember—every Member gets a thing called the Congress Daily at their door each morning. And I remember 2 or 3 years ago, there was a cartoon in there, and it showed these banks with huge bags full of money, and the banker saying, "Lend, lend"—I mean, excuse me, and it showed the President, President Obama, saying, "Lend, lend, lend." And then it showed the regulators pulling back, saying, "No, no, no."

And I was under the impression that the banking industry, even before Dodd-Frank, was one of the more heavily regulated industries in this—or businesses in this country. Is that correct?

I mean, before you had the 2,300-page Dodd-Frank law and the hundreds of new rules and regulations, you already had all kinds of rules and regulations and red tape for these banks anyway?

Ms. PEIRCE. That's correct. And unfortunately, some of those rules directed bankers to instead of using their own skills in figuring out whether to loan and when, it tried to direct them when to loan and tried to make decisions for them, just as you mentioned.

Mr. DUNCAN. Mr. Creamer, did you start your bank? Or were you in at the first?

Mr. CREAMER. No, sir. I did not.

Mr. DUNCAN. What size was it when you first got involved?

Mr. CREAMER. When I joined Prosperity Bank in—16 years ago, the bank was about $75 million in assets.

Mr. DUNCAN. Seventy-five million?

Mr. CREAMER. Yes, sir.

Mr. DUNCAN. How—what do you think would be the effect on a bank much smaller than yours? Let us say a $100 million or a $200 million bank?

Mr. CREAMER. Of a regulation—of the current regulations?

Mr. DUNCAN. Yes, of the Dodd-Frank law.

Mr. CREAMER. Catastrophic.

Mr. DUNCAN. Catastrophic?

Mr. CREAMER. Yes, because resources are resources. Banks operate on net interest margin and non-interest income. Both of those are a function of asset size. The larger the bank, especially in a community bank that gets over $500 million, and there's been a lot of conversation that if you're not over $500 million, you probably can't afford to operate in the regulatory scheme. But economies of scale build in, and you have some efficiencies at that point to afford compliance staff and, at some point, outside legal help.

If you're below that level, with net interest margins compressed, as they are today, and non-interest income being regulated down as hard as it is today, it's going to be extremely difficult for those banks to, one, I would say, survive. And I don't mean survive from a failure standpoint. I mean without having to merge out. And two, to be profitable to return any modicum of return to the shareholders.

Mr. DUNCAN. Ms. Marsh, do you think that this law is going to continue this trend of forcing smaller banks either out of business or forced to merge with bigger banks?

Ms. MARSH. Absolutely. It already has, actually.

I think Ms. Peirce and I have both conducted or are conducting research to try and quantify what the regulatory burden actually costs banks and to see what actually happens as a result. It's very difficult to figure that out, especially since many of the rules are still being created.

But there's all kinds of anecdotal evidence that small banks are merging, and if you listen to the testimony and the public statements of the leaders of some of those banks, they're doing it because, as Mr. Creamer mentioned, a smaller bank simply can't absorb the costs. And they have to bind together to survive collectively.

Mr. DUNCAN. Well, I just think it is very sad that a law that was aimed at a few big giants on Wall Street is ending up hurting the little guys and the medium-sized guys most of all.

Thank you very much, Mr. Chairman.

Mr. DESANTIS. Thank you.

And the chair will now recognize the ranking member of the full committee, Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

And I want to thank all of you for being here.

And to Congressman Miller, it was good to see you back. I always respected your work in so many areas, but particularly in this area.

Many of the provisions under the Dodd-Frank Act are geared towards the larger, too big to fail institutions. However, there are many examples where community banks receive positive treatment under new regulatory requirements implementing the Dodd-Frank Act. For example, the Dodd-Frank Act raised the Federal deposit insurance coverage on consumer bank accounts to $250,000 while shifting the cost to larger institutions to better reflect their industry market share.

Community banks have benefited by a significant drop in Federal deposit insurance premiums paid by the institutions with less than $10 billion. And it was recently announced that there will be

a refund of $5.8 billion in deposit insurance fund prepayments from the last 3 years.

Now, Congressman Miller, by reforming the deposit insurance assessments, do you think that the regulators have it right, have the right balance in terms of assessments charged to large banks versus the small banks?

Mr. MILLER. Mr. Cummings, I think we did that. We don't want to give the regulators credit for that.

Mr. CUMMINGS. Okay. All right. Well, we will take credit.

Mr. MILLER. I know that Mr. Creamer, in his written testimony at least, did speak of the burden of deposit insurance, the assessments, the premiums. But the adjustment of those was something that truly does help. The GAO study pointed it out as something that would truly help community banks.

The fact that community banks were having to compete with nonbank lenders that were not playing by any rules at all was unfair to community banks, took away business. That is something else that helps community banks.

And the GAO study said, as for the rest, it's certainly true that we've passed the most significant financial reform package since the New Deal because we had the most significant financial crisis since the Great Depression. So, of course, there will be some compliance cost.

But until the implementing regulations come down, we can't know what they will be. So all of what we've heard about how crushing they will be is—is speculation because we don't know because most of them have not come down.

The CFPB, at least in their rulemaking to this point, has taken to heart the suggestions of small banks. They have a trade association, an Independent Community Bankers Association, ICBA, that has been very involved in the rulemaking. The reformers like Center for Responsible Lending, CRL, is working closely with ICBA and trying to be reasonable and compromise.

So, as I said in my prepared—as I said both in my oral statement and my written statement, I very much encourage the regulators to look closely at the concerns raised by community bankers to see what is not a necessary cost of compliance, as we did in Congress with having a different examination regime for the CFPB for small banks, and try to make sense of this.

Not needlessly drive up compliance costs, but also recognize where the rules do need to be the same.

Mr. CUMMINGS. Okay. The Dodd-Frank provides the CFPB with supervisory authority over nonbank financial institutions in a capacity new to that industry. Congressman Miller, in your testimony today, you have stated, and I quote, "A GAO study last fall concluded that some provisions will help community banks, such as the supervision by the CFPB of certain nonbank lenders that competed unfairly with responsible community banks in the past."

Would you comment on that, please?

Mr. MILLER. Certainly. There were some—like the New York community bank I spoke about in my testimony, my prepared testimony, there are some bad actors. But generally, the community banks were not—were not guilty of the worst practices.

Some of the worst practices were by mortgage companies that were not depository institutions at all, did not have a charter from anybody. They were almost completely unregulated.

I've heard Ben Bernanke say in sort of defense of the Fed—because they had rulemaking authority they never used under HOEPA, Home Ownership and Equity Protection Act, passed in 1994—that the mortgage market, mortgage practices went to hell in a very short period of time in a pretty dark part of the market, where they did not really see what was going on.

You certainly had lenders like Ameriquest that weren't—weren't depository institutions at all. You also had really a gray line between brokers and an originator that all you really needed to be—needed to do to become a mortgage company was to get a warehouse line of credit and to have a relationship with a Wall Street investment bank that would buy the mortgages as soon as you made them.

And those folks were competing with Mr. Creamer. And when you make them play by the same rules that Mr. Creamer plays by, that his bank plays by, it's going to help him a lot.

Mr. DESANTIS. Thank the gentleman.

And the chair now recognizes the gentleman from Georgia, Mr. Collins.

[Pause.]

Mr. COLLINS. May as well go for it. You made a comment earlier. You made a statement. Micropolitan? What was your ——

Mr. MILLER. Micropolitan. It's a Census Bureau term. It just means small towns.

Mr. COLLINS. Well, I have another term for it. It's called home. And ——

Mr. MILLER. It was called my district, too. Yes.

Mr. COLLINS. Exactly. So we understand that. And I think it sort of sets the stage for my questions and just really where I am at as well because I like your analogy. And by the way, it is a traditional favorite at our house of the Baileys and the Potters, and we understand that.

Mr. MILLER. You're raising your children right.

Mr. COLLINS. Exactly right. But I think there is an issue of the market taking care of the Potters of the world, and there is an issue with the Baileys, and neither one were exactly models of bookkeeping, okay, in that movie.

[Laughter.]

Mr. COLLINS. But what I see here and what I want to talk about, Mr. Creamer, as I see you here today, and I sense as we were talking about this, I just sense a frustration not in necessarily your voice, but in your eyes. That you are just, see, you look a lot like the bankers that I talk to in northeast Georgia.

One of the stories that I have, and it may be similar in your area of north Florida, was we had a community bank, a little three-branch community bank, great little lender. Came in with all the regulations. They came in with—their auditors came in to their home office.

Their home office had 10 employees. They brought in about 14 auditors and got mad because they didn't have a place to work out

of. This is the kind of things that I think folks just don't understand.

Mr. Creamer, are you seeing this sort of thing as you talk to other bankers? I would like just to hear. I have read your statement, and I am sensing that. But I also want to hear from you again.

Mr. CREAMER. Well, I'd like to apologize first for speaking with my eyes and not my voice because ——

Mr. COLLINS. But I think this happens.

Mr. CREAMER. There is a large level of frustration. And I had breakfast with my vice chairman last week, and he told me I was becoming cynical and I needed to guard against that. So I am guarding against that.

Mr. COLLINS. Well, you came to the wrong city for that.

[Laughter.]

Mr. CREAMER. Yes. Well, you know, I would first like to say I was remiss in not thanking the Members for speaking very complimentary about community banks and even the testimony here and saying a number of times that we did not cause the financial crisis. Because, frankly, if you've been on the business end of 8 safety and soundness exams over the last 6 years like I have, you would believe that you were the sole cause of the crisis.

It is comforting that the FDIC is going to give back some of the premiums. However, in the State of Florida, there is about 200 community banks, plus or minus. Seventy-five of those were put under consent or cease and desist orders over the past 4 years.

Of those 75 cease and desist orders, 63 read exactly the same, and they all impose 8 percent and 12 percent capital ratios, which are above the regulatory standards. If you have one of those consent orders, you do not get a refund of that premium. So it is not very helpful in that.

From the examination story, in our bank, it's more like 30 to 35 examiners. It is a 6- to 8-week process. That is new in the last 4 years, and it's—I mean, it's something we have to do because we're an insured institution. But it is difficult at best.

Mr. COLLINS. And one other thing that I want to emphasize in the little bit of time I have left here is Georgia has had a large issue with that problem as well, failed banks and failed specifically community banks, for a number of reasons, some good and some bad. But one of the issues that I am having trouble as we get around just some issues that my banks are bringing to me was not being able to get into the markets that are de novo standard, that coming out in 2008 were well capitalized or limited.

If they were established after 2008, that standard coming in where they can't reach out in the markets in a different way. Can you explain to me, and Mr. Creamer or others want to jump in, explain the change in the de novo status that is meant for newer community banks trying to come in and fill the gap where some have been mentioned?

And also has there been an effect of this standard maybe cutting back the access to residential mortgage markets in areas that preventing healthy community banks from entering into those markets? Is that something that would you speak to or someone else would speak to?

Mr. CREAMER. I'm not sure I can speak to the de novo situation because we're not a de novo.

Mr. COLLINS. Not de novo, yes.

Mr. CREAMER. And I can't imagine anybody would want to start a bank today anyway.

Mr. COLLINS. Well, we have had a couple, and I have one bank in particular that was starting to get into a new market, had hired consultants, went through the paperwork, and went through everything else. The consultants then went to another job because of the length of time it was taking to get this up. So they finally just put it on hold, and it stopped the market.

And it was just, again, we are in an area which is a little bit different. So anybody else want to take a stab it, Congressman and others? I mean, because it seems like we are limiting our environment here, and that is the one thing we really don't want to do, as long as the standards are properly and appropriately applied.

Mr. MILLER. I'm not familiar with any—like Mr. Creamer, I'm really hearing for the first time about a discussion about newly chartered banks. I think there's probably true there are not a whole lot.

Now there has been a study of the 200 or 300 community banks that failed during the financial crisis. I think it was the GAO. It may have been the FDIC. But in fact, most of those were fairly newly chartered banks, and they were fairly newly chartered banks that were chartered specifically to get involved in what they called at the time the real estate boom, now we call the real estate bubble.

And that doesn't even take into account—it's like 70 or 80 percent of the failed banks were newly chartered banks that their business model was largely dirt lending, either acquisition development in construction loans, a form of commercial lending, or mortgages. And those were the ones that they got into trouble.

And then, in addition to that, there were a fair number of investors who bought community banks specifically to get in on the real estate boom, now we call the bubble, and a lot of those got into trouble as well.

But it's probably pretty hard to raise capital right now in part because the economy is still kind of bad.

Mr. COLLINS. And especially in those that exist. And Mr. Chair, I know my time is out.

But I think one of this is the thing that they are actors. And as you—and I do like the analogy to a point of the Bailey and Potter issue. But we can't continue to regulate the Potters of the world at the expense of the Baileys of the world, and I think that is the problem that I am seeing right now, and it is the concern that I have.

Mr. Chairman, I yield back.

Mr. DESANTIS. Thank the gentleman from Georgia.

Now we don't have anyone from the other side. Obviously, if they come, they will be recognized. But seeing the lack of Members on that side, the chair will now recognize the gentlelady from Wyoming.

Ms. LUMMIS. Thank you, Mr. Chairman.

Kind of following in on this theme, I, too—I'm from Wyoming, the smallest population in the Nation. There really are no big banks in Wyoming, none. We are completely reliant on community banks, and so the thought that we would all have to drive to Denver or Salt Lake to bank for an entire State is absurd.

Professor Marsh, I want to ask you, does too big to fail give systemically important institutions an advantage that community banks can't get?

Ms. MARSH. Well, to clarify, what do you mean by "too big to fail?" So, do you mean systemically ——

Ms. LUMMIS. Systemically ——

Ms. MARSH.—significant designation?

Ms. LUMMIS. Yes.

Ms. MARSH. That hasn't really been my focus of my research, but there are a number of people who would argue that that's true.

I think it is true that that designation means that many people in the marketplace consider that the Government, even though Dodd-Frank repeatedly says we're not bailing anyone out, the marketplace doesn't believe it. And the marketplace is giving a premium to the larger banks at the expense of the smaller banks.

So ——

Ms. LUMMIS. Why doesn't the marketplace believe it?

Ms. MARSH. I think because if you allow an institution to remain that large, if we found it difficult to imagine a world where they all cascaded in failure 5 years ago, and they've only gotten bigger since then, how can we imagine a world where the Government would allow them to all cascade in failure this time?

Ms. LUMMIS. Mr. Creamer, why didn't your bank—why doesn't your bank believe it?

Mr. CREAMER. Because it's been the practice that too big to fail, whether you are a financial institution or an automobile manufacturer, it has just been a practice that you've been bailed out. The moral hazard has been created. And as a financial person, we fully understand that a $2.3 trillion financial institution that can manipulate the electricity market cannot be allowed to fail.

Ms. LUMMIS. So how is this going to affect the needs of customers in States like mine and communities like Mr. Collins' in northern Georgia, very rural areas? What are we going to do?

Mr. CREAMER. Well, as Mr. Miller said earlier, and he's accurate on residential loans that all the forms are basically the same, not so on small business loans where the forms can be different. But the difference then is the customers are not all the same. And in a community bank, it's about the story of the customer.

It's about the need of the customer, what the customer is trying to accomplish, and how can the community bank help that customer accomplish what they're trying to accomplish. Because if we're successful in helping a small business owner accomplish what they want to accomplish, then they hire more people.

More people potentially bank with us. More people then potentially borrow for their homes and their cars, which makes our community stronger, and it makes our bank stronger, and it's just a good thing.

Ms. LUMMIS. So how many Fortune 500 companies do you think are incorporated in Wyoming, have their home offices in Wyoming? What would you guess? Anybody?

Mr. CREAMER. None?

Ms. LUMMIS. You got it. So with places like Wyoming or any of these districts that are really comprised of small towns, what is the future for the borrower, for the small business person, the small business person?

Mr. CREAMER. The future should be a strong, viable community banking system.

Ms. LUMMIS. How do we get it back?

Mr. CREAMER. We have to relieve the overwhelming regulatory burden off of the community banks, and we have to allow community banks to be able to effectively compete in the niches they compete in.

Ms. LUMMIS. Professor Marsh, and you can answer that as well, but in addition, would you answer this question? Will the regulations coming out of Dodd-Frank make smaller banks more or less able to compete with larger banking institutions?

Ms. MARSH. Well, I'll answer both questions at once, if I may?

Ms. LUMMIS. That would be great.

Ms. MARSH. Because I think that, as I've said before and others have said, the issue is not to look at Dodd-Frank in a vacuum because no bank can look at Dodd-Frank in a vacuum. It's regulation by accretion. So it's on top of decades and decades and decades of regulations that the banks have to deal with.

And so, that's our problem, right? 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.

Ms. LUMMIS. And the community banks, did they create this crisis that Dodd-Frank was built to address?

Ms. MARSH. I do not think so.

Ms. LUMMIS. I yield back, Mr. Chairman.

Mr. DESANTIS. Thank you for that.

I am going to go ahead and do a second round. We may have—I know there are some Democratic Members coming. I did see, just on kind of some of the news that I know Mr. Cartwright is down there for an IRS hearing. So it should give him a chance to come back up here.

In terms of just the cause of the financial crisis, and I know you got to it a little bit in your report, but there was a narrative developed that it was Wall Street decided, you know, they got greedy and they tanked the whole economy.

And I have no problem with criticism directed at Wall Street, but it seems to me that really overlooks the extent to which Government policy created incentives that created the environment to where you would have that. So is that something that you would agree with just in your research?

Ms. MARSH. I very deliberately stayed away from researching that.

[Laughter.]

Ms. MARSH. Well, I mean, I am much more interested in what the impact is because from the perspective of what I was trying to write about, I don't care what caused the financial crisis. I care what's going to cause the next financial crisis and what's going to cause problems for small businesses and farmers and rural communities.

Rural communities, I think, are the most vulnerable to this increased pressure on the small banks. And you didn't hear about a lot of problems in rural communities in the lead-up to the financial crisis.

Mr. DESANTIS. Sure. Ms. Peirce, do you have anything on that? Because it just seems to me that—and I wasn't in Congress during this. This is my first term. But it seems to me that people here are quick to try to say, oh, it was this, but not very quick to do a little self-examination in terms of bad policies that have created—that have helped create some of these problems.

Ms. PEIRCE. Yes, I mean, I think that institutions will take advantage of bad policies to work for their own advantage. And unfortunately, the Government has set up a regulatory regime that really takes away consequences for poor decisions made by people in the private sector.

And so, what we need to do and what we should have done instead of doing what Dodd-Frank did, we should have put more responsibility on the people who actually make bad decisions to pay for them. And I think community bankers will pay for their bad decisions because they're going to go out of business if they make a lot of bad lending decisions.

But these bigger banks, we let them stay in business even though they continue to make very bad decisions. So, yes, there's definitely a role of Government policy.

Mr. DESANTIS. So shifting the risk from taxpayers to shareholders, basically, do you think that would be good policy?

Ms. PEIRCE. It would be good policy. And making creditors responsible, too, because they should be monitoring the institutions to which they lend.

Mr. DESANTIS. When I walk around here, I will get people bringing me these leaflets or whatever, and every week for sure, but sometimes even every day, someone will come up and Glass-Steagall, Glass-Steagall. Do you, Mr. Miller or Ms. Peirce, anyone, that repeal of Glass-Steagall, it is kind of a simplistic narrative that Glass-Steagall is repealed and then, lo and behold, the economy cratered.

What role do you think that that had in the financial crisis?

Mr. MILLER. I think the deregulation generally in the '80s and '90s played a very large role. The separation of commercial investment banking or the ending of that separation at least had the role of making the institutions very large and very complex and, therefore, too big to fail.

The problem with too big to fail, the reason that it's a problem for community banks is that there is an assumption in the market, which I think Ms Peirce talked about generally, or someone talked about the assumption. The assumption is that they will not be allowed to fail. So if you lend them money, you're going to get paid back one way or the other.

If they can't pay you back, then the taxpayers will, one way or the other, pay you back. So you're going to get paid back. And that's worth something.

There have been various estimates. Bloomberg, I think, estimated that it's a quarter to a half a percent advantage. The rating agencies point to that to give better credit rating—credit ratings to big banks, the assumption that they would not be allowed to fail.

They're almost impossible to underwrite. They're too big to fail, too big to manage, too big for the market to discipline, too bit to underwrite. And so, they're getting at least a half a point less when they borrow money than Mr. Creamer's bank does.

ICBA is now very much on the issue of too big to fail, and their issue is that they get money more cheaply. There is a GAO study coming on it, I think, shortly, if it hasn't already come out, but on too big to fail. And that is an unfair competitive advantage for Mr. Creamer and every other community bank.

Mr. DESANTIS. Do you want to weigh in, Ms. Peirce?

Ms. PEIRCE. Yes, with respect to Glass-Steagall, I don't think that—I mean, I think it's a nice rallying cry. But I don't think that that's going to solve the problem to put Glass-Steagall back ——

Mr. DESANTIS. Because Lehman Brothers was pretty much a pure investment bank. Correct?

Ms. PEIRCE. Right.

Mr. DESANTIS. Now in terms of ending too big to fail, some have said, hey, let us just set kind of some arbitrary caps on capital requirements or size. I have concerns about whether Members of Congress have the competence to decide those things. So in terms of ending too big to fail, what would be your policy prescriptions in that respect?

Ms. PEIRCE. Well, if we could trade capital requirements for all the other regulations, then we could pare back a lot of the other regulations that, as Professor Marsh said, have accreted over time. Unfortunately, I think if we do increase capital requirements, it's not going to be at the expense of other requirements.

And also we put in risk-based capital requirements, which don't work as well as a simple leverage ratio. I mean, community banks tend to be more heavily capitalized than the larger banks. And so, I think we need to think creatively about perhaps even increasing the liability for shareholders so that if your bank fails, you end up having to kick in some more money. That will make you pay a little more attention.

Mr. DESANTIS. Ms. Marsh?

Ms. MARSH. I don't know that it's going to be a magic bullet for anything, but if we're trying to limit the size of these institutions, I think it makes more sense to separate depository institutions from investment banks than it does to put a cap on, an artificial cap that you said. I mean, none of us are really in a position to determine what is too big to fail.

It makes more sense to split them up functionally as Glass-Steagall did than to set an arbitrary cap.

Mr. DESANTIS. Yes, I mean, I think some of us—look, I mean, if you are a big bank, and you are not getting special policies that give you competitive advantage, and if you are bearing the risk, I

think a lot of us are concerned when you have a system of privatized gains and socialized losses.

Obviously, there is a moral hazard issue, and there is just an unfairness issue because no one is going to care outside of our community if your bank fails. You are not going to get bailed out, obviously. But when one of the big banks, then they would get a disparate treatment. So that is just a problem with our policy.

The gentlewoman from Wyoming, do you have any other questions? Because if you do, I can recognize you to give maybe Mr. Cartwright some time. And then, otherwise, I will just probably the gavel the hearing to a close.

Ms. LUMMIS. I do have additional questions, Mr. Chairman.

Mr. DESANTIS. Okay. The chair recognizes the gentlewoman from Wyoming for 5 minutes.

Ms. LUMMIS. Thank you very much.

Could I ask any of you to comment on the proposed Basel III regulations?

Ms. PEIRCE. Well, I mean, I would just say that, first of all, having our regulations decided by central bankers across the world and imposing one uniform standard doesn't seem like the wisest approach to me.

But second of all, the focus on risk-based capital, which Basel III embodies, is I think a very dangerous approach because it homogenizes the banking sector further, and it forces people to try to gain—I mean, it's an invitation to arbitrage, and that's what happened ——

Ms. LUMMIS. Isn't it true that banking is more concentrated in Europe than it is in the United States?

Ms. PEIRCE. It is. We have a more—we have a much more competitive landscape than Europe does.

Ms. LUMMIS. So, Basel III, Mr. Creamer, would do what to American banking?

Mr. CREAMER. Well, to go back very briefly to what Mr. DeSantis had said about regulation incenting some things, first of all, risk-based capital regulation incented residential mortgage loans because they were risk-weighted lower, and it required lower capital requirements. In many cases, there's more inherent risk in a residential mortgage loan than there is in an owner-occupied commercial real estate loan to an operating business.

In addition to that, Fannie Mae and Freddie Mac put explicit Government guarantees. Now they were implicit at the time, but we all know they're explicit. So when you have an incentive to capital and you have explicit guarantees by the Government in a product, you'll probably create a price bubble.

Basel III doesn't really address that. Basel III still risk-weights residential mortgage loans at 50 percent. So there's still an encouragement to make residential mortgage loans. It still risk-weights small business loans at 100 percent.

Right now, each quarter my bank files a call report. That call report is about 78 pages. All call reports—all banks file call reports. The call report instructions are 626 pages for that 78 pages.

This is a mailer we received last week from a very reputable brokerage firm with a breakdown of Basel III as it relates to community banks. Basel III doesn't simplify that. It makes it more com-

plicated for our staff to calculate. And while they say they have simplified the definition of leverage capital, I'd simply refer to one section of this, which is about 16 lines of the deductions from what is qualified as regulatory capital.

And I am a banker and an accountant by trade, and I don't recognize the acronyms that are in here, and these are the ones that supposedly apply to me.

Ms. LUMMIS. I hear a lot about Basel III from the banks in my communities, and they are expressing true alarm over them.

Another question for anyone on the panel who wishes to address it. The Consumer Protection Financial Bureau has only completed about a third, a little more than a third of its regulations thus far, and they were supposed to have them all completed at this time. So given that, and the fact that the interpretations of those regulations was really given to the regulators, so how is a bank supposed to determine what services you can provide based on rules that haven't been written or rules that haven't been interpreted?

Mr. CREAMER. Well, I think Ms. Marsh said it—Professor Marsh said it very well a while ago. It is an accretion of regulation. We already have consumer protection regulations. We have the Federal Reserve alphabet regulations, Regulation A through YY.

Equal Credit Opportunity, Home Mortgage Disclosure, Electronic Funds Transfer, Privacy of Consumer Information, Fair Credit Reporting, Truth in Lending, Unfair Deceptive Acts or Practices, Community Reinvestment, on and on and on. These laws are very effective. And yes, as Mr. Miller said, there are bad actors.

As a community banker who has been doing this for 31 years, I expect bad actors to be dealt with. But it's difficult to deal with the entire industry because of one or two bad actors, and that makes this more difficult.

I have heard that the Consumer Financial Protection Bureau is going to make it easier for consumers. Well, these regulations are Government-promulgated as well, and I'll simply point out to you that under Fair Lending, in Regulation Z, this is a residential mortgage application that a consumer that comes into any bank has to fill out and understand.

Now the easiest way to take care—to take advantage of a consumer is something like this. Now I shudder to think what the unwritten regulations that are coming down the pike will do to this and what that will do to my customer, who is normally a plumber or electrician or a carpenter who is buying their first home, who has no chance of understanding what this is.

Ms. LUMMIS. Mr. Chairman, would you indulge one other of the respondents to weigh in on that?

Mr. DESANTIS. Sure.

Ms. LUMMIS. Anyone wish to?

Mr. MILLER. Ms. Lummis, I have heard differently. I've heard that CFPB is doing a better job of hitting their deadlines than any of the other agencies, which may be a low standard, but I think

---

Ms. LUMMIS. That is a low standard, I would suggest.

Mr. MILLER.—they are actually getting their regs in on time. And they've also shown a willingness that Congress rarely shows of adjusting their regulations after they've adopted them.

Just within the last—either last week or even earlier this week, they just issued a lot of little changes to the QM rules, the qualified mortgage rules, based upon concerns that were raised. Congress tends to enact some big act and then not touch it for a generation.

And when the inevitable little things that aren't working exactly the way Congress thought they would work come forward, instead of just fixing that, usually the people who've been opposed to the bill now point to that as evidence that it should never have been passed, and the people who supported the bill are unwilling to admit any error.

So CFPB is actually showing some reasonableness and flexibility and a willingness to listen. And some of what they're doing is designed to make forms more readable, more understandable. The Truth in Lending Act and RESPA, TILA and RESPA, the Real Estate Settlement Practices Act, required really almost identical disclosures, but not quite identical.

And one thing I've heard from—when I was in Congress, one of the things I heard from my community bankers and my credit unions was that their lawyers told them that they were afraid to try to take statutory language, which was legalese, and turn it into plain English for fear they might get it wrong. And so, with TILA and RESPA, what they would do is set out in the statutory language, which no one could read.

And with TILA and RESPA, they set out all of TILA and then all of RESPA. So CFPB has issued a form that is both disclosures, TILA and RESPA, on one form that is plain English. That is clearly better for consumers. I assume that Mr. Creamer prefers it as well.

And so, I think there is some hope with CFPB, if part of their mission is to make finance understandable, that they will actually turn unreadable forms into something that can be understood by a normal human being.

Ms. LUMMIS. I hope so, too, Mr. Miller. Everything I hear so far from my community banks and their borrowers, their customers, is to the contrary.

Mr. MILLER. The baseline against which we're working was complete inability to understand anything.

Ms. LUMMIS. Thank you.

I yield back. Thank you, Mr. Chairman, for your indulgence.

Mr. DESANTIS. Thank you.

Well, we really appreciate the witnesses here. I think you all did a great job. I think what we were trying to establish here is when Government takes on, Congress implements, passes these big bills designed to deal with certain issues, that oftentimes we can create new problems and disadvantage smaller institutions vis-a-vis competing with larger institutions or even just make life more difficult for smaller institutions.

So I think we were able to demonstrate that. I think that from what I heard from the comments on the other side, I don't think that many of these folks, who probably supported Dodd-Frank, want to see community banks harmed. And so, there may be some opportunity to get some bipartisan relief from some of the onerous regulations.

We talked a little bit towards the end about CFPB, and I think that may be something for another day. But I think that that is going to be something that is very concerning to me because if you look at the way CFPB is structured, it is essentially immune from any type of congressional oversight. We don't have any way to affect their budget or conduct meaningful oversight.

And really, the President is limited in removing the head of that agency or the head of the board, and the courts are limited in their review of that. So, to me, that is problematic.

Madison in Federalist 51 said, "If men were angels, no government would be necessary. If angels were to govern men, neither internal nor external constraints would be necessary." The way the CFPB is structured we better hope that he was wrong about that and that these folks are angels because, otherwise, I fear that there will be some unintended consequences, or maybe even intended down the—but that is something for another day.

At this time, I want to thank again the witnesses for their time, and this hearing is adjourned.

[Whereupon, at 4:08 p.m., the subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

CUNA
Credit Union National Association
cuna.org

BILL CHENEY
President & CEO

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-508-6745 | FAX: 202-638-3389

July 18, 2013

The Honorable Jim Jordan
Chairman, Oversight Subcommittee on Economic Growth,
Job Creation and Regulatory Affairs
Committee on Government Reform and Oversight
2157 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Jordan:

Thank you very much for the opportunity to submit comments on today's hearing, "Regulatory Burdens: The Impact of Dodd-Frank on Community Banking," with respect to the Dodd-Frank Act's impact on credit unions. The Credit Union National Association (CUNA) is the largest credit union advocacy organization in the United States, representing America's state and federally chartered credit unions and their 96 million members.

The Wall Street Reform and Consumer Protection Act (P.L. 111–203, H.R. 4173), also known as the Dodd-Frank Act ("the Act"), was signed into law by President Barack Obama on July 21, 2010. The size and scope of this law affects nearly every sector of the financial services marketplace. Hundreds of rulemakings were required by the law and many have still to be finalized or implemented. The Act's effect on credit unions, specifically, has been immense. As rulemaking continues, we do not know the full effect of the Act on credit unions. Nevertheless, the Act has added significant burdens to all financial institutions, including credit unions. This is not meant to imply that some of the law's reforms were necessary and beneficial. However, this multitude of new regulations has created a "crisis of creeping complexity," where credit unions must hire additional specialized employees just to ensure compliance with the law's many new requirements and reporting burdens. This is especially detrimental to the thousands of small credit unions that often have only one branch office and five or fewer employees. In this statement, I will detail some of the burdens that the Act has created for credit unions.

As member-owned financial cooperatives, credit unions have been praised by Administration, Congressional, and media figures as being prudently managed and not having caused nor contributed the housing collapse in 2007 and the subsequent Wall Street crash of 2008. Despite enduring collateral damage from unscrupulous financiers and mortgage brokers, credit unions continued to lend and assist their memberships and communities, and continue to do so, during this economic upheaval. In fact, millions of Americans have dumped their banks and joined credit unions since 2008.

AMERICA'S CREDIT UNIONS
PO Box 431 | Madison, WI 53701-0431 | 5710 Mineral Point Road | Madison, WI 53705-4454 | PHONE: 608-231-4990

Credit unions greatly appreciate the attention that this subcommittee is giving to the ever-increasing, never-decreasing regulatory burden that they face. This "crisis of creeping complexity" is not just one new law or revised regulation that challenges credit unions but the cumulative effect of regulatory changes. This is not a new phenomenon. It has been building for over a decade. It certainly was not simply caused by the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act; however, as the CFPB continues to promulgate and review the regulations under its jurisdiction as required by the Dodd-Frank Act and other statutes now subject to its jurisdiction, there will likely be hundreds of additional changes credit unions will be required to make, notwithstanding the fact that everyone agrees that credit unions did not cause or contribute to the financial crisis.

The costly and pervasive impact of these new rules on credit union operations, a number of which are detailed and complex, covering hundreds of pages, simply cannot be overstated. Because credit unions are financial cooperatives, owned by their members, costs a credit union bears to meet the multitude of wide-ranging regulatory training and compliance responsibilities are ultimately paid by their members. The diversion of funds to pay for compliance may mean members see lower rates on savings, higher rates on loans, and foregone or reduced services. For some credit unions, it may also result in pressure on earnings.

The burden of complying with ever-changing regulatory requirements is particularly onerous for smaller credit unions because most of the costs of compliance do not vary by size, and therefore proportionately are a much greater burden for smaller as opposed to larger institutions. If a smaller credit union offers a service, it has to be concerned about complying with most of the same rules as a larger institution, but can only 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. Problems fulfilling regulatory requirements are frequently cited when smaller credit unions seek to be merged.

Every time a new rule is implemented, a credit union must evaluate the rule and determine how to comply with it; the regulations themselves are not always clear about how to comply. Once the credit union management believes they understand what is necessary to achieve and remain in compliance, the credit union has to write new policies and develop appropriate procedures. They have to train their staff and often print new forms. In most cases, these rules are not changing how they offer services to their members but they do affect how much they are able to do for their members. There is no question about it: when a regulation is changed because some bad actor found a new way to take advantage of its customer or because some bureaucrat decided it was time for things to be done differently, it means that credit unions have to divert credit union member resources away from programs and services designed to help members.

One example of an area of continuing concern for many credit unions is the CFPB's remittances regulation. To its credit, the CFPB has taken a number of steps to listen to stakeholders during and after its rulemaking process. Despite some improvements, credit unions continue to have very significant concerns with the CFPB's remittance proposal. The final rule includes an

exemption level that is far too low to be effective. The agency's rule exempts transfer providers with 100 or fewer transfers a year under its authority in the Dodd Frank Act to determine "normal course of business" regarding international remittance transfers. However, 100 transfers per year is equal to approximately 8 transfers per month, or about two a week. We do not think that meets any reasonable notion of what constitutes "normal course of business," particularly since a number of credit unions have as many as 1,000 or more transfers per year, still only four per day. A number of these credit unions do not charge explicit fees to send remittances and some actually lose money in providing these services. There have been absolutely no examples of abuses we have been able to unearth regarding remittance services that credit unions provide. Nevertheless, a number of credit unions are considering exiting the service as a result of the requirements for new disclosures regarding exchange rates, fees, taxes, and the date money will be received (all of which may be difficult to determine), the required thirty minute waiting periods before a transaction can be sent, investigation and error resolution requirements and additional liability. We urge the Committee to work with the CFPB to revisit the exemption level and allow more credit unions and small banks to qualify for an exemption.

In another area earlier this year, the Consumer Financial Protection Bureau (the Bureau) issued a final "Ability to Repay" rule to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding the borrower's ability to repay a residential mortgage loan and establishing requirements for a qualified mortgage (QM) under the Truth in Lending Act, which is implemented by Regulation Z. On May 29, 2013, the Bureau finalized additional amendments to the rule.

These amendments made needed changes to the QM rule and were well received by credit unions. America's credit unions want to commend the Bureau for listening to the concerns of credit unions, and for incorporating many of our concerns into the new rule. Nevertheless, credit unions continue to have serious apprehensions about how the QM rule will be implemented and believe that it could have the unintended effect of reducing credit union members' access to credit.

Credit unions have every incentive to evaluate a member's ability to repay because their members are also the owners. It is not in the interests of a credit union or its other members to lend money to a member likely to default. As a result, credit unions employ strong underwriting standards, consistent with the spirit of the QM rule. Credit unions also have a history of tailoring lending products to meet the needs and demands of their members. Credit unions have proven they can provide credit on fair terms to borrowers who cannot meet QM standards, but are good credit risks nevertheless. Congress and the regulators should encourage financial institutions to offer loan products focused more on the individual. Unfortunately, depending upon how the QM rule is interpreted by the prudential regulators and how it is utilized within the marketplace, the QM rule may stop this from happening. The unfortunate result will be that some members who would otherwise have qualified for a mortgage from their credit union may not receive loans.

Credit unions worry that the QM rule will make it all but impossible for credit unions to write non-QM loans because the standard, designed to be an instrument of consumer protection, may serve as an instrument of prudential regulation, effectively setting a bureaucratic standard for loan quality. Further, we have concerns that there may not be a viable secondary market into which credit unions can sell non-QM loans. If the prudential regulator will not permit credit unions to hold non-QM loans and the secondary market will not accept them, credit unions will not be able to write them. To the extent that happens, credit unions will not be able to meet the mortgage lending needs of a sizeable segment of their membership. In addition to these concerns, we also have specific views and concerns regarding the 43% debt-to-income ratio requirement, the 3% limitation on points and fees, the definition of rural and underserved area, and the bifurcated approach to the QM rule.

We encourage the Subcommittee to continue to exercise its critical oversight function. Closely scrutinize the proposals coming from the CFPB, NCUA and other agencies to ensure that these changes are not only within the intent of Congress but also have minimal adverse impact on the institutions serving Main Street. Ask the regulators how their proposals will impact the delivery of financial services to those they serve. Encourage the CFPB to use its exemption authority to exempt credit unions and other community based financial institutions from regulations designed to reign in the abusive activity of unregulated entities. In many respects, Main Street financial services providers, like credit unions, are consumers' and small businesses' last hope for receiving affordable and fair financial services. This is certainly the case with respect to credit unions because their users are also their owners. When Congress exercises its oversight function, it has been our observation that the rules tend to improve for financial services as well as consumers. Finally, we urge Congress to consider comprehensive regulatory relief for all financial institutions.

Best regards,

Bill Cheney
President & CEO

○