



Testimony of

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On behalf of the

Independent Community Bankers of America

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Hearing on

"The State of Community Banking: Challenges and Opportunities"

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Opening

Chairman Brown, Ranking Member Corker, and members of the subcommittee, my name is William A. Loving, Jr., and I am President and CEO of Pendleton Community Bank, a \$250 million asset bank in Franklin, West Virginia. I am pleased to be here today to represent the nearly 5,000 members of the Independent Community Bankers of America. Thank you for convening this hearing on “The State of Community Banking: Challenges and Opportunities.”

We appreciate your interest in the community banks of this country, which will undoubtedly play a significant role in any broad based economic recovery because we serve rural, small town, and suburban customers and markets, that are not comprehensively served by large banks. Our business is based on longstanding relationships in the communities in which we live. We make loans often passed over by the large banks because a community banker’s personal knowledge of the community and the borrower gives him firsthand insight into the true credit quality of a loan, in stark contrast to the statistical model used by a large bank in another state or region of the country. These localized credit decisions, made one-by-one by thousands of community bankers, will restore our economic strength.

Community banks are prodigious small business lenders. We provide small business credit in good times as well as challenging times – supporting a sector responsible for more job creation than any other. In his recent speech before the ICBA annual convention, Federal Reserve Chairman Ben Bernanke shared new Federal Reserve Bank research that shows that while overall small business lending contracted during the recent recession, lending by a majority of small community banks (those of less than \$250 million in assets) actually increased, and small business lending by banks with asset sizes between \$250 million and \$1 billion declined only slightly. By contrast, small business lending by the largest banks dropped off sharply. The viability of community banks is linked to our small business customers in the communities we serve, and we don’t walk away from them when the economy tightens.

When community banks thrive they create a diverse, competitive financial services sector offering real choice, including customized products, to consumers and small businesses alike. An economy dominated by a small number of large banks wielding undue market power and offering commodity products would not provide the same level of competitive pricing and choice. Promoting a vibrant community banking sector is an important public policy goal.

Community Banks Remain Strong

The past few years have been tumultuous for community banks, but the vast majority of them are well capitalized and are helping to lead the economic recovery. Still, community banks were not unaffected by the financial collapse. The weakened economy has caused many consumers to tighten their belts and reduced the demand for credit. Despite the wave of failures and consolidations since the financial crisis, I fully expect the community bank business model will thrive in the future, to the benefit of consumers, small business, and the economy. Many ICBA members have been in business for more than 100 years and have survived the Great Depression and numerous other recessions. The community banking sector will remain vibrant, but policymakers must help by providing relief from overly-burdensome regulations.

Oppressive Examination Environment

In addition to contracting demand for credit and impairing asset quality, the financial crisis harmed community banks by provoking an overreaction among bank examiners. The most frustrating aspect of this exam environment is the disconnect between the examiners in the field and the directives from Washington.

A November 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers in order to help initiate and sustain an economic recovery. It stated, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Unfortunately, this policy is often neglected by examiners in the field, especially in the regions most severely affected by the recession. Field examiners are second guessing bankers and independent professional appraisers and demanding unreasonably aggressive write-downs and reclassifications of viable commercial real estate loans and other assets. The misplaced zeal of these examiners is having a chilling effect on lending. Good loan opportunities are passed over for fear of examiner write down and the resulting loss of income and capital. The contraction in credit is having a direct, adverse impact on the recovery.

Community Banks are Disproportionately Impacted by Regulation

Community banks have little in common with Wall Street firms, mega-banks, or shadow banks and did not cause the financial crisis or engage in abusive consumer practices. Community banks have a much different risk profile because their business model is built on long-term customer relationships, and they cannot succeed without a reputation for fair treatment. For these reasons, ICBA believes it is appropriate to tier regulation of the financial services industry. Overly prescriptive regulation would only reduce community banks' flexibility in serving the unique needs of their customers. Moreover, regulation has a disproportionate impact on community banks because they have fewer resources to dedicate to compliance.

We are pleased the Dodd-Frank Act exhibits a clear preference for tiered regulation of the financial sector -- one of the most important precedents of that legislation. We believe Congress should further advance this trend by enacting legislation to provide much needed regulatory relief for community banks, their customers, and their communities. Such legislation should also reduce the tax burden on community banks and narrow the competitive gap between tax-paying community banks and tax-exempt credit unions.

Areas in which ICBA seeks relief include:

- Requiring FASB to conduct a cost/benefit analysis for any proposed accounting change;
- Lowering Small Business Administration origination and program fees for rural and small business borrowers;
- Restoring dividend payments on GSE preferred stock;
- Increasing the SEC shareholder registration threshold;

- Amending the Dodd Frank Act to restore bank reliance upon external credit ratings; and
- Extending the 5-year net operating loss (NOL) carry back provision.

The Communities First Act (CFA), a bill meeting the broad objectives outlined above, was introduced and advanced during the 109th and 110th Congresses with bi-partisan support. In the 110th Congress, CFA was introduced in the House by then-Small Business Committee Chairwoman Nydia Velazquez (D-NY). The Senate version was introduced by then-Senator Sam Brownback (R-KS).

The 2006 Financial Services Regulatory Relief Act (FSRRA) and other laws were welcome down payments on needed regulatory and tax relief for community banks. These laws have included provisions taken from prior versions of CFA, notably doubling to \$500 million the asset size of banks eligible for the extended 18-month exam cycle. Our communities would benefit from the further relief provided by similar legislation in 2011.

The Dodd-Frank Act

The Dodd-Frank Act was generational legislation and will permanently alter the landscape for financial services. Every provider of financial services – including every single community bank – will feel the effects of this new law to some extent. Undeniably, it will result in additional compliance burden for community banks and will be challenging for them. The full and ultimate impact won't be known for years, depending on how the law is implemented and how the market adjusts to it. There's still an opportunity to improve some negative provisions in the law – with the help of this committee and Congress – and provisions that could be helpful to community banks are still at risk of being weakened in the implementation.

Debit Interchange

By a wide margin, the most troubling aspect of the Dodd-Frank Act is the debit interchange, or “Durbin,” amendment. Despite the statutory exemption for institutions with less than \$10 billion in assets, which many Senators thought would help community banks; we believe small financial institutions cannot be effectively carved out. Chairman Bernanke, the regulator charged with implementing the new law, conceded this point in a recent hearing before the Senate Banking Committee. Visa's announced two-tiered pricing system, however well-intentioned, also will not work. Small issuers will feel the full impact of the Durbin amendment over time. It's too easy to focus on the large issuers and lose sight of the thousands of community bank issuers who will be harmed if the Federal Reserve proposal is implemented. Not only are small issuers not carved out in practice, they would be disadvantaged relative to large issuers, and a likely consequence of the Federal Reserve's proposed rule, if implemented, is further industry consolidation, higher fees and fewer choices for consumers.

Why won't the carve-out work? The reasons are twofold. First, in addition to the interchange price-fixing provisions of the law and the Federal Reserve proposal, other less-discussed provisions shift control of transaction routing from the card issuer to the merchant. These provisions apply to all financial institutions, regardless of size, and negate the benefit, if any; small financial institutions would gain from the interchange price-fixing exemption. Granting retailers the ability to route debit card

transactions over the network of their choice – the card issuer currently designates the network on which its card is routed – will allow retailers to bypass the two-tier system. Further, large retailers will be able to incentivize customers to use the rate-controlled cards issued by the largest financial institutions, discriminating against community banks and their customers. Community bank cards will either be subject to the lower rate or their cards will be neglected by retailers.

There's a second way in which the carve-out fails to shield small issuers. In any two-tier system, the small issuer interchange rate, to the extent that small issuers actually receive it, will surely be lower than the current interchange rate. The payment card networks will be under considerable pressure from their clients with more than \$10 billion in assets to narrow the gap between the two tiers.

For these reasons, a tiered system will not protect community banks. Over time, community bank interchange revenue will drop sharply with a direct impact on community bank customers.

What would happen if the current Federal Reserve proposal were implemented? ICBA recently completed a survey of its members, and the results demonstrate that the Federal Reserve proposal would alter the economics of community banking and fundamentally and adversely change the nature of the relationship between a community bank and its customers. Among the survey results: Community banks would be forced to charge their customers for services currently offered for free and that customers have come to expect and value – debit cards, checking accounts, online or mobile banking. Community banks will have difficulty offering their customers – both consumers and small businesses – competitive rates on deposits and loans. It will be harder to qualify for a debit card. Finally, twenty percent of survey respondents say they will have to eliminate jobs or halt plans to open new bank branches – extending the impact from individual consumers to communities. To use my bank as an example, in 2010 we had about 6,250 debit cards outstanding and our profit for the year was approximately \$132,000 pre-tax. If the Federal Reserve proposal goes into effect, I estimate that we could lose, based upon the lowest proposed interchange rate, approximately \$237,000 pre-tax on our debit card program – lost income that we would have to make up through higher fees on our products and services.

Our global payments system works so well that thousands of small community banks are able to stand toe-to-toe and offer services to consumers in direct competition with banks like Citigroup and Bank of America, while providing the quality of relationship service only a community banker can give. The new law and the Federal Reserve proposal would threaten the ability of community banks to compete with large issuers and would bring about further industry consolidation, to the detriment of consumers and small businesses in small town and rural America.

ICBA is grateful to Senators Tester and Corker for introducing S. 575, the Debit Interchange Fee Study Act, which would delay implementation of the Durbin amendment for two years.

Mortgage Risk Retention

Community banks make commonsense mortgages supported by sound, conservative underwriting. As the banking regulatory agencies implement Section 941 of the Dodd-Frank Act, which requires mortgage originators to retain credit risk on non-qualified residential mortgages, ICBA strongly urges them not to define “qualified residential mortgage”, or QRM, too narrowly. An unreasonably narrow definition of QRM will drive thousands of community banks from the residential mortgage market, leaving it to only a few of the largest lenders. Too narrow a definition will also severely limit credit availability to many borrowers who are creditworthy though unable to make significant down payments. In ICBA’s view, the definition of QRM should be relatively broad and encompass the largest portion of the residential mortgage market, consistent with the stronger underwriting standards called for by the Act. An unduly narrow definition of QRM will disadvantage community banks because they lack access to the increased capital needed to offset risk retention requirements, despite conservative underwriting. What’s more, community banks operating in rural areas will be driven out of the market by Farm Credit System direct lenders who carry an exemption for the loans or other financial assets that they make, insure, guarantee or purchase.

We are currently reviewing the proposed rule released last week, which is over 300 pages and raises scores of questions. While I am sure we will offer many suggested changes, overall, for the community banking industry, there are many positive provisions in the proposal, notably, the exemption from the QRM standards and risk retention requirements for loans sold to Fannie Mae and Freddie Mac, as long as they have government capital. Because the vast majority of residential mortgages originated by community banks are conforming loans sold to Fannie Mae and Freddie Mac, the proposal would preserve the ability of community banks to continue to provide their customers with long-term mortgages. ICBA is also pleased that the proposed rule does not impact mortgage loans held in portfolio and focuses the risk retention requirement on securitizers, not originators.

Consumer Financial Protection Bureau

While we are pleased the Dodd-Frank Act allows community banks with less than \$10 billion in assets to continue to be examined by their primary regulators, ICBA remains concerned about CFPB regulations, to which community banks will be subject. ICBA strongly opposed provisions in the Dodd-Frank Act that excluded the prudential banking regulators from the CFPB rule-writing process. Bank regulators are in the best position to balance the safety and soundness of banking operation with the need to protect consumers from unfair and harmful practices and provide them with the information they need to make informed financial decisions.

The Act gives the prudential regulators the ability to comment on CFPB proposals before they are released for comment and an extremely limited ability to veto regulations before they become final. This veto can only be exercised if, by a 2/3 vote, FSOC determines that a rule “puts at risk safety and soundness of the banking system or the stability of the financial system,” an unreasonably high standard and one that should be amended. ICBA supports changing the standard so the FSOC is permitted to veto

a CFPB rule that could adversely impact a subset of the industry in a disproportionate way. We believe this standard would give prudential regulators a more meaningful role in CFPB rule writing.

Absent such legislation, ICBA encourages the CFPB to reach out to community banks as they contemplate rules – before proposed rules are issued – to better understand how proposed rules would impact community bank operations and community bank customers. In particular, any rules that privilege “plain vanilla” products (credit cards, mortgages, etc.) would adversely impact community banks, who are frequently the only providers who are willing to customize products to meet customer needs.

Any enhanced consumer protection laws should focus on the “shadow” financial industry which has been most responsible for victimizing consumers while avoiding serious regulatory scrutiny. This segment of the financial services industry should be brought under the same regulatory and supervisory umbrella as commercial banks. ICBA supports a balanced regulatory system in which all financial firms that grant credit are subject to meaningful supervision and examination. Under Dodd-Frank, the CFPB has discretion in defining non-depository “covered persons” subject to CFPB rules, examination and enforcement. ICBA urges the CFPB to broadly define “covered persons.”

Community banks are already required to spend significant resources complying with voluminous consumer protection statutes. CFPB rules should not add to these costs. The Dodd-Frank Act gives the CFPB authority to exempt any class of providers or any products or services from the rules it writes considering the size of the entity, the volume of its transactions and the extent to which existing law already has protections.

ICBA urges the CFPB to use this authority to grant broad relief to community banks and/or community bank products where appropriate.

The Dodd-Frank Act is a mixed outcome for community banks. I’ve noted some of our concerns, but the legislation also gave us an opportunity to advance long sought priorities.

Too Big To Fail

ICBA has long expressed concerns about too-big-to-fail banks and the moral hazard they pose, well before the financial crisis. Community banks are more finely tuned to these concerns because we and our customers feel the direct impact. It’s challenging for us to compete against mega-banks whose too-big-to-fail status gives them funding advantages. For this reason, we’re pleased the Act takes steps to mitigate too-big-to-fail.

ICBA supported the creation of the Financial Stability Oversight Council (FSOC) whose duties include identifying and responding to risks to financial stability that could arise from the failure of a large, interconnected bank or nonbank. We are pleased that Dodd-Frank provides for enhanced prudential standards for systemically risky firms, including higher capital, leverage, and liquidity standards, concentration limits and contingent resolution plans. Firms subject to these higher standards should include, but not necessarily be limited to, large investment banks, insurance companies, hedge funds,

private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special purpose vehicles, and nonbank mortgage origination companies.

We also support the FDIC's new resolution authority to empower it to unwind large, systemically-risky financial firms. The government must never again be forced to choose between propping up a failing firm at taxpayer expense and allowing it to fail and wreak havoc on the financial system. Powerful interest groups are lobbying doggedly to undermine the too-big-to-fail provisions of Dodd-Frank, which are essential to creating a robust and competitive financial services sector to the benefit of consumers, businesses, and the economy. We urge this committee to ensure that these provisions are upheld and enforced.

Deposit Insurance

ICBA was a leading advocate for the deposit insurance provisions of the Act, including the change in the assessment base from domestic deposits to assets (minus tangible equity), which will better align premiums with a depository's true risk to the financial system and will save community banks \$4.5 billion over the next 3 years. The deposit insurance limit increase to \$250,000 per depositor and the two-year extension of the Transaction Account Guarantee (TAG) Program, which provides unlimited deposit insurance coverage for non-interest bearing transaction accounts, will help to offset the advantage enjoyed by the too-big-to-fail mega-banks in attracting deposits.

Small Business Lending Fund

ICBA fully supports the \$30 billion Small Business Lending Fund (SBLF) program. This program will provide capital for interested community banks to increase small business lending in their communities and boost economic growth. With the private capital markets for small and mid-sized banks still largely frozen since the financial crisis, SBLF provides an important alternative source of capital for interested healthy banks, structured to incentivize increased lending. We urge Treasury to complete the term sheets for Subchapter S and Mutual banks so they too can have access to tier 1 SBLF capital as Congress intended.

Closing

Thank you again for your interest in and commitment to community banks and for the opportunity to testify today. I've outlined some of the more significant regulatory challenges we face in the months ahead. Negotiating these challenges will help us to serve our communities and promote the economic recovery – a goal we share with this committee. Thank you for hearing our concerns. We look forward to working with you.