Testimony of Paul Reed, Chairman of the Ohio Bankers League, and President and Chief Executive Officer of the Farmers Bank and Savings Company Before U.S. Senate Financial Institutions Subcommittee April 6, 2011

Mr. Chairman, Members of the Financial Institutions Subcommittee, my name is Paul Reed. I am president and chief executive officer of the Farmers Bank and Savings Company in Pomeroy, Ohio. Farmers is a community bank serving a largely Appalachian market. I was born and raised in my community. That same can be said of most of the other bankers in my market. We serve those we grew up with.

I appreciate your invitation to testify on behalf of the Ohio Bankers League. My association represents most of Ohio's commercial banks, savings banks, and savings & loan associations.

I hope to address three themes in my testimony:

- A good community bank plays a unique role in economic development important to public policy.
- The regulatory structure in 2008 unintentionally but effectively empowered abuse.
- Dodd Frank does too little to simplify and rationalize an extraordinarily complex and ineffective financial regulatory structure.

I'll start my testimony with a question – why should community banking matter to Congress?

My answer is pretty simple. While larger financial institutions care about their customers, they do not care where they live. That doesn't make big guys bad. It does mean community banks are a critical element of economic redevelopment in many communities.

As a community bank I have a vested interest in the economic and social health of my local market. If my customer cannot find a good job in my community and leaves, I cannot follow him. So my bank's operations must closely sync with what my community needs.

The news media has become very sloppy with the term bank, so let me call myself a traditional bank. There is a difference, important to national policy, between a traditional bank and the various forms of investment companies. I need my customer to be successful. I want long term customers. I win if my customer is successful. Contrast that with the investment bank for which the deal is too often an end in itself rather than the means to the end.

Because I have a practical loan size limit, my bank has always focused on small business. That is our expertise. I am close to my customers which, if I do my job well, will give me added insight. I should be able to make more loans safely than my bigger, distant competitors. Many successful small businesses in Ohio, including those that have grown to be large, started with a close call on a loan, made by a community bank which could say yes safely because it knew its customer.

Recently, walking down a hallway in my bank, I overheard a customer talking to another bank officer. The customer said "I didn't know what to do; but knew if I came to see you, you would." Any good community bank hears that sentiment every day.

As we forge recovery from a very painful recession, small businesses in the communities I serve need me to customize financial tools to answer their needs. I know you want me to do that; but the thousands and thousands of pages of regulation we labor through crush our ability to respond effectively, efficiently and quickly. Looking to the future, Dodd Frank will add more thousands of pages of new regulations.

This last statement should not be interpreted as opposition to effective regulatory modernization. The country needs effective, efficient financial regulation. We all will suffer if we fail to achieve it. Long before the financial crisis, most bankers I know had been calling for a streamlined, modern system which justified public confidence. Without question our regulatory safety net had developed severe flaws. Dodd-Frank improves parts but it does not do enough. As a community banker, I appreciate the steps taken to try to benefit me. Unfortunately, I fear there are unintended consequences Congress did not consider. Let me provide a few examples.

Deposit Insurance - In Dodd-Frank, Congress changed the basis for deposit insurance premiums from deposits to assets. That change has been touted by some as a great victory for community banks that fund most of their loans from local deposits. Ignored in that analysis are FDIC's subsequent actions to increase its target reserve ratio from 1.25 to 2.0, an increase of 60 per cent. Moreover, the FDIC eliminated the threshold beyond which it would charge no premium because the fund was judged adequately capitalized. Today, I am paying premiums at a historically high rate because an obsolete regulatory structure failed to catch bad guys in time. These changes mean that I will continue to pay more than I have historically paid, not less, for a very long time.

It does make sense to build the insurance fund reserves in good times; but please consider that every dollar I pay in deposit insurance translates into ten dollars I cannot lend. We need to stop the traditional swing of the regulatory pendulum from too lax in good times, to too punitive in the wake of economic troubles. It is the good actors who will pay this greatly inflated bill. The increase is huge despite the many other changes which will limit future risk to the fund. And under it all, the overly complex, inflexible regulatory structure that let the bad guys run rampant is too little changed.

Capital - Capital is a challenge for community banks. Historically, most community bank capital came from the leaders of our communities who wanted a locally focused bank. That source was doubly helpful because investors cared about long term benefit to the community as well as the return on their investment. A troubled economy both increases the need for capital while it reduces the ability of those traditional sources to invest. A further barrier to investment comes from an expensive regulatory regime for traditional banks which artificially constrains the potential return on any investment.

A tool the marketplace had evolved to address this dilemma was the trust preferred security. Some of the early banks closed by regulators proved to have invested in poorly underwritten trust preferred securities. As a result FDIC lost money. In reaction the Senate adopted the Collins amendment to Dodd Frank that will likely kill this source of funding for community banks. Dodd Frank created nothing to replace it. The right response would have been to limit banks' ability to directly invest in these securities. It was counterproductive to cripple the use of trust preferred securities as a tool for healthy community banks looking to raise funds from investors outside the banking industry.

Too-Big-to-Fail Community banks and the nation were grievously harmed by financial institutions grown too-big-to-fail. The risks from a Fannie or AIG were not new, yet nothing substantive was done to control them. We heard there was no government guarantee of the very big against failure. Of course there was.

For years I faced funding costs higher than the largest financial institutions because the marketplace knew they were guaranteed against failure. Proportionally I also paid far higher regulatory costs than my large competitors.

The marketplace does not believe Dodd Frank has ended too-big-to-fail. The Wall Street Journal recently reported that the funding costs for the biggest institutions are still 78 basis points lower than mine. While we all supported ending too-big-to-fail, the market suggests we have not done so. And we continue to aggressively, if unintentionally, to forge what is in affect "too small to survive".

Debit card transaction fees I know the intent of Dodd – Frank was to exempt community banks from the rule that set a ceiling on debit interchange fees at roughly a fourth of my cost. However, my understanding is the choice of the transaction processor is the retailer's. Processors competing for business from the big box stores will drive down the price I am paid. In the real world, the exemption will prove fiction.

The campaign by retailers focused on the big and only told part of the story. When my customers use debit cards I provide them, it saves a merchant on each transaction over their acceptance of checks or cash. Additionally, it is the bank that faces the risk of fraud. Only the merchant will have the contact when it can check to see that the card is not stolen. Few check. In 2009, a case of fraud involving a single merchant cost me more than our entire interchange income for the year.

Banking is very competitive. Competition has driven banks to spend interchange income on benefits we hope will attract customers – free checking accounts, convenient branches, more ATMs. Now my debit account income will be far less than my expense. Home Depot tells financial analysts my loss will translate into $35 million in an annual, windfall profit to its shareholders. Where is the consumer benefit?

A focus on trees ignoring the forest In the lead-up to the global financial meltdown, a significant portion of the financial services market evaded governmental oversight. People motivated by greed flowed into the enforcement vacuum. Some were criminals. Many newer market entrants evaded governmentally imposed costs of doing business.

Banks must meet significant capital requirements. We must pay the full cost of regular, onsite, extensive examination. We pay for deposit insurance. We pay material sums for personnel and paperwork required by voluminous, too often poorly crafted regulation. Government says banks are the most important financial service provider. It sets up an extensive system to prevent failure and protect consumers if it does happen. Then policy and practice perversely tilt the competitive playing field steeply against traditional banks. And community banks suffer the greatest harm because scale provides compliance efficiency.

Consumer Financial Protection Bureau - To right consumer wrongs Congress created the CFPB. It promises clearer, simpler disclosures and universal coverage. The goal is right, but Congress chose to exempt a substantial percentage of financial service providers. Many exempted companies offer direct or functional substitutes for what I sell. Inevitably that very artificial wall will spawn more providers operating outside it.

I do have a community bank exemption from direct examination by CFPB. Congress determined that my primary regulator will continue to enforce compliance rules, now written by the new bureau. CFPB will handle the big guys. That exemption sounds like it should be helpful to me; but please understand any time a rule changes, whether for good or bad, traditional banks face a significant burden in replacing forms, systems, and then re-training. The smaller the bank, the harder it will prove to absorb these costs without losing competitiveness.

Today and tomorrow my regulator will regularly come into my bank with a large examination team to probe every aspect of my operations. That is effective but it is also a huge disruption to business. In contrast, no government compliance examiners visited my non-bank competitor’s office. There is little reason to believe they will tomorrow either. And to the extent the new bureau does examine my non bank competitor; the cost of that exam will be paid for by the Federal Reserve System. I get a bill.

I want to emphasize this point. The consumer’s safety net failed to keep pace with the marketplace. It failed to recognize and oversee new providers of functionally equivalent products and services. As a result costs were imposed on banks but not on new non bank competitors. That meant banks continually struggled to be price competitive. Government regulation often had the perverse impact of motivating consumers to use a company where they would have little or no protection. One reason many of these problematic new financial companies escaped attention was that they were individually small; but they became very large in number and even larger in damaging impact. CFPB is not being developed to catch or prevent abuse in small companies where history suggests it will likely occur.

There had long been warning voices within Congress; but for a variety of reasons Congress as a whole rarely acted. One relevant example - if you read transcripts from Senate banking committee hearings four decades ago, you will find then Chairman William Proxmire repeatedly pointing to risks to the public in Freddie and Fannie that arguably led both to fail.

Did we fail to act because an existing agency was perceived as too politically powerful, or even if inefficient, that its purpose was too worthy? Did inconsistent Congressional oversight mean we failed to detect a foundation built on sand? Did divided committee jurisdiction cost Congress important perspective?

Over the years we have responded to crises by adding agency after agency. I cannot detect grand design. I would argue we mistook actions for progress.

Predictably the multiplicity of inward looking financial regulators resulted in glaring holes in our safety net. One good example - AIG told state insurance departments that debt swaps weren't insurance. The SEC apparently thought they were insurance. Ultimately no one looked to see if AIG had the money to make good on its commitments.

Theoretically, to prevent conflict of interest U.S. policy separates finance from commerce. We haven't always adhered to that separation in practice. An example - we allowed Detroit automobile companies to form captive finance companies that subsidized rates from the price of the cars. It was hard for a bank that wasn't selling the car, to compete with a 0% loan. Even though it was a shell game, no government agency intervened. Unfair competition largely drove banks out of the auto finance business. The new auto lenders got bigger, began mortgage lending, and soon grew so big they became "too big to fail". To add to the injury, we then pretended they had been banks all along. We bailed the failed companies out in part by using the deposit insurance fund which traditional banks had capitalized.

We failed to address other conflicts of interest. Unless a mortgage broker closed a loan it didn't get paid. In some cases the broker received a bonus if it convinced the consumer to buy unneeded extra features. As a result the broker's needs fundamentally differed from the borrower's. Yet no one in government checked for misrepresentation or fraud.

A car salesmen closing an auto loan faces the same conflict. Dodd Frank attempted to address the problem of the mortgage broker. However, it specifically exempts the car salesman. We lack a comprehensive theoretical regulatory concept. As a result we get very different answers to very similar questions over time.

I have heard some observers conclude that the financial melt down was the result of deregulation. Specifically, some have cited the Gramm, Leach, Bliley Act. Whether you liked GLBA or not, there was little de-regulation in that bill. It simply acknowledged what had already happened in the marketplace. What was completely absent from the bill was any modernization of financial regulation to cope with that new marketplace reality.

The OBL shared our concern about the shortcomings of Gramm Leach Bliley with the then chairman of the House Financial Services Committee. He acknowledged the shortcoming; but observed regulatory turf had grown so entrenched in Washington, that it would take a crisis to trigger modernization. Well, we have now suffered that crisis. And we have gotten a 2,300 page bill. Some of its provisions do represent progress. But I believe it missed fundamental flaws that continue to plague our regulatory system.

The news last week brought an example of obsolete design when six federal agencies jointly issued a rule on mortgage risk retention in response to the Dodd Frank mandate. My point is not the rule – but six agencies? That is the post Dodd Frank world. Can so many be nimble, efficient, effective, or timely? Can they detect the new marketplace abuse? Or will the traditional agencies assume, as was the case consistently on our path to financial meltdown, that the abuse was somebody else's responsibility. In practice complexity seldom supports effective or efficient.

As this country began to be victimized by predatory lending mortgage securitization had allowed the invention of the mortgage broker – tens of thousands of them. My understanding is the FTC had jurisdiction over non bank consumer lending. Yet the FTC's structure was not well suited to overseeing mortgage closings in this new, very decentralized environment. Congress hadn't given FTC examiners so it didn't systematically examine.

This new form of consumer loan broker wasn't paid unless the loan closed. It wasn't penalized if the borrower couldn't repay. That structure created powerful incentive to the broker to falsify and lie. No government agency looked to find the ones who were doing so.

In Ohio alone we estimate there were twelve thousand mortgage brokers at the high point. Theoretically their lending was covered by the many federal consumer protection laws dealing with mortgages. Mortgage documents arriving on Wall Street appeared correctly filled out; but no one checked for fraud or that consumers had been told the truth. Consumers labored to protect themselves. Federally required mortgage closing forms were so lengthy and complex that few read, let alone understood, them. Where the lender was honest, there was no harm. When it was not, we got predatory lending. Ohio became a national scandal of predatory lending. When my state belatedly got around to licensing those brokers, it discovered a very high percentage had criminal records.

Dodd Frank does address those mortgage brokers. I hope that will result in better consumer protection. But I fear we have missed the lesson. Will we quickly detect and effectively respond to the next marketplace invention which seeks to avoid governmental imposed costs of consumer protection? History suggests that is unlikely.

Why did dishonest mortgage brokers escape detection for so long? They were small.

Individually they were inconsequential. Collectively they collapsed the global financial world. No federal regulator saw them as their responsibility. States pled poverty even when they saw the problem.

Historically, our laws have tended to address specific types of companies. Dodd Frank attempted to refocus on the product; but my understanding is that is the model the new Financial Consumer Protection Bureau is using to organize itself focused on provider not product or service. If that is correct I think that is the wrong model.

Would it not make more sense to make rules consumer centric?

Should not all functionally equivalent products be regulated equally?

Should not government imposed costs of business fall on all competitors evenly?

Should the consumer have some assurance of honest treatment regardless of provider?

If compliance costs do not favor one competitor over another, then competition works to the consumer's advantage. We need to end regulatory gaps driven either by regulatory or Congressional committee jurisdiction at the expense of the consumer.

No one ever would have designed the regulatory structure we have today on purpose. It is the product of historic accident, not grand design. That it has worked as well as it has is amazing. It speaks to the many good people that work for the agencies. That it has not worked as well as the American public deserves, is testimony to the fact many successive Congresses have failed to systematically address evolution of the marketplace. We have an alphabet soup of moving pieces in this protective engine. Many of the pieces were machined to fit engines in a different century. And today's engine, using those parts, gets very bad mileage and breaks down frequently.

Before Dodd-Frank we had too many regulators, and too many holes between them. Dodd Frank gave us more regulators. We still have the gaping holes. I am asked to believe that's progress.

Let me close with a few suggestions.

Community Bank Regulator - The Dodd Frank Act did eliminate an agency. In July the Office of Thrift Supervision disappears, giving the OCC jurisdiction over federally chartered savings & loan institutions and the FDIC that authority over state charters.

Nevertheless, community banks will wind up with more regulators. We have already discussed CFPB. There are other examples.

Today OTS examines both savings & loan companies and their holding companies. That makes sense to me. Corporate veils shouldn't frustrate public protection. Transactions in either the parent or the bank can affect the safety of the other. Dodd Frank transfers thrift holding company jurisdiction to the Federal Reserve. It transfers regulation of the bank to one of two other agencies. Two different regulators with overlapping turf create opportunity for inefficiency and ineffectiveness.

I would submit that Congress might have served the consumer and country better by creating a community bank regulator, merging the current oversight of smaller, healthy banks and their holding companies conducted by either OCC, FDIC, OTS or Federal Reserve. Freed of small bank exam responsibility, the agencies could concentrate on areas of greatest national risk. The new community bank regulator could focus on rules and examinations that work for small banks and their customers.

Community Bank Examinations - I want to briefly address the bank examination process itself. Its current form can drive focus on form over substance. I understand it is easier to check to see if there is a policy in a file, than it is to determine whether practice works. It is easier to check to see that collateral protects against any loss, rather than to evaluate lender judgment in trying to help a small business navigate through the land mines of a serious recession. I do understand the risk Washington would take when it tells examiners that if a bank's management team in both ethical and competent that their job is to help the bank navigate the mine field with advice and counsel. Some judgments will be wrong. Nevertheless, the question should always be what approach leads to the greatest success not that which best shields the regulator from blame.

I have great respect for the individuals that make up the teams that examine my bank. They are bright and well intentioned. But too little in exams really deals with what is most important to my community. During my last exam, a few weeks ago, there was little discussion over the regulator's decision to downgrade a loan to a small business which had been a long time customer of the bank. The business was troubled but we were paying close attention and working closely with the business to try to help it survive. We had already taken steps to fully protect the bank, and the customer was making payments. The regulator's decision cut the funds I had available to lend and hampered my flexibility in working with my customer. In contrast there was extensive discussion on issues like depreciation schedules of minor amounts which had little to do with my bank's safety and nothing to do with the well being of its customers.

We have evolved a system that is safest for regulators. The goal must be one that is safer for the communities I serve. I believe one reason for the system we have is that Congress flails regulators when they are wrong. It rarely commends them for taking risks that result in benefit for the economy.

More Rigorous Oversight I can claim no expertise in politics, but I suspect a Senator would not be rewarded were he to go back home and campaign on the slogan "I didn't introduce a single new bill; but I worked hard to make sure that existing law and the rules worked well." However it is exactly that rigorous, unrelenting, painstaking, unglamorous oversight we will need if we are to reinvigorate the American economy and avoid a recurrence of the financial meltdown that began in 2008.

I do recognize that we, as constituents, literally expect you to be expert on everything in the universe. Demands on your time are unrelenting. You individually cannot spend as much time looking and listening as I want. However, you can systematically get your aides out of the artificial environment defined by the beltway. Get them back home talking with consumers, small businesses, farmer and community bankers, so they understand the financial world your constituents live in. And please dramatically expand systematic, rigorous oversight. Be vigilant. Study carefully. Act only when the case to do so is compelling. When you act, do so with comprehensive vision that considers unintended consequence.

If you want to protect the consumer you must simplify the structures that serve that end. Consumers must know how they are protected and who protects them. Forge a modern regulatory system that:

- looks through their eyes;
- treats all functional competitors equally;
- is designed to stop the bad guy from causing harm; but in ways that do not keep good guys from innovation in response to legitimate customer needs.

Thank you for the important step you take today.

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