ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

Testimony of

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Independent Community Bankers of America

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Opening

Chairman Brown, Ranking Member Corker, and members of the Subcommittee, I am Sal Marranca, Director, President, and CEO of Cattaraugus County Bank, a $174 million asset bank in Little Valley, New York. 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 "Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement."

The safety and soundness of our banking system is a significant concern to community banks. Early in my career, I was a Senior Bank Examiner with the FDIC for over a decade, and the commitment I made then to safety and soundness I still carry with me today as President of Cattaraugus County Bank and as Chairman of ICBA.

The recent financial crisis was caused by high risk lending and speculation by the megabanks and Wall Street firms. Significant harm was done to taxpayers and the economy. Community banks too were harmed. The economic decline retracted consumer spending and dramatically reduced the demand for credit. Residential and commercial real estate markets remain stressed in some areas. Still, the community banking industry remains well capitalized and – because we take a conservative, commonsense approach to lending – we have fewer problem assets than other segments of the industry.

We must ensure the crisis never repeats itself, and appropriate supervision of all financial services providers is an important part of that. But *how* safety and soundness is achieved is very important. Misguided, though well intentioned, efforts could be very economically damaging. Frankly, many community bankers are deeply frustrated with the current exam environment, which has consistently registered as a top concern among ICBA members.

Difficult Exam Environment

As we consider the topic of safety and soundness, we must remember that community banks did not cause the financial crisis, nor are they a source of ongoing systemic risk. Community banks have a starkly different risk profile from other financial services providers because of their smaller scale, which precludes systemic risk, and more importantly, because they practice conservative, common sense lending to customers they often know personally. This different risk profile must be taken into consideration as policymakers consider how community banks should be examined. Community banks are eager to make prudent loans in their communities, and as we consider ways to enhance safety and soundness, we must not tip the scale into actions that will suffocate economic activity. Safety and soundness is a very real concern, but so is the seemingly intractable unemployment that has plagued our economy for nearly three years. Smart examination and compliance practices will allow for more lending without creating undue risk to the financial system.

Specifically, exams could be greatly improved by being more consistent and rational. This would encourage prudent lending without loosening standards. Arbitrary exams chill lending indiscriminately – sound loans as well as risky loans. There are more thoughtful, systematic ways to reduce risk without discouraging sound lending.

I'm fortunate to enjoy a cooperative and constructive working relationship with my regulator, the FDIC. I value this relationship very highly. It is an important part of the success of my bank and has allowed me to weather the financial crisis. Having worked as a bank examiner, I've been on both sides of the table and can appreciate the concerns and challenges examiners face. It's a difficult job with a great deal at stake. The stakes were raised sharply after the financial crisis, but I believe many examiners overreacted and the pendulum has swung too far in the direction of over-regulation. I've met with thousands of community bankers from every part of the country in recent years, and I can tell you there is an unmistakable trend toward arbitrary, micromanaged, unreasonably harsh examinations that have the effect of suffocating lending.

This has not always been the case. Before the crisis, examiners frequently worked in partnership with the banks they examined. They were a resource, a help in interpreting often ambiguous guidance. Where corrections were needed, opportunity was given to make them, and compliance was a mutual goal. This was the model of examination I followed when I was an examiner. I believed then and still believe today it is the best means of achieving safety and soundness without interfering with the business of lending. Currently, the relationships are too often adversarial. Understandably, an examiner does not want to be blamed for the next crisis. Examiners are not evaluated on banks' contributions to the economy. At all costs, they want to avoid a bank failure that would put a black mark on their record. The examiner's incentive is to err on the side of writing down too many loans, demanding too much capital.

The crisis was not caused by a failure to adequately examine community banks, but examiners have reacted to the crisis with overreaching exams that have harmed the economy and made it harder to emerge from the recession.

A particularly frustrating aspect of the 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. They are 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.

Furthermore, examiners are demanding capital levels higher than those required by regulation. To bankers, the process feels arbitrary and punitive. Many community banks complain that the required capital level goalpost is unpredictable. Regulators simply keep moving it further, making it nearly impossible to satisfy capital demands in a difficult economy and capital marketplace. So bankers are forced to pull in their horns and pass up sound loan opportunities in order to preserve capital. This is not helpful for their communities and economic growth. Bankers used to expect prompt feedback that they could act on immediately as part of the exam process. Quick, useful feedback has been replaced by examination reports that follow months after the examiner's visit, with no opportunity for the banker to sit down with the examiner, go over the results, and respond to the examiner's concerns on the spot.

Legislative Help is Needed

ICBA supports legislation to bring more consistency to the examination process. With regard to loan classifications, for example, one of community bankers' greatest concerns, a bill recently introduced in the House would establish criteria for determining when a loan is performing and thereby provide for more consistent classifications. When loans become troubled often the best course for the borrower, lender, and the community is a modification that will keep the loan out of foreclosure. But in recent years, many examiners have penalized loan modifications by aggressively placing loans on non-accrual status following a modification – even though the borrower has demonstrated a pattern of making contractual principal and interest payments under the loan's modified terms. This adverse regulatory classification results in the appearance of a weak capital position for the lender, which dampens further lending in the community and puts a drag on the economic recovery. Rep. Bill Posey's Common Sense Economic Recovery Act of 2011 (H.R. 1723) would establish conservative, commonsense criteria for loan classifications.

Community bankers enthusiastically support this bill because it resonates with their experience in examination. It would give bankers flexibility to work with struggling but viable borrowers and help them maintain the capital they need to support their communities. We hope a counterpart bill will soon be introduced in the Senate and considered by this committee.

Consumer Financial Protection Bureau

The new Consumer Financial Protection Bureau (CFPB) presents another potential challenge to the safety and soundness of community banks, which will be subject to its rules though institutions with less than $10 billion in assets are exempt from primary examination. Because the CFPB is not charged with protecting safety and soundness, and does not have experience or expertise in this area, there is a real risk CFPB rules could promote consumer protection at the expense of safety and soundness. For example, any rule that interferes with a bank's ability to price for risk in a given product, or that disrupts an important revenue stream, could compromise safety and soundness. Prudential regulators, on the other hand, have long experience with regulating consumer protection in the context of safety and soundness. This is why ICBA supports legislation that would give prudential regulators a stronger voice in CFPB rulemaking.

There are different ways of accomplishing this. One example is a bill recently passed by the House Financial Services Committee. The Consumer Financial Protection Safety and Soundness Improvement Act, sponsored by Rep. Sean Duffy, would strengthen prudential regulatory review of CFPB rules, which is extremely limited under the Dodd-Frank Act. Prudential regulators have 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, the Financial Stability Oversight Council (FSOC) determines that a rule "puts at risk the safety and soundness of the banking system or the stability of the financial system," a standard that is nearly impossible to meet. A rule that doesn't meet this high standard could nevertheless do extraordinary harm to banks and consumers. H.R. 1315 would change the voting requirement for an FSOC veto to a simple majority, excluding the CFPB Director, and change the standard to allow for a veto of a rule that "is inconsistent with the safe and sound operations of United States financial institutions." While this change would improve CFPB rulemaking, ICBA has proposed language that would further broaden the standard to allow FSOC to veto a rule that could adversely impact a subset of the industry in a disproportionate way. We believe that this standard would give prudential regulators a more meaningful role in CFPB rule writing.

Communities First Act

The ICBA-backed Communities First Act (CFA, H.R. 1697) captures many reforms the community banking sector deems necessary to alleviate the difficult regulatory burden they face, including a change to the FSOC veto standard for CFPB rules very similar to H.R. 1315 discussed above. This legislation was recently introduced in the House and cosponsored by members from both sides of the aisle. ICBA is working to introduce a similar bill in the Senate. Notably CFA would:

- Increase the threshold number of bank shareholders from 500 to 2,000 that trigger SEC registration. Annual SEC compliance costs are a significant expense for listed banks.
- Reduce the paperwork burden that acts as a dead-weight cost for community banks, consuming scarce resources that could support lending.
- Defer taxation of interest on long-term certificates of deposits and tax the interest at capital gains rates so more consumers are rewarded for saving and investing.
- Extend the 5-year net operating loss (NOL) carryback provision to free up community bank capital now when it is most needed to boost local economies.

These and other provisions would improve the regulatory environment and community bank viability, to the benefit of their customers and communities.

Moral Hazard and Too Big To Fail Institutions

The greatest threat to safety and soundness remains the too-big-to-fail institutions that dominate the financial services sector. Today, the four largest banking companies control more than 40 percent of the nation's deposits and more than 50 percent of the assets held by U.S. banks. The largest banks have grown larger since the financial crisis. The ten largest hold 77 percent of all U.S. bank assets compared with 55 percent of total assets in 2002, according to a recent Bloomberg study. ICBA does not believe it is in the public interest to have ten institutions controlling a significant majority of the assets of the banking industry. A more diverse financial system would reduce risk and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

As a result of the financial crisis, our nation went through an agonizing series of forced buy-outs or mergers of some of the nation's largest banking and investment houses, costing American taxpayers hundreds of billions of dollars. Some mega-institutions – too-big-to-fail and also too big-to-be-sold to another firm – were directly propped up by the government. One large institution, Lehman Brothers, was allowed to go bankrupt, with disastrous consequences that only confirmed the policy of too-big-to-fail. The doctrine of too-big – or too-interconnected – to-fail finally came home to roost, to the detriment of the American taxpayer and our economy. Our nation cannot afford to go through that again. Systemic risk institutions that are too big or inter-connected to manage, regulate or fail should either be broken up or required to divest assets until they no longer pose systemic risk.

In a speech made as the country was emerging from the crisis, Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> The belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger. A recent Bloomberg Government study concluded that the number of too-big-to-fail banks will increase by 40 percent over the next 15 years.

Government efforts to stabilize the financial system, though necessary to stave off a full scale financial collapse and even deeper recession, were deeply unfair to community banks. The government bailed out too-big-to-fail institutions, while the FDIC summarily closed too-small-to-save institutions, victims of a crisis created on Wall Street. Community bankers across the country were deeply angered by the results of too-big-to fail.

This is why ICBA generally supports the too-big-to-fail measures in the Dodd-Frank Act. These include measures to prevent firms from getting too big; offset the advantages of being too big; more diligent monitoring for systemic risk; subject large, interconnected firms to enhanced capital and prudential standards; and create a resolution authority for large firms so the government is never again forced to choose between propping up a failing firm and allowing it to fail and wreak havoc on the financial system. However, whether the Dodd-Frank Act will succeed in ending the market perception that large, interconnected firms are too-big-to-fail will largely depend on the implementing rules and how diligently they are enforced in the coming months and years.

Housing Finance Reform, If Not Done Properly, Could Lead to Industry Concentration

Key aspects of the housing finance system – the rules governing underwriting, risk retention, servicing, foreclosure, securitization, and the structure of secondary market entities – are facing review and revision. This is an expected and appropriate response to the housing-driven financial and economic crisis we've just experienced. But we must recognize that ill-considered changes – singly and cumulatively across a number of areas – could unintentionally reduce competition, amplify moral hazard, and jeopardize safety and soundness. Specifically:

- The agencies "qualified residential mortgage" (QRM) exemption from the Dodd-Frank risk retention requirement on mortgages sold and securitized should be sufficiently broad to encompass the majority of the residential mortgage market, consistent with stronger underwriting standards. Because risk retention will require increased capital, which will pose a challenge for community banks, a narrow definition of QRM will drive thousands of community banks and other lenders from the residential mortgage market, leaving it to the largest lenders whose actions brought about the financial crisis. In our view, the QRM definition currently proposed by the banking agencies, which includes a 20 percent down payment requirement, is too narrow.
- While policy makers are rightly alarmed by the sloppy and abusive servicing standards of some large lenders, they must recognize that community banks have fundamentally different standards, practices, and risks. With smaller servicing portfolios, better control of mortgage documents, and close ties to their customers and communities, community banks have generally been able to identify repayment problems at the first signs of distress and work out mutually agreeable solutions with struggling borrowers. Overly prescriptive servicing requirements – a burden for community banks which do not have the staffing and financial resources to implement extensive new programs – could cause many community banks to exit the mortgage servicing business and accelerate consolidation of the servicing industry with only the largest too-big-to-fail lenders surviving.
- As proposals for replacing Fannie Mae and Freddie Mac are considered, policymakers should be extremely careful not to recreate the moral hazard they represented. Some of the proposals put forward would, by allowing just a small number of large banks to dominate the secondary mortgage market, create a new variety of moral hazard, just as pernicious as the old variety. Any solution that fuels consolidation is only setting up the financial system for an even bigger collapse than the one we've just been through.

Policymakers must proceed with caution in housing finance reform. The mortgage market is critical to the broader economy, as we learned during the recent crisis, and the potential for unintended consequences is significant.

Conclusion

Thank you again for convening this hearing and giving ICBA the opportunity to testify. We share your commitment to enhancing the safety and soundness of our financial system and hope that the community bank perspective has been valuable.