April 14, 2017

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
U.S. Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and Urban Affairs
U.S. Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the Conference of State Bank Supervisors (CSBS), I am writing in response to your joint request for proposals increasing economic growth. We appreciate you undertaking this effort and welcome the opportunity to offer our thoughts.

About CSBS

CSBS is the nationwide organization of banking regulators from all 50 states, American Samoa, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. The mission of CSBS is to support the leadership role of state banking supervisors in advancing the state banking system; ensuring safety and soundness; promoting economic growth and consumer protection; and fostering innovative state regulation of the financial services industry.

State regulators charter and supervise 78 percent of all banks in the United States. In addition, state regulators license and supervise a variety of non-depository financial services. CSBS, on behalf of state regulators, also operates the Nationwide Multistate Licensing System (NMLS) to license and register those engaged in mortgage, money transmission, consumer finance, and other non-depository financial services industries. As of 2016, 194,400 state regulated companies, branches, and mortgage loan originators were licensed through NMLS.

Because state regulators are responsible for chartering and supervising a diverse array of both bank and non-bank entities, they interact with their federal regulatory counterparts frequently. Federal policymakers recognize the importance of coordination between state and federal regulators in order to ensure a smooth operation of our dual banking system. To that end, policymakers have codified state participation on key federal regulatory agencies,[1] including the Federal Financial Institutions Examination Council and the Financial Stability Oversight Council. This state-federal coordination, in conjunction with the tangible and local supervisory

[1] The Federal Deposit Insurance Corporation (FDIC) Board requires an independent director "shall have State bank supervisory experience," 12 U.S.C. § 1812(a)(1). A state banking commissioner retains a non-voting seat on the Financial Stability Oversight Council, 12 U.S.C. § 5321(b)(2)(D). The Federal Reserve Board (FRB or Fed) reserves one Governor with community banking or community bank regulatory experience, 12 U.S.C. § 241.

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approach of state regulators, provides the states with a unique perspective on a range of proposals to increase economic growth.

Community Banks Need Right-Sized Regulation and Supervision

Community banks are essential to the U.S. financial system and economy. The defining characteristic of a community bank is its relationship-lending business model – a business model that relies on the bank's knowledge of its local market, citizens, and economic conditions. Community banks play an outsized role in lending to America's small businesses, holding 43% percent of the banking industry's small loans to farms and businesses while only making up 13% percent of the banking industry's assets as of Q4 2016.[2]

Policymakers are rightfully questioning whether the current regulatory framework appropriately supports and supervises the traditional, relationship-based community banking business model. There are concerns that some of the recent Dodd-Frank Act and Basel III rules, in conjunction with other regulations, may pose an undue burden for community banks. Congress has recently taken some actions to right-size community bank regulation and supervision,[3] but more needs to be done.

Like their federal counterparts, state regulators are responsible for ensuring financial institutions operate in a safe and sound manner and treat consumers fairly. However, state regulators are unique in that they are also charged with promoting local economic development in their states. Given the vital role community banks play in economic development, below are some suggestions that will both help right-size community bank regulation and promote economic growth.

Congress Should Simplify Community Banks' Capital Regime

State banking regulators strongly support requiring sufficient, high quality capital. However, the costs associated with the complexity of the current rules disproportionately impact smaller institutions, and potentially inhibit community banks from serving the credit needs of their markets. State regulators have urged the agencies to hasten efforts to devise a more practical

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[2] FDIC Quarterly Banking Profile, Q4 2016. Available at: https://www.fdic.gov/bank/analytical/qbp/2016dec/qbpcb.html

[3] The Fixing America's Surface Transportation (FAST) Act, signed into law in December of 2015, contained a number of provisions designed to relieve community bank regulatory burden: 1) Establishing a process for banks and other stakeholders to petition the CFPB to designate an area as 'rural' or 'underserved' for the purposes of the CFPB's ability-to-repay rule; 2) Expanding the CFPB's ability to exempt creditors serving rural or underserved areas from escrow requirements; 3) Providing the CFPB with greater flexibility to treat a balloon loan as a 'qualified mortgage' if such a loan was extended by a community bank or creditor operating in rural or underserved areas; 4) Granting relief from Gramm-Leach-Bliley privacy notice requirements; and 5) Increasing from $500 million to $1 billion the threshold for well-capitalized banks eligible for an 18-month exam cycle.

approach to regulatory capital for small, non-complex banks.[4] State regulators also ask Congress to pursue legislative solutions to minimize the complexity of community banks' capital requirements. Specifically, capital rules that are based on standards developed for large internationally active firms are inappropriate for community banks. Capital provisions aimed at curbing the risks identified from the last crisis such as high volatility commercial real estate and mortgage servicing assets should be dealt with through the supervisory process for small community banks. In addition to these specific concerns, the general complexity of the rules requires institutions to redirect resources that could otherwise be employed to serve the financial needs of their communities. Adopting a simpler regime and rethinking Basel III's applicability for community banks would encourage community banks to engage in more relationship lending, lead to increased economic growth, and have collateral benefits like alleviating call report burden.

Congress Should Adopt an Activities-Based Approach to Community Bank Regulation

Policymakers have often approached bank regulatory requirements based on an institution's asset size. However, this has led to a fragmented and arbitrary regulatory framework that negatively impacts community banks. Figure 1 shows a sample of current regulations and their applicability based on asset size, illustrating just how inconsistent this regime can be.

State regulators are concerned that the current regulatory framework falls short in providing a holistic, thoughtful approach to community bank regulation, which in turn harms these institutions and the communities they serve. For example, commissioners have seen community banks approaching the $10 billion asset mark choose to acquire another institution to quickly achieve a size well beyond that threshold (rather than organically grow) to absorb the increased costs of direct CFPB supervision. Simply put, our current framework is not creating opportunities for economic growth, but rather inhibiting them.

[4] State regulators, through the FFIEC State Liaison Committee, submitted a letter during the recent Economic Growth and Paperwork Reduction Act process and called on the federal banking agencies to simplify capital rules for community banks. See "Appendix 1: State Liaison Committee Letter. Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act." *Federal Register,* Vol. 82, No. 60. March 30, 2017. Available at: https://www.gpo.gov/fdsys/pkg/FR-2017-03-30/pdf/2017-06131.pdf

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Figure 1. Various Asset Thresholds for Regulations and Exemptions

ASSET THRESHOLD:	< $500 Million	$500M to $1B	$1B to $2B	$2B to $10B	$10B to $15B	$15B to $50B	$50B to $250B	More than $250B
REGULATION	**APPLICABILITY**							
Supplementary Leverage Ratio								
Liquidity Coverage Ratio								
Large Bank/SIFI Assessment								
Comprehensive Capital Analysis & Review (CCAR)								
Collins Amendment - TruPs								
Dodd-Frank Act Stress Testing (DFAST)								
Fed Dividend Reduction								
CFPB Supervision								
Durbin								
Enhanced Prudential Standards for BHC's								
CRA Reporting								
Overdraft Reporting								
Audit Requirement								
HMDA Data Collection								
Volcker Rule								
EXEMPTION	**ELIGIBILITY**							
AOCI* Opt-out								
Swap Clearing Exemption (CFTC)								
Small Creditor - QM								
Small Bank Holding Company								
18 Month Exam Cycle								

**Accumulated Other Comprehensive Income (AOCI)*

LEGEND

Covered by Rule	Eligible for Exemption	Streamlined Compliance

CSBS believes policymakers could use other factors and measures (in conjunction with one another) besides asset thresholds that better reflect the true character of a community bank. CSBS believes the FDIC's research definition of a community bank – which takes into account an institution's business activities, funding characteristics, and geographic footprint – provides a good foundation on which to build a more rational regulatory and supervisory framework for community banks.[5] State regulators believe there could be other criteria that policymakers use to help identify community banks, such as:

- Operating primarily in local markets;
- Deriving funding primarily from these local markets, specifically through deposits of members of the communities in which a bank operates;
- Focusing on lending out the deposits a bank collects to the communities in which it predominately operates;
- Having a lending model based on relationships and detailed knowledge of the communities and its members, not one that is volume-driven or automated;

[5] "Appendix A – Details of the Research Definition of the Community Bank." *FDIC Community Banking Study*, December 2012. Available at: https://www.fdic.gov/regulations/resources/cbi/report/cbsi-a.pdf

- Focusing on providing high-quality and traditional banking services; and
- Having locally based corporate governance.

Whether Congress uses the FDIC community bank research definition or other measures, state regulators urge you to create a process for community bank identification that is not solely based on asset thresholds, but takes activity-based and other qualitative criteria into account. A more holistic definition of community banks could be used as a basis for a broad range of regulatory right-sizing initiatives. With a new approach in place to identify community banks, Congress and state regulators working collaboratively with their federal regulatory counterparts could then move forward to right-size a more appropriate regulatory and supervisory approach for these institutions. Creating a right-sized regulatory environment will empower community banks to better serve their local markets, thus promoting economic growth.

Congress Should Encourage Mortgage Lending by Granting Qualified Mortgage (QM) Status for Loans Held in Portfolio

State regulators have long supported a flexible approach to underwriting for institutions that retain mortgages in portfolio because interests are inherently aligned between consumers and lenders that retain 100 percent of the risk of default.

One solution that would tailor the requirement to the nature of community bank mortgage lending is to grant the QM status to all mortgage loans held in portfolio. State regulators have been a leading voice in advocating for mortgage rules to accommodate community bank portfolio lending, including June 2013 testimony by Commissioner Charles Vice of the Kentucky Department of Financial Institutions in which he offered numerous proposals for Congress and federal regulators to expand access to affordable mortgage credit by amending the mortgage rules. [6] Commissioner Vice's testimony included the idea of granting QM status to mortgage loans held in portfolio, and we have been encouraged to see Congress explore this idea in numerous hearings and CSBS-supported legislation during the 113th and 114th Congress. This proposal has received bipartisan support and we encourage this Congress to pursue legislation to promote portfolio lending by community banks. Regulatory recognition of the portfolio lending model will encourage banks to lend more to homeowners, align the interests of the bank and the borrower, and promote economic growth.

Congress Should Empower and Encourage Examiner Discretion in Compliance Examinations

Feedback from the *Community Banking in the 21st Century Research and Policy Conference* shows that community banks see a discrepancy in the value of safety and soundness examinations and the value of compliance examinations. Bankers state that safety and

[6] Vice, Charles. Statement to the House, Committee on Financial Services. *Examining How the Dodd-Frank Act Hampers Home Ownership*, Hearing, June 18, 2013. Available at: http://financialservices.house.gov/uploadedfiles/hhrg-113-ba15-wstate-cvice-20130618.pdf

soundness examinations provide multiple benefits to their institutions, including examiner insights that help management better understand their bank's risk exposures and provide ideas for improving their operations and practices.

Alternatively, bankers often feel like federal compliance examinations provide little strategic value to their institutions, primarily based on the federal agencies' stringent supervisory approaches. Community banks experience a "zero tolerance" approach to compliance issues that leaves no opportunity for institutions to correct their practices or examiners to provide guidance and follow-up steps on how to improve compliance. Much of this dynamic is due to increased centralization of decision making in Washington, DC, at the expense of local, boots-on-the-ground examiner expertise.[7]

To make federal compliance examinations a more valuable process and to encourage better regulatory outcomes, Congress should look to devolve power away from centralized authorities in Washington, DC. Instead, Congress should empower federal officials located in the field to guide institutions on how to improve their practices to meet rigorous compliance standards.

Improved State-Federal Coordination Fosters Innovation

As described above, state and federal coordination is essential to ensure proper functioning of our dual banking system. While this coordination works in many instances, there is room for improvement. As described below, one area for improvement is amending the Bank Service Company Act (BSCA) to enhance coordination and information sharing among federal and state regulators.

Congress Should Amend the Bank Service Company Act

The BSCA is the primary federal statute governing technology service providers (TSPs), enabling banks to efficiently use new business technology in serving customers and to better leverage resources. The BSCA authorizes federal banking agencies to regulate and examine TSPs and the services they provide as if such services were being performed by the bank itself. While the BSCA does not bar state regulators from participating in exams with federal regulators, the law's failure to include state regulators has been interpreted as a barrier to information sharing and regulatory coordination. As a result:

- When state and federal regulators do examine TSPs jointly, state and federal regulatory authorities are unable to both "sign off" on these joint exams, denying regulators the ability to rely on the other agency's exam for regulatory purposes; and
- Federal and state banking regulators are not able to fully share information encompassing vital areas of how banks conduct their business.

[7] For example, see "Five Questions for Five Bankers: Tennessee" in *Community Banking in the 21st Century Research and Policy Conference: Town Hall Publication*, pg. 59. Available at: https://www.communitybanking.org/documents/2016-Conference-Papers/CB21Cpublication_2016.pdf

Amending the BSCA to clearly and explicitly synchronize the authorities of state and federal regulators on TSP exams will enhance coordination, improve information security, and reduce burden on both the regulators and the industry, promoting economic growth.

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Thank you for the opportunity to offer state regulators' thoughts on ways to improve the regulatory framework for community banks and state and federal regulatory coordination. We look forward to working with you and your staff during the 115th Congress on bipartisan proposals to promote economic growth.

Sincerely,

John Ryan
President and CEO

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