Testimony of

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On behalf of the

**Independent Community Bankers of America**

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Hearing on

# "Rising Regulatory Compliance Costs and Their Impact on the Health of Small Financial Institutions"

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## Opening

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, I am Samuel Vallandingham, Senior Vice President and Chief Information Officer of First State Bank, a $288 million community bank in Barboursville, West Virginia. I am pleased to be here today to represent the nearly 5,000 members of the Independent Community Bankers of America at this hearing on "Rising Regulatory Compliance Costs and their Impact on the Health of Small Financial Institutions." Rising compliance costs have changed the nature of my job and the community banking industry in recent years. The problem, which is already straining our ability to serve customers, only stands to get worse and could possibly drive further industry consolidation. We appreciate you raising the profile of this critical issue and hope that you will advance needed legislative solutions.

Community banks play a crucial role in the economic life of rural areas and small communities passed over by larger banks. The credit and other financial services we provide in these communities will help advance and sustain the economic recovery and ensure that it reaches every corner of the country. Community banks are responsible for 60 percent of all small business loans under $1 million. As the economy recovers, small businesses will lead the way in job creation with the help of community bank credit. I'm proud to note that First State Bank was awarded SBA Lender of the Year in 2001 and SBA Community Bank of the Year in four consecutive years: 2005, 2006, 2007, and 2008. But the role of community banks in advancing and sustaining the recovery is jeopardized by the increasing expense and distraction of regulation drastically out of proportion to any risk posed by community banks. We didn't cause the recent financial crisis, and we should not bear the weight of new, overreaching regulation intended to address it.

## Regulatory Compliance Expenses Have Risen Sharply

Let me share with you some headline numbers, derived from First State Bank. The examples below are discrete and limited but illustrate the overall trend of dramatically rising regulatory complexity and compliance costs.

- As a senior executive, I am currently spending as much as 80 percent of my working time on compliance-related issues compared to approximately 20 percent as little as 3 years ago.
- Every job function at my bank has assumed a greater compliance component. Loan officers, who should be focused exclusively on clients and underwriting, are diverting more and more of their time to compliance. Loan originators who used to spend 5 to 10 percent of their time per file on compliance now spend 30 to 35 percent of their time. This does not include training or education just to remain current on changes.

- Mortgage lending now involves such regulatory complexity that it can only be done by a dedicated specialist. More generalized consumer lenders can no longer originate mortgages. We've had to add a new mortgage originator and plan to add a third.
- First State originates and sells mortgages to Freddie Mac, which we then service on their behalf. Since 2008, the annual rate of rules changes has roughly quadrupled. Any one year brings as many changes as we saw in the four years prior to 2008. In 2011 alone, we saw 36 origination and 59 servicing rule changes. Most of these changes require costly software upgrades.
- As a result of new servicing requirements stemming from HAMP, HARP, and other foreclosure avoidance programs, since 2008, we've gone from one collector to 3.5 collectors at an incremental payroll expense of over $93,000 – a substantial expense for a community bank.
- Our expenses for webinar training in the first four months of 2012 alone ($12,000) are double our webinar expenses for all of 2008 ($6,000). This does not even include the expense of in-house training.
- We've formed a risk assessment committee of 6 to 8 senior employees that meets monthly.

Though illustrative, these examples do not capture the full impact and expense of compliance changes. Every change requires software updates, a lengthy process that includes a risk assessment, installation on a test network, testing, installation on a production network, more testing, procedural review, training and audit. What's more, policy revisions require committee review and Board approval. Compliance changes result in legal and audit expenses and sometimes the expense of printing and mailing new disclosures.

But even these "hard costs" do not tell the full story. Soft costs – harder to measure but of no less impact – have also increased dramatically over this time frame. Employee turnover is a good example of a soft cost. Regulatory complexity causes employee turnover and increases the cost of such because of the expense of training new employees to comply with increasingly complex rules.

## Compliance Costs Directly Reduce Community Investments

Every dollar spent on compliance is a dollar less that we have to lend and invest in the communities we serve. Every hour I spend on compliance is an hour I could be spending with customers and potential customers, acquiring new deposits and making new loans. There is of course an important role for compliance, but regulation should be balanced, practical, and calibrated to the systemic and consumer risk posed by any given bank. Like many community banks, First State Bank has been in business for over a century and survived the Great Depression and many intervening recessions. Our longevity is a testament to our conservative risk management. We treat our customers fairly because we live in the same communities and because an unimpeachable reputation for putting customers first is the key our success. The compliance costs that we are now incurring are vastly out of proportion to any risk we pose.

I talk to a lot of community bankers from my region and across the country, given my active role in ICBA, and I can tell you that my experience is sadly typical. The job title, Vice President for Risk Assessment, unheard of three years ago in the community banking industry, has now become commonplace. Compliance is almost all I do now. Many days I feel like I'm not a banker anymore.

## What Regulations Are Driving the New Costs?

What regulations in particular are driving these costs? They are too numerous to discuss in full or even to catalogue here. We have documented an astronomical 921 compliance changes, from a spectrum of agencies, implemented since 2008. While not all of these apply to my bank, we nonetheless have to evaluate each one to determine to what extent our organization is impacted. My Board members, who represent a range of industries, including insurance, manufacturing, energy, and accounting, often express their astonishment at the surge of new rules facing the financial services industry, even when compared to their highly regulated industries. So while I have a daunting surplus of examples from which to draw for this testimony, let me focus in on a few recent and particularly troubling ones.

**Servicing standards.** Mortgage servicing is a substantial component of First State's business. New standards for loans serviced for Fannie Mae and Freddie Mac, which went into effect last year, have added significantly to our compliance burden. Overly prescriptive with regard to the method and frequency of delinquent borrower contacts, the new standards are a challenge to implement and have reduced our flexibility to use methods that have proved successful in holding down delinquency rates. Examples of difficult and unnecessary requirements include rigid timelines for making contacts that leave no discretion to the servicer; mandatory property inspections; establishing a single point of contact for the borrower; the creation of a special servicing group for delinquent loans; requiring significant oversight of third-party providers; developing burdensome compliance programs; and annual independent audits of controls and processes. Servicing quality control is new, costly and very burdensome. Our small size and our local presence in the communities we serve make many of these requirements unnecessary. ICBA is also concerned that the servicing standards set forth in the recent state attorneys general settlement agreement, though targeted at the five largest national mortgage servicers, will become the foundation for national servicing standards to be written by the CFPB. First State Bank services loans with care, diligence, and accountability because quality servicing contributes to the reputation we enjoy in our communities. For us, customers are more important than a large volume of transactions. This is a fundamental difference between the larger national servicers and my bank. We don't need threat of enforcement to incentivize quality servicing.

**Regulatory examinations.** The trend toward oppressive, micromanaged exams is a grave concern to community bankers nationwide. The harsh examination environment impacts community banks both because we are forced to expend time and resources in interacting with examiners and because examiners are unjustifiably requiring capital

levels much higher than current official standards and are inappropriately downgrading performing commercial real estate loans. Both aspects of the exam environment adversely affect community banks' ability to lend, further exacerbating the current economic downturn.

**New appraisal standards.** Appraisal standards have changed significantly over the past few years. First as a result of the Home Valuation Code of Conduct from Fannie Mae and Freddie Mac, and more recently as a result of the Dodd-Frank Act. These standards are well intentioned, having been designed to prevent abuses by unregulated mortgage brokers that contributed to the collapse of the housing market. However, they have made it nearly impossible for my bank to use local appraisers. Hiring an appraisal management company is quickly becoming the only practical option for a community bank and has raised appraisal costs by 25 to 50 percent. Passed on to the borrower, these costs increase the cost of credit. What's more, because the appraisal management company uses appraisers from outside the area, they produce poorer quality appraisals.

## Future Prospects Are Not Reassuring

As expensive and wasteful as the current regulatory environment is, far from the relief that is needed, we only expect it to get worse in the future, absent legislative action, as new regulations become effective. The Dodd-Frank Act, which is only beginning to be implemented, is a source of particular concern among community bankers, and I will focus my remarks on that 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. Community banks don't engage in abusive consumer practices and did not cause the financial crisis, and we appreciate the support our industry received to shield us from some of the provisions designed to respond to the crisis. Because we pose no risk to consumers or the financial system, the manner in which we are regulated should be distinct from that of large banks and Wall Street firms. Regulation calibrated to large bank risks and business models can suffocate smaller banks and thereby harm the communities we serve.

The full and ultimate impact of the Dodd-Frank Act won't be known for years, depending on how the law is implemented and how the market adjusts to it. A perfect example of this is the Durbin Amendment, which imposed price controls on debit interchange fees. Such a dramatic and unnecessary intervention in the market will without question have a direct impact on the revenue received by community banks like mine, despite the exemption for issuers with less than $10 billion in assets. For example, already my bank has seen portions of our debit program's compliance costs *double* as a direct result of the Durbin Amendment's provision mandating the use of multiple PIN debit networks. Prior to Durbin, we did business with one PIN debit network because it was better for our business model and met the needs of our customers. Now we are forced to enter into a contract with an additional network, must train staff on a new set of compliance standards, and absorb significant new costs, while our customers receive no net benefit.

There's still an opportunity to improve 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. Below I discuss the provisions of the Dodd-Frank Act that pose the greatest threat to community bankers.

**Consumer Financial Protection Bureau**

While we are pleased that 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 have long expertise in balancing the safety and soundness of banking operation with the need to protect consumers from unfair and harmful practices.

Community banks are already required to spend significant resources complying with voluminous consumer protection statutes, as I have detailed for you. 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.

ICBA is particularly troubled that the CFPB intends to play an active role in developing servicing standards, which I have already discussed as a major source of compliance costs, and in writing overdraft rules, not instead of the prudential regulators but in addition to them.

**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" too narrowly. An unreasonably narrow definition of QRM will drive thousands of community banks and other lenders 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 do not have significant down payments or who, despite high net worths, have relatively low incomes and high debt-to-income ratios. 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.

**Escrowing for taxes and insurance would be costly for small lenders**

The Act's new mortgage escrow requirements will be costly to community bankers, particularly those that serve rural areas. Rural customers have unique credit needs, collateralized by rural properties, which do not lend themselves to securitization. As a result, community banks that serve rural customers tend to hold loans in portfolio, where the lender is exposed to the entire credit risk of the borrower for the full term of the loan. They not only have "skin in game," but bear the full risk of default. For this reason, portfolio lenders exercise special diligence in underwriting, and we believe that portfolio loans held by banks with assets of less than $10 billion should be exempt from the requirement that first lien mortgage lenders establish escrow accounts for the payment of taxes and insurance. There is a significant cost involved with establishing escrow accounts, particularly for community banks that have small lending volumes, and many community banks would need to outsource their escrow services at a significant cost. A long-standing industry rule of thumb held that the break-even point at which it made business sense for a lender to establish escrow accounts was a portfolio of $250 million. That break-even point has escalated in recent years as delinquencies have given rise to negative escrow balances that must be funded by the lender. At First State Bank, unfunded escrow balances have ballooned 816 percent since 2007. The costs are such that an escrow requirement could lead many community banks to sharply reduce or eliminate their mortgage businesses.

**Community Banks Must Be Able to Rely on Credit Rating Agencies**

The Dodd-Frank Act requires the regulatory agencies to replace all references to "credit ratings" with an "appropriate" standard for measuring creditworthiness. Community banks, lacking the resources to independently analyze credit quality, will be disproportionately affected by this provision.

As an alternative approach that addresses the legitimate concern with credit ratings, ICBA recommends amending Dodd-Frank to reintroduce the use of credit ratings, but also give the regulators the authority to confirm the credit ratings in those situations where additional credit analysis is warranted.

**Municipal Advisor Registration**

Another concern for community bankers is the Dodd-Frank Act municipal advisor registration requirement. Community banks have always provided traditional banking services such as demand deposits, certificates of deposit, cash management services, loans and letters of credit to the municipal governments of the communities they serve. Community banks provide these services under close supervision by state and federal

bank regulators. The Dodd-Frank Act provision, if interpreted broadly by the SEC, could force thousands of community banks to register as municipal advisors with the SEC and the Municipal Securities Rulemaking Board and be examined by the SEC in order to continue providing traditional banking services to municipalities. An act as simple as a town treasurer phoning a community bank to inquire about CD rates could be enough to trigger registration. ICBA strongly supports legislation introduced by Rep. Robert Dold, H.R. 2827, to provide an exemption for banks from this onerous and over-reaching requirement.

### Small Business Loan Data Collection Requirements

Community bankers are deeply troubled by the Dodd-Frank Act's new HMDA-like data collection requirements. In addition to maintaining records of all credit applications received from small businesses, community banks are required to maintain records of applications from women-owned and minority-owned businesses of all sizes and a separate record of the responses to all such applications. Where feasible, these records are to be kept separate from the underwriting process. In other words, the requirement creates a separate bureaucracy within the bank that cannot be integrated with lending operations. Further, data collected by community banks and subsequently made public by the CFPB could compromise the privacy of applicants in small communities where an applicant's identity may be easily deduced, despite the suppression of personally identifying information.

## What Can Congress Do to Help?

ICBA is very pleased that this committee has recognized the scope and severity of the problem of excessive regulation and is considering a number of bills to provide relief for community bankers. ICBA supports these efforts and urges this committee to advance them. The most beneficial pieces of legislation include the following:

### The Financial Institutions Examination Fairness and Reform Act

The Financial Institutions Examination Fairness and Reform Act (H.R. 3462) will go a long way toward improving the oppressive examination environment, a priority concern of community bankers and a barrier to economic recovery, by creating a workable appeals process and consistent, commonsense standards for classifying loans. We are grateful to Chairman Capito for introducing this legislation. The current appeals process is arbitrary and frustrating. Appeals panels, or other processes, routinely lack the independence and market expertise necessary to reach a fair, unbiased decision. H.R. 3461 is a good start to improving the appeals process by taking it out of the examining agencies and empowering a newly created Ombudsman, situated in the Federal Financial Institutions Examination Council, to make final appeals decisions. Though we favor additional measures to bring a higher level of accountability to the regulators and their field examiners, we are pleased to support the provisions of H.R. 3461 as a foundation on which to build a more rigorous appeals process in the future.

**Consumer Financial Protection Bureau Reform**

ICBA strongly supported legislation passed by this Committee and the House to strengthen the accountability of the CFPB. The Consumer Financial Protection Safety and Soundness Improvement Act (H.R. 1315), sponsored by Rep. Sean Duffy (R-WI), would reform the structure of the CFPB so that it is governed by a five member commission rather than a single director; strengthen prudential regulatory review of CFPB rules by reforming the voting requirement for an FSOC veto from a 2/3rd vote 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" – a much more realistic standard than under current law. Combined, these changes would better protect the safety and soundness of the financial system, and provide reasonable measures to insulate community banks from additional regulatory burden.

**Communities First Act**

Many of the regulatory concerns highlighted in this testimony are addressed in the Communities First Act (H.R. 1697) – from a community bank exemption from the new mortgage escrow requirement, to restoring the use of credit ratings for bank-held investments, to making the CFPB more accountable, and a range of other community bank regulatory and tax relief provisions. Sponsored by Rep. Blaine Luetkemeyer (R-MO), himself a former community banker, the Communities First Act has over 80 cosponsors from both parties and the strong support of 37 state banking associations. ICBA is grateful to this committee for convening a hearing on CFA on November 16 at which our Chairman had the opportunity to testify.

**Temporarily extend the FDIC's Transaction Account Guarantee Program**

Regulatory relief is a key community bank priority, and we're grateful to this committee for focusing on this topic today. I urge this committee to also consider a topic of equivalent interest to community banks – the need for temporary extension of the FDIC's transaction account guarantee (TAG) program. Extending TAG would serve the same goals that I have stressed in this testimony: preserving community bank viability, maintaining small business credit, and deterring further industry consolidation. If TAG is allowed to expire at year-end 2012, in a still fragile and uncertain economic recovery, large commercial and municipal transaction account deposits will be abruptly withdrawn from community banks in favor of the too-big-to-fail banks. I urge this committee to keep these deposits in the community where they are reinvested for the benefit of the community and to protect small business and municipal deposits by providing a 5-year extension of the FDIC TAG program.

### SEC registration relief

Finally, I'd like to thank the committee for passing H.R. 1965 which raised the threshold number of bank shareholders that triggers SEC registration from 500 to 2,000. Registration is a significant expanse and an update to the threshold trigger was long overdue. This provision, which was included in the Communities First Act, was a long-standing ICBA priority and we were extremely pleased to see it enacted into law as part of the JOBS bill.

## Closing

Thank you again for the opportunity to testify today. I hope that my testimony, while not exhaustive, gives you a sense of the sharply increasing resource demands placed on community banks by regulation and examination and what's at stake for the future of community banking. I can assure that the experience of First State Bank is broadly typical of our industry. On behalf of the nearly 5,000 members of ICBA and all community banks, I urge this committee to provide legislative relief to our industry in order to preserve our viability and directly aide the economic recovery and job creation. We look forward to working with this committee to craft urgently needed legislative solutions.