Testimony of Bradley E. Rock
On Behalf of the American Bankers Association
Before the
Subcommittee on Financial Institutions and Consumer Credit
Of the
Committee on Financial Services
United States House of Representatives

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Mr. Chairman and members of the Subcommittee, my name is Bradley Rock. I am Chairman, President and CEO of Bank of Smithtown, a 95-year old, $625 million community bank located in Smithtown, New York. I am also the Vice Chairman of the Government Relations Council and a member of the Community Bankers Council of the American Bankers Association (ABA). The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

I want to express our appreciation to you, Mr. Chairman, for your leadership in reducing unnecessary regulatory costs and for providing this forum to thoroughly discuss these issues. I would also like to acknowledge Congressman Bereuter, who throughout his many years in Congress has been instrumental in developing and passing legislation to reduce the regulatory burden.

I am glad to be here today to present the views of the ABA on the need to reduce the burden of red tape and paperwork. This is an important issue for ***all*** businesses, including banking. In my testimony, I would like to make three key points:

- The regulatory burden is not just a minor nuisance for banks – it has a significant impact on bank customers and local economies.

- The regulatory burden is significant for banks of all sizes, but pound for pound, small banks carry the heaviest regulatory load. The community bank, which has been the

cornerstone of economic growth in this country, is in great danger of being regulated right out of business.

- The review of regulatory costs by the federal bank regulators is very positive; results are what counts, however, and many bankers are skeptical that significant relief from the regulators is possible. It will take Congressional action to make a difference.

I will touch on each of these in the remainder of my statement.

I. The Regulatory Burden Has a Significant Impact on Bank Customers and Local Economies

Reviewing regulations and their impact on our businesses and communities should be an ongoing process, as the marketplace continues to change rapidly. Outdated laws and regulations only squander scarce resources of banks that could otherwise be used to provide financial services demanded by our customers. New laws, however well intentioned, have added yet more layers of responsibilities on businesses like ours. While no single regulation by itself is overwhelming to most businesses, the cumulative weight of all the requirements is overwhelming. It is like playing football against a defensive line that weighs 70 pounds more per player. New laws add heft to the regulatory burden like additional pounds increase the weight of an already massive defensive line. There is simply no way to advance the ball against such a barrier.

The burden of regulation has a significant impact on bank customers and local economies. Compliance costs are a significant drain on bank resources, taking precious resources away from meeting the needs of our customers. And every new law, regulation or rule added means two things: more expensive bank credit and less of it. This is likely to hurt small businesses the most, as they cannot go directly to the capital markets, yet need low-cost financing. The result is slower economic growth.

Over the past 25 years, the compliance burden has grown so large and is so pervasive throughout all levels of bank management that it is extremely difficult to measure. Research done by

the ABA and the Federal Reserve[1] in the 1990s indicates that the total cost of compliance ***today*** for banks would range from $26 billion to $40 billion per year. And these costs do not include the cost related to major legislation enacted in the last five years, such as the Gramm-Leach-Bliley Act, the Sarbanes-Oxley Act, the USA Patriot Act, and the FACT Act. Nor do these costs include the cumbersome layering of additional rules, issued by the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA), which are often focused on financial instruments and financial institutions. Nor do these costs include changes in existing regulations either (such as the recently effective changes for HMDA reporting), which occur with such regularity that it is the modern equivalent of Chinese water torture.

Compliance costs are expected to grow at an even faster pace in the coming years. As the table below illustrates, bank compliance officers are bracing for large increases in spending for document development and generation, consultants, outside attorneys, software and offsite record storage.

Projections for 2003 compliance spending over 2002 spending

(Figures in Percentages)

	UP	DOWN	EVEN
Consultants	29.3	13.0	57.7
Outside attorneys	22.2	12.2	65.6
Mystery shoppers	6.9	13.8	79.3
Software	26.4	9.3	64.3
Offsite record storage	22.0	4.9	73.2
Document development & generation	34.5	3.6	61.9

Source: *ABA Banking Journal*, June 2003

[1] "Survey of Regulatory Burden", American Bankers Association, June 1992; Elliehausen, "The Cost of Banking Regulation: A Review of the Evidence," Staff Study, Board of Governors of the Federal Reserve System, April 1998.

Certainly, some of the regulatory cost is appropriate for safety and soundness reasons. But consider the direct impact on bank lending and economic growth if this burden could be reduced by 20 percent and redirected to bank capital; it would support additional bank lending of $52 billion to $78 billion. This would clearly have a big impact on our economies. In fact, it represents nearly 10 percent of all consumer loans or 15 percent of all small business loans.

II. Community Banks Are In Danger of Being Regulated Right Out of Business

Regulatory costs are significant for banks of all sizes, but pound for pound, small banks carry the heaviest regulatory load. In 1996, Congress found that "small businesses bear a disproportionate share of regulatory costs and burdens."[2] For the typical small bank, about one out of every four dollars of operating expense goes to pay the costs of government regulation. For large banks as a group, total compliance costs run into the billions of dollars annually.

The cumulative effect of new rules and regulations will ultimately force many community banks to look for merger partners to help spread the costs; some will go out of business altogether. At a recent meeting of ABA's Community Bankers Council, we had a long discussion on the future of banking. Consistently, every banker mentioned regulatory burden as the first or second critical factor threatening the viability of his or her community bank over the next five years. In fact, many bankers and bank consultants believe that half of the banks in the U.S. will disappear in the next five years because of the regulatory burden and that only banks greater than $500 million in assets will have the capacity to meet their regulatory obligations. These are quite shocking comments as there are 8,000 banks with less than $500 million in assets and only 1,100 above this level. As my bank is just above that asset size, I can tell you, Mr. Chairman, the pressures to comply with all the regulations and still meet the demands of our customers are enormous. We feel that we must grow the bank rapidly to generate more revenues simply to pay for the ever-increasing regulatory cost. The sad part is that too much time and effort is now devoted to compliance and not to serving our customers.

Bankers at all levels, from bank directors and CEOs to compliance managers and tellers, spend endless hours on compliance paperwork. In fact, much of the burden of regulatory paperwork

[2] Small Business Regulatory Enforcement Fairness Act of 1996

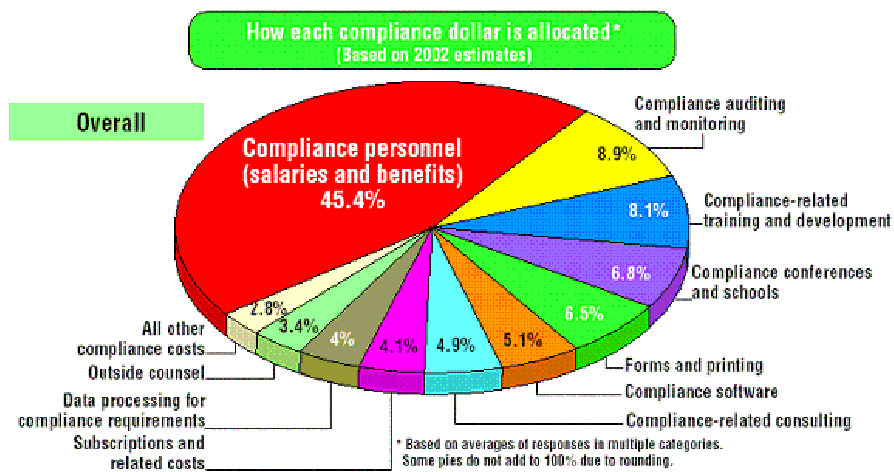
– for example, filling out hundreds of forms, providing reams of disclosure statements to loan customers and documenting virtually every community lending activity – falls heavily on tellers and loan officers. For example, HMDA alone requires the bank to complete 25 specific items on the Loan Application Register for every routine mortgage refinancing. Considering that more than 10 million mortgages were refinanced over the last three years and it is obvious that this is a huge reporting burden.

Considering the very high turnover for tellers and other business-line staff and the complexity of the regulations (particularly for mortgage lending), the training costs required to assure compliance with the many regulations is large and growing. In fact, compliance-related training and development and compliance conferences and schools, taken together, make up the second-largest portion of total compliance spending, after salaries and benefits.[3]

Compliance issues are discussed at virtually every meeting of the Board of Directors. I personally spend about one and a half days per week just on compliance issues. Some CEOs tell me that they are now spending nearly half of their time on regulatory issues. This means that for banking alone, CEOs spend over 5.5 million hours per year on compliance – time that could have been better spent on ways to expanding their businesses and to meet the changing needs of their customers.

Thus, compliance puts a big strain on manpower, especially at small banks. Large banks typically have many full-time employees devoted just to compliance. Many community banks cannot afford to have full-time staff for compliance. At Bank of Smithtown, every person in every department has major compliance responsibilities. Because of the complexities involved, my bank pays tens of thousands of dollars each year to an outside firm to help us with the big compliance issues. On top of this, one person on my staff has a full-time job just to coordinate all the activities throughout the bank related to regulatory compliance. Of course, labor costs are a small part of the entire cost required to meet all the compliance obligations that we have. In addition, banks spend billions annually on compliance training, outside compliance support (including accounting firms, consultants and attorneys), compliance related hardware and software, printing, postage, and telephone connections.

[3] *Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey.* ABA Banking Journal, June 2003. Sponsored by the ABA Banking Journal, ABA Compliance Executive Committee and Bankers Systems, Inc.



Source: *Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey.* ABA Banking Journal, June 2003.

I was shocked to learn from a banker this weekend that his bank – with only 20 employees – has had to add a full time person to complete reports related to the Bank Secrecy Act. Not only is this a huge expenditure of time and money, he and other bankers wonder if these reports are even being read. The cost vs. benefit analysis fails to make the case for many of the rules and regulations banks must follow, and the reports that we generate.

This banker is not alone. In fact, there are more than ***3,350 banks and thrifts with fewer than 25 employees; more than 1,000 banks and thrifts have fewer than 10 employees***. These banks simply do not have the human resources to run the bank *and* to read, understand and implement the thousands of pages of new and revised regulations, policy statements, directives, and reporting modifications they receive every year. In fact, according to the Small Business Administration's Office of Advocacy, the total cost of regulation is 60 percent higher per employee for firms with fewer than 20 employees compared to firms with more than 500 employees due to the fixed costs associated with regulations.[4]

To illustrate the magnitude of this burden on small banks, consider this: Each year the ABA publishes a book called the "Reference Guide to Regulatory Compliance." This ***600-page reference*** guide attempts to ***summarize and outline*** the requirements embodied in thousands and thousands

[4] Crain and Hopkins, "Impact of Regulatory Costs for Small Firms," Small Business Administration, Office of Advocacy, 2001

of pages of regulations promulgated from more than 50 statutory requirements. It covers 26 key requirements for consumer protection, ten for safety and soundness, eight on information reporting, seven on bank operations, and four on "social responsibilities" (such as CRA). The upcoming edition will no doubt have even more pages outlining the new responsibilities under the USA Patriot Act, the expanded HMDA reporting requirements, HIPAA requirements, additions under the Sarbanes-Oxley Act and the inevitable changes in regulations that occur every year.

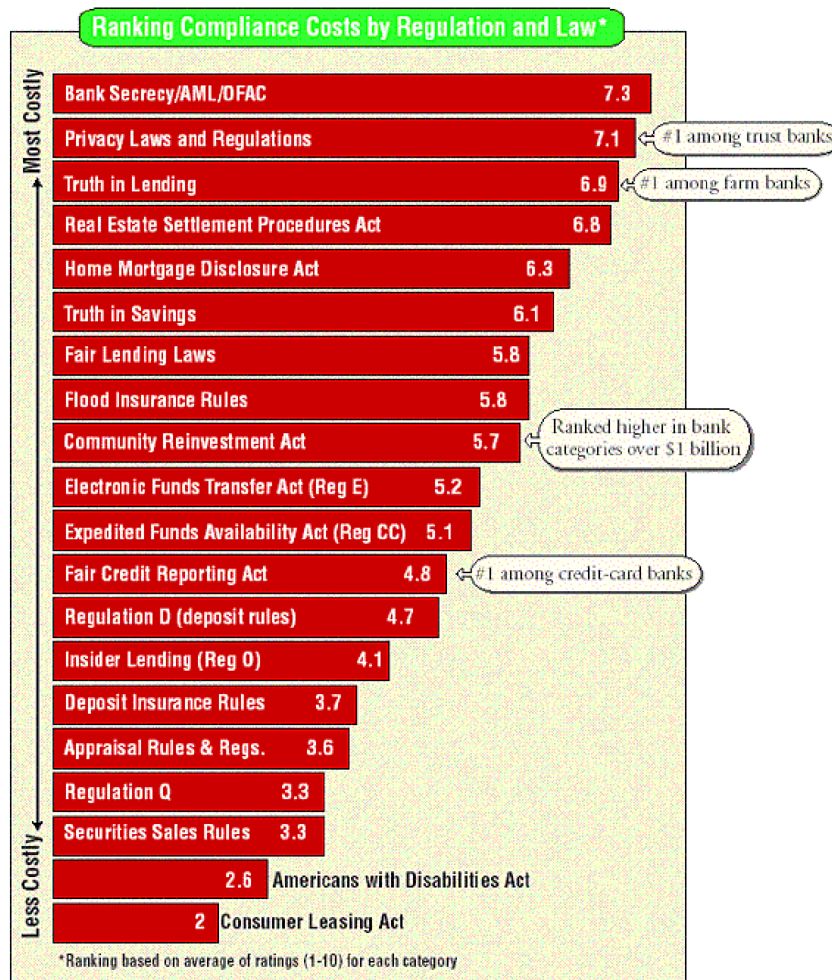
Moreover, this reference guide covers compliance obligation, but bankers face other call report and disclosure requirements by the banking regulators, and other new requirements from the SEC, FASB, PCAOB and AICPA.

In 2003, several Texas banks quantified the burden they face every day due to regulatory issues. One of those institutions, Austin Bank, a $600 million bank based in Jacksonville, Texas, calculated that its employees spend almost 31,500 hours annually on compliance issues. Almost 27,000, or over 85 percent of these hours are spent on Bank Secrecy Act or USA Patriot Act responsibilities at the bank. In excess of 14,000 of these hours alone are spent on currency transaction reporting.

Another institution, Southside Bank, Tyler, Texas, with $1.5 billion in assets, found that its employees spend over 13,000 hours annually on HUD, HMDA, CRA, and Truth in Lending Act compliance. The bank has found that while some regulations have real merit and do help the consumer, most consumers largely ignore the flood of disclosures they are presented with as part of a banking transaction. In addition, in the age of fast computers and quick decisions, the bank finds a real contradiction between meeting the technical requirements of regulatory disclosures and what their customers really are concerned about or interested in knowing, which is getting an account opened or a loan approved.

The experiences of these two banks are illustrative of a theme repeated consistently in the outreach meetings hosted by the regulatory agencies regarding the Congressionally-mandated review of existing regulations. It is clear from the comments of bankers at these meetings that the overwhelming burden is in statutes and regulations classified by the agencies as Consumer Protection and Anti-terrorism/Anti-money laundering. This corresponds with the most recent increases in

regulatory burden, including massive new HMDA reporting requirements, annual privacy notices, and extensive new USA Patriot Act requirements, including customer identification programs, and mandated responses to urgent law enforcement information requests. In fact, it appears that the great bulk of comments from bankers to the regulators about how to reduce the regulatory burden will fall into the two categories of consumer protection and anti-terrorism/anti-money laundering. The Chart below provides a ranking of the regulations based on their relative compliance cost.



Source: Compliance Watch, 2003. Nationwide Bank Compliance Officer Survey. ABA Banking Journal, June 2003.

Banks that are regulated by more than one bank regulatory agency have a particular challenge, in that opinions about what is correct or adequate with regard to certain regulatory requirements differ between agencies. Such banks currently lack one definitive answer about what is required and necessary to comply with any specific aspect of a regulation. Another challenge facing institutions is

the fact that compliance regulations can come from a variety of sources, including HUD and FTC for instance, that are not familiar with the banking industry and how it functions, and are not sensitive to the cumulative costs and burdens of compliance.

Sensitivity to the overall regulatory burden further needs to consider what new changes are being required of the industry from other standard setters, such as the SEC, FASB, PCAOB, and AICPA. The system lacks monitoring of the overall increasing regulatory and reporting burden on financial institutions. Just over the last few years, numerous accounting changes have been issued and have cost the industry an enormous amount of valuable staff time and money to implement. A few of the most recognizable rules include: fair value disclosures, accounting for derivatives, accounting for guarantees, accounting for loan loss reserves, accounting for special purpose entities, and accounting for purchased loans. These rules are being issued at a very rapid speed with an extraordinarily short amount of time given to implement them; this presents a significant challenge to all banking institutions. Moreover, we are concerned that a significant amount of time, effort and expense has been directed to rules that have not been demanded by investors and will not be used or even understood by them.

This year banks are also experiencing large increases in annual auditing fees as a result of the Sarbanes-Oxley Act and new rules developed by the PCAOB. Like many other community banks, my bank's accounting fees will double this year, and I see very little resulting additional benefit for our investors or our customers. Many publicly traded community banks are exploring whether to de-register under the Securities Exchange Act of 1934 because the huge regulatory expenses and the doubling – and even tripling – of accounting and legal costs that result directly from Section 404, Management Assessment Of Internal Controls, and other provisions of the Sarbanes-Oxley Act.

Another rule maker that I am compelled to mention is the International Accounting Standards Board (IASB). Although I am a community banker, and currently do not have to follow rules issued by the IASB, there is a rapid movement in the U.S. to converge accounting and reporting required by the FASB with those of the IASB. As the convergence continues, more and more demands will be placed on the industry that will require systems changes, process changes, and an increase in reporting requirements – and at what cost?

ABA believes there is a serious need to look periodically at the total picture of all new rules and requirements placed on the industry, prioritize those requirements, and assess what is immediate and what can be implemented over time.

The bottom line is that too much time and too many resources are consumed by compliance paperwork, leaving too little time and resources for providing actual banking services. I'm sure I speak for all bankers when I say that I would much rather be spending my time talking with our customers about their financial needs and how my bank will fulfill them than poring over piles of government regulations. The losers in this scenario are bank customers and the communities that banks serve.

III. Federal Banking Agency Review of Regulations Must Show Results; Congressional Support for Reduction is Critical

Congressional initiatives to roll back unnecessary regulation have created an environment within the bank regulatory community that has encouraged review, streamlining and even elimination of some unnecessary regulations. In fact, the agencies have made considerable progress in the last five years in improving some of their regulations. Nonetheless, not all of the agencies' regulations have been so revised, although we certainly recognize that, in many cases, the agencies are constrained by the language of statutes in reducing the burdens in a meaningful fashion.

We are hopeful that the current review of bank regulations, required under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), will provide meaningful relief. We applaud the openness of the banking regulators to the concerns of the industry as they conduct this review. Attachment 1 provides some of the key concerns communicated to the regulators in this process from ABA.

Doubt exists as to whether this effort will be – or even can be – successful in achieving a meaningful reduction in the burden. Most bankers have seen previous efforts at regulatory relief come and go without noticeable effect, while the overall level of regulatory burden has kept rising. Results are what matters.

There is a dilemma here: at the same time that the regulatory agencies are undertaking a review of all regulations with an eye toward reducing the overall compliance burden, they must promulgate new rules for the new laws that Congress has enacted. Simply put, any reduction in existing compliance obligations is likely to be obliterated by compliance requirements of new regulations implementing new laws. The hours that Austin Bank has devoted to compliance with the Bank Secrecy and USA Patriot Act shows how overwhelming new obligations can be.

We expect similar compliance energy to be expended when the numerous FACT Act provisions become effective. While ABA strongly supported that Act and commends Congress for its passage, some provisions of that act will impose additional new burdens. We strongly urge Congress to emphasize to the various agencies responsible for implementing the FACT Act regulations that those agencies be sensitive to compliance burdens when promulgating the regulations.

It should be noted that even when Congress has acted to reduce a burden, the agencies have at times not followed through. For example, in 1996, Congress amended RESPA so as to reduce the amount of information that must be provided to mortgage customers relating to a lender's sale, transfer or retention of mortgage loan servicing. This change eliminated the requirement that lenders provide historical data on the likelihood of this transfer and that customers acknowledge receipt of this information in writing. ***HUD has never implemented this statutory change to RESPA***. Thus, since 1996 HUD's regulation continues to require language in the disclosure form, which Congress struck from the statute. This creates an unnecessary burden on banks.

Bankers continue to be concerned about "the uneven playing field" in compliance between depository institutions and other financial institutions. While bankers spend increasing amounts of time and money dealing with regulatory red tape, non-bank competitors, including money market funds and mutual funds, are selling savings and investment products to bank customers. The same is true of the local credit union and the Farm Credit System, both of which are free from much of the red tape and expenses imposed on banks. Even when the regulatory requirement is the same on paper, such as the case with the Truth in Lending requirements, non-bank competitors are not subject to the frequent, in-depth, on-site examination that banks are subject to. The result is slower growth for banks, leaving fewer community resources available for meeting local credit needs.

Bankers know that their loans will be examined for consumer compliance at least once every two years. They also know that nonbank lenders will not have their loans examined, probably ever, because the Federal Trade Commission and the state agencies that have jurisdiction over them do not have the examination and supervision infrastructure to do so. One solution is to fund, by assessment of the nonbank lenders, if necessary, a real supervisory examination program to stop some of the consumer abuse and predatory lending that we hear about constantly. Congress should ensure that the FTC has the resources to actually enforce against nonbank lenders the consumer protection laws currently in effect.

Importantly, the EGRPRA mandate encompasses more than just regulatory action: it calls for the agencies to advise the Congress on unnecessary burdens imposed by statute, which the agencies cannot change but the Congress can. As noted, in many cases, meaningful compliance burden reduction cannot be achieved absent statutory changes. Mr. Chairman, we hope this Subcommittee will seriously consider the recommendations made under this effort.

Conclusion

In conclusion, the cost of unnecessary paperwork and red tape is a serious long-term problem that will continue to erode the ability of banks to serve our customers and support the economic growth of our communities. We thank you for continuing to look for ways to reduce the regulatory burden on banks and thrifts, and to restore balance to the regulatory process. Mr. Chairman, the ABA is committed to working with you and the members of this subcommittee to achieve this goal.

Attachment 1

Some Specific Regulatory Concerns

ABA has raised several broad concerns with the bank regulators in comment letters on the EGRPRA review. First, the agencies need to consider the overall bank regulatory burden in making any new regulatory proposals, whether they are changes to existing regulations or implementation of new ones. Consider, for example, the major changes to the Home Mortgage Disclosure Act data collection and reporting requirements of Regulation C adopted by the Fed in December of 2001. Originally, the Fed would have required that the new data be collected in 2003, but the number of changes and the complexity involved were so great that the Fed subsequently amended the rule to require most data to be collected beginning in 2004.

The changes include a new census tract reporting system that uses five rather than four identifiers; a complex new reporting of whether applicants are of Hispanic ethnicity and of reporting from which races from a multiple racial designation system is the applicant; whether the loan is for a manufactured home; whether the loan is a HOEPA loan; whether the loan is secured by a first lien, junior lien or no lien; the rate gap on loans secured by a first mortgage that are more than three percent higher than similar term Treasuries, if a first lien, or five percent higher, if a junior lien; a change in the definition of home improvement loans; a major change in the definition of refinance that captures for the first time significant numbers of commercial loan refinancings; newly requiring government monitoring information on ethnicity, race, and gender on telephone applications; a requirement making preapprovals of loans subject to HMDA reporting; and a new identifier for a purchaser of the loan. ***Almost all home mortgage applications had to be revised and reprinted, every telephone and electronic application system had to be revised, every automated computer system for HMDA data collection had to be extensively reprogrammed, and virtually every mortgage lending officer had to be retrained in order to implement these changes***. The industry is still staggering under the burden of adjusting to the burden of these changes.

Agencies should also always take into account regulatory burden arising from those other regulators and rulemakers. There are examples where this has not occurred. For example, the Department of Housing and Urban Affairs recently proposed a significant revision of Regulation X

which implements the Real Estate Settlement Procedures Act that was inconsistent with the closely related existing Truth in Lending Act regulations, promulgated by the Federal Reserve Board. If adopted, it would have created much new burden and great confusion. Thus, we believe that it is not enough just to review banking regulations. The agencies and the industry need to review the entire burden of regulation on banking.

Second, bankers are concerned that some regulatory proposals from the agencies suggest that the staff members writing the proposals are not as familiar with banking practice and the current level of regulatory burden as they might need to be. For example, the existing HUD requirement that hazard insurance and property taxes for junior liens and home equity loans be disclosed on the Good Faith Estimate and HUD-1 creates regulatory burden for banks and confusion for their customers. Frequently a bank does not have access to this information and must ask the customer for such information in order to provide disclosures back to the customer. At the same time, the customer is confused because the hazard insurance and property taxes disclosed are already paid as escrowed in servicing the first lien. Eliminating this redundancy will benefit lenders and their customers.

ABA believes that familiarity is crucial to reducing the regulatory burden, to minimize ***changes*** to existing regulations as much as possible and to avoid new regulations. ABA is concerned that the cost and burden of regulatory changes and new requirements are often underestimated. It is assumed that a new disclosure or revision to an existing disclosure means simply purchasing the new forms and software. But it usually involves much more. Banks must always look for changes to existing regulations and new requirements, review them, make necessary modifications, order new forms and programs, revise websites and advertisements, educate staff, prepare staff for customer inquiries, and implement auditing measures. As one banker put it, "Just hold still!"

The agencies also could be more sensitive to regulatory burdens and costs when proposing changes to regulations. A good example is the Federal Reserve Board's (Fed) proposal in late 2003 to alter the meaning of "clear and conspicuous" for virtually all required consumer protection disclosures. While well intentioned, the Fed's staff seemed unaware that all forms, all documents, all software programs, all advertisements, websites, education materials, etc., would have to be reviewed, revised, and redistributed and that staff would have to be reeducated. The Fed's staff also seemed to equally underestimate the costs associated with potential litigation, both the actual costs as well as the

costs associated with litigation avoidance, all well-documented costs. And yet, there is little if any evidence that the existing disclosures are inadequate so as to justify enormous new compliance costs.

The March 2003 amendments to Regulation B and its Commentary involving joint applications provides another example of how regulatory changes, which appear to be minor, can create confusion and compliance burdens. The Fed modified the regulation to clarify the need for creditors to document that co-applicants have applied for a loan. The Fed also added language to the model forms so that applicants could specifically indicate whether they were applying jointly or individually.

While the Fed stated that written applications are not necessary (except where otherwise required) and that model forms are optional, some institutions and examiners incorrectly concluded that the changes required written applications and that the language added to the model forms is mandatory. Some agency examiners also asserted that certain common secondary mortgage forms no longer complied. On this basis, some creditors altered their forms.

The bottom line is that even though an Agency may issue an advisory that revisions or procedures are optional, compliance officers see a significant risk in not adopting what seems to be sanctioned forms or language. Retaining current forms along with new language would reinforce the concept of flexibility and choice.

Third, we believe that the Paperwork Reduction Act has outlived its usefulness as a mechanism to achieve meaningful reductions in regulatory burden. Amendments to the law in 1995 removed from judicial review approvals of paperwork collections by the Director of OMB. This essentially eliminated any effective challenge to new paperwork burden by banks and their trade associations. Since then, the filings by the agencies and the review of them by the OMB have become just routine. Moreover, responses to OMB requests for comment on the paperwork burden have apparently dropped to almost nothing, since virtually every request for maintenance or additional paperwork is approved under the current process. Thus, commenting would be a waste of precious time. Simply put, the Paperwork Reduction Act is not effective in reducing or preventing additional paperwork and may just be serving to increase agency paperwork.