Testimony of

William A. Loving

President and CEO
Pendleton Community Bank
Franklin, West Virginia

On behalf of the
Community Bankers of West Virginia

Before the

Congress of the United States
House of Representatives
Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

Field Hearing on

"An Examination of the Challenges Facing Community Financial Institutions in West Virginia"

August 20, 2012
Charleston, West Virginia

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is William A. Loving, Jr., and I am President and CEO of Pendleton Community Bank, a $250 million asset bank in Franklin. Thank you for convening this field hearing here in Charleston to examine challenges facing community financial institutions in West Virginia.

Strong, vibrant community banks will play a critical role in the future prosperity of our state. I deeply appreciate you raising the profile of the serious challenges we face, and I'm pleased to testify on behalf of the Community Bankers of West Virginia. I would also like to note that I serve as Chairman-Elect of the Independent Community Bankers of America.

Speaking for the thousands of community bankers of the CBWB and ICBA, I can assure you that growing regulatory complexity and compliance costs is a top concern. In particular, the proposed rules to implement Basel III are a cause of serious alarm among community bankers. Basel III may be the gravest regulatory threat we face today and has the potential to trigger a wave of consolidation that will remake the financial industry to the harm of the communities of West Virginia. Exemptions for community banks will ensure that we are not overly burdened by international standards that are not appropriate for banks like mine serving communities in West Virginia.

But before detailing our concerns with Basel III and other regulations, it's worth considering why the preservation of the community banking industry in West Virginia and elsewhere is so important and should be a priority for policymakers. Community banks serve the credit and other financial needs of rural, small town, exurban, and suburban customers and markets that are not comprehensively served by large banks. For that reason, we will play a significant role in any broad based economic recovery. Our business is based on longstanding relationships in the communities in which we live. We make loans often passed over by the large banks because a community banker's personal knowledge of the community and the borrower provides firsthand insight into the true credit quality of a loan, in stark contrast to the statistical model used by a large bank in another state or region of the country. These localized credit decisions, made one-by-one by thousands of community bankers, will restore our economic strength.

When community banks thrive they create a diverse, competitive financial services sector offering real choice, including customized products, to consumers and small businesses alike. An economy dominated by a small number of large banks wielding undue market power and offering commodity products would not provide the same level of competitive pricing and choice. Promoting a vibrant community banking sector is an important public policy goal.

Community bank regulatory burden must be reasonable, manageable and calibrated to the actual level of risk they pose to individual customers and to the financial system. Community banks did not cause the financial crisis nor have we engaged in abusive practices that were pervasive in the lead-up to the crisis such as trading in exotic financial instruments or making mortgage loans with little chance of being repaid. Community banks should be shielded from the regulatory onslaught triggered by the crisis. Overreaching and overly complex regulation of community banks is unwarranted and imposes a disproportionate burden on them. Unlike large banks, we don't have large in-house legal and compliance teams and cannot amortize the cost of compliance over a large asset base. Even the "hard costs" of compliance do not tell the full story. Soft costs – harder to measure but of no less impact – have also increased dramatically. Employee turnover is a good example of a soft cost. Regulatory complexity causes employee turnover and increases the cost of turnover because of the expense of training new employees to comply with increasingly complex rules.

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. Pendleton Community Bank survived the Great Depression and many recessions since that time. 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 to our success. The compliance costs that we are now incurring are vastly out of proportion to any risk we pose.

New regulations have been layered on for decades but they are rarely repealed or revised. The result is a nearly unmanageable burden that is quickly approaching a tipping point where the community banking model is no longer feasible due to excessive regulatory costs.

Basel III

Regulations touch every aspect of a community banker's business. I'd like to start with a topic that is current and that is setting off alarms among community bankers in West Virginia and across the nation – the proposed rules to implement the Basel III capital standards. Unchanged, these rules have the potential, by themselves and in conjunction with many other regulatory burdens, to make community banking itself a losing proposition and trigger further industry consolidation. Today, just four banks control some 40 percent of the nation's deposits. Increasing regulatory burden will accelerate that trend, and Basel III, on top of everything else, could well spell the demise of community banking before the end of the decade.

I will note here just a few of the top concerns we have with Basel III:

- New risk weights on certain residential mortgages will impose punitive capital charges on all but standardized, "plain vanilla" loans. What's more, because of their complexity, the new risk weights will be exceedingly difficult to comply with without incurring significant software upgrades and other operational costs. Customized home loans like balloon loans – a staple of community banking – will be severely penalized with new capital constraints during a fragile housing recovery. This strikes right at the heart of the community banking model. Our direct knowledge of the community and often the borrower him or herself allows us to underwrite loans tailored to the unique needs of the borrower – loans that larger lenders are unwilling to make. It is critical that we overturn these punishing risk weights, which are also troublesome for certain types of commercial loans and nonperforming loans. We recommend that community banks have the option of continuing to use the current Basel I risk weights.

- Accumulated other comprehensive income (AOCI), a component of shareholders' equity that represents unrealized gains and losses on certain investment securities held at fair value, should not be included in regulatory capital. AOCI, as a result of a fair value measure, introduces volatility in capital that does not represent a bank's ability to absorb future losses. Additionally, in this ultra low interest rate environment, banks have been carrying large positive AOCI balances that will quickly evaporate with any meaningful rise in interest rates, which, we can all agree, will eventually occur. Larger banks have tools at their disposal to minimize the impact of AOCI on regulatory capital; community banks do not and would therefore be subject to the greatest amount of capital volatility.
- We oppose the phase-out of Tier 1 treatment of trust preferred securities (TRUPS). We believe the intent of Section 171 of the Dodd-Frank Act, commonly known as the Collins Amendment, was to permanently grandfather Tier 1 treatment for TRUPS issued prior to May 19, 2010 by bank holding companies with less than $15 billion in consolidated assets. TRUPS are a reliable source of capital for community banks and one that would be difficult to replace.
- Community banks should be given more time to meet the proposed minimum regulatory capital levels. Unlike their larger too-big-too-fail counterparts, community banks do not have access to the capital markets to raise new capital. All new regulatory capital must come from retained earnings, which is difficult to accumulate today. Artificially low interest rates make it very difficult for community banks to generate the earnings needed to meet regulatory capital minimum levels. More time is needed to ensure community banks can meet the proposed requirements for adequate capitalization. We recommend that community banks be allowed to extend the phase-in schedule for minimum regulatory capital by at least five years.

Basel III was meant to apply to the largest, interconnected, internationally active and systemically important banks. Applying the same regulatory capital standards to community banks – in a one-size-fits-all fashion – demonstrates a failure to appreciate the fundamental distinctions between banks like mine and the largest banks. West Virginia, as a largely rural state, would be significantly disadvantaged by a banking system dominated by a handful of large banks. But Basel III will put us on a fast track to just such a system. Though the rules do not become fully phased in until 2019, examiners are already beginning to apply them in the field. I urge this subcommittee to support our efforts to exempt community banks from Basel III.

To understand why Basel III is such a grave threat to community banks, consider the many other recent and pending regulations that are reshaping the regulatory landscape for community banks, particularly in the critical area of mortgage lending. 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. This complexity will only get worse. New underwriting standards, risk retention requirements, new servicing standards, escrow requirements, and new rules governing the use of disclosures will all be finalized and take effect in the coming months.

In the limited space of this testimony, it is impossible to enumerate our concerns with the gamut of these new rules. I will focus on a select few beginning with the Consumer Financial Protection Bureau's proposed ability-to-repay, or "qualified mortgage," regulations.

Ability-to-Repay Determination in Mortgage Underwriting

The CFPB proposal requires mortgage lenders to determine the borrower's ability-to-repay a mortgage before extending credit and provides an exemption from this requirement for "qualified mortgages" (QM). Because the ability-to-repay determination exposes the lender to significant legal liability in the event of default, the QM definition, and the legal protection provided to lenders for mortgages that meet the definition, will determine whether mortgage lending is an acceptable risk for community banks. We urge the CFPB to provide a "safe harbor" legal protection standard for QM loans, as opposed to a "rebuttable presumption," a much weaker standard that exposes lenders to ongoing legal liability. We thank Chairman Capito, Representative Sherman, and the 90 members of the House, including many who serve on the Financial Services Committee, for their recent letter to the CFPB in support of a safe harbor standard. Without a safe harbor many community banks will withdraw from the market, making it less competitive and more costly for borrowers. Many rural areas and small communities would be left with no or extremely limited access to mortgage credit. Without a safe harbor, the ability-to-repay provision would harm the very borrowers it is intended to help and would seriously impede the housing recovery.

We also urge the CFPB to include in the safe harbor balloon mortgage loans held in portfolio by the originating banks for the life of the loan, regardless of where and to whom the loans are made. Community banks provide these loans as a service to their customers, especially in smaller markets and rural areas where loans may be ineligible for sale into the secondary market due to property or borrower characteristics. Community banks have a vested interest in the performance of loans held in portfolio.

Municipal Advisor Registration

Another concern for community bankers is the new 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. We strongly support legislation introduced by Rep. Robert Dold, H.R. 2827, to provide an exemption for financial institutions and their employees from this onerous and over-reaching requirement. We thank the committee for passing H.R. 2827 and will work with you to advance it into law.

Regulatory examinations

In addition to the proposed regulations I have mentioned, and many others I could have mentioned, 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. As examiners begin to apply the new Basel III standards, which is already occurring well in advance of their formal effective date of 2019, the exam environment will further suffocate community banks' ability to lend and exacerbate the current economic downturn.

The Financial Institutions Examination Fairness and Reform Act (H.R. 3462) will go a long way toward improving the oppressive examination environment 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, frustrating, and ineffective. 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.

Temporarily Extending the Transaction Account Guarantee (TAG) Program

I would also encourage Members to support a temporary extension of full FDIC coverage of non-interest bearing transaction accounts. Transaction accounts, which have no restrictions on withdrawals, are typically used by businesses of all sizes as well as municipalities, hospitals and other nonprofit organizations to meet payroll and operating expenses. With so much uncertainty hampering the economy – from the looming "fiscal cliff" to unstable foreign and domestic markets – the last thing small businesses need is for the full insurance on their business accounts to expire.

With $1.4 trillion (or 20% of all domestic deposits) insured under this coverage, Congress should not ignore the danger of the sudden withdrawal of insurance if the program expires as scheduled at year-end 2012. Once-stable deposits will become "hot money" that could flee an institution at the click of a mouse in pursuit of a higher interest rate or the implicit government guarantee of a too-big-to-fail institution. The abrupt shift in funds an expiration of TAG could trigger could easily destabilize the recovering banking system, curtail credit, and threaten the fragile economic recovery.

Closing

Thank you again for your commitment to the community banks of West Virginia and for the opportunity to testify today. I've outlined some of the more significant regulatory challenges we face in the months ahead. We ask for this committee's help in providing regulatory relief for community banks so we can better serve our communities and promote the economic recovery – a goal we share with this committee. Thank you for hearing our concerns. We look forward to working with you.