JEB HENSARLING, TX, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Committee Majority Staff

Date: April 11, 2013

Subject: April 16, 2013 Subcommittee on Financial Institutions and Consumer Credit Hearing on "Examining Community Bank Regulatory Burdens"

The Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on "Examining Community Bank Regulatory Burdens," at 10:00 a.m. on April 16, 2013, in Room 2128 of the Rayburn House Office Building. This will be a one-panel hearing with the following witnesses:

- Mr. Ken L. Burgess, Chairman, First Bancshares of Texas, Inc., on behalf of the American Bankers Association
- Mr. Charles G. Kim, Executive Vice President & Chief Financial Officer, Commerce Bancshares, Inc., on behalf of the Consumer Bankers Association
- Mr. William A. Loving, President & CEO, Pendleton Community Bank, on behalf of the Independent Community Bankers of America

Background on Community Banks

In December 2012, the FDIC issued its Community Banking Study,[1] which was commissioned by FDIC Chairman Marty Gruenberg to examine the challenges and opportunities facing community banks. The study shows that community banks hold the majority of banking deposits in U.S. rural counties, and that in more than 600 counties—or almost one in five counties—there are no physical banking offices except those operated by community banks. The study also shows the positive impact community banks have on entrepreneurship. As of 2011, community banks held 14 percent of banking industry assets, but made 46 percent of the industry's small-denomination loans to farms and businesses.

Understanding Regulatory Compliance Costs

Regulatory compliance costs fall into two categories: costs that result from regulations that prevent an institution from engaging in certain activities, and costs that result when regulations require an institution to perform certain actions. For instance, when a regulation is

[1] Federal Deposit Insurance Corporation, "Community Banking Study," December 2012, *available at* http://www.fdic.gov/regulations/resources/cbi/study.html.

proposed, an institution may incur legal expenses from hiring lawyers to interpret the regulation and comment on its possible impact. After the regulation has been finalized, an institution may continue to incur legal expenses to hire lawyers to review its procedures and forms to ensure that it complies with the regulation; administrative expenses for coordinating compliance activities and designing internal audit programs; training expenses; information technology expenses for programming and testing software; compliance costs for designing, printing and mailing new forms and other disclosures; and managerial expenses for monitoring employees' compliance with the regulations and making records and employees available for examinations by regulatory agencies. Because smaller institutions do not have the same economies of scale of larger institutions, these costs can disproportionately impact a smaller institution's ability to offer competitive pricing for their services.

For decades, financial institutions have registered concerns with policymakers about compliance costs, claiming these costs are ballooning rapidly and threatening the economy by diminishing their ability to offer loans and discounted services to their customers. Despite these complaints, Congress has increased the regulatory burdens on financial institutions over the years by enacting more laws that result in additional regulation. At the same time, rationalizing and streamlining existing regulations has not been a legislative or regulatory priority, particularly in the wake of the financial crisis, which resulted in even more regulation.

Expansion of Regulations since the Financial Crisis

In the wake of the financial crisis, financial institutions have been confronted by even more regulations promulgated under laws like the Credit Card Accountability Responsibility and Disclosure Act (P.L. 111-24) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). The Dodd-Frank Act established several new government agencies—such as the Consumer Financial Protection Bureau (CFPB), the Office of Financial Research (OFR), and the Financial Stability Oversight Council (FSOC)—and directed these new agencies and existing ones to promulgate more than 400 new rules. The Dodd-Frank Act also mandated changes to several business practices, such as limiting the amount that financial institutions could charge for processing debit card transactions. Proponents of these regulations contend that although financial regulations may impose costs on financial institutions and reduce the availability of credit, the alternative is a bigger cost borne by the public in the form of financial institution failures and credit busts that follow booms fueled by imprudent lending.

Nonetheless, these increased regulatory costs are significant. A PricewaterhouseCoopers survey estimated that regulatory changes will likely depress revenues, increase operating costs, and squeeze community bank profits.[2] In that survey, nearly 90 percent of banking industry leaders cited over-regulation as the biggest threat to business. Financial institutions also point to the 2012-2013 edition of the Bureau of Labor and Statistics' Occupational Outlook Handbook,

[2] "Banks' Best Customer May Be the Stranger Who Just Walked Out the Door, says PwC US," July 13, 2011, *available at* http://www.prnewswire.com/news-releases/banks-best-customer-may-be-the-stranger-who-just-walked-out-the-door-says-pwc-us-125481958.html.

which states that "employment of financial examiners is projected to grow 27 percent from 2010 to 2020, faster than the average for all occupations."[3]

The Difficulty in Tracking Compliance Costs

The FDIC Community Banking Study also addressed regulatory costs for community banks, concluding that while the effect of regulation on lending and the economy is an important issue, measuring that effect presents substantial challenges. The study summarizes interviews the FDIC conducted with nine community bankers on the impact of regulatory compliance costs on their banks. Most of the participants stated that no one regulation or practice had a significant effect on their institution; rather, it was the cumulative effects of all regulatory requirements that weighed down their bank. Nonetheless, several bankers identified certain laws as being particularly burdensome, including the Home Mortgage Disclosure Act, Unfair and Deceptive Acts and Practices, Fair Lending, Bank Secrecy Act, USA Patriot Act, Privacy Notices, and Electronic Funds Transfer Act.

The bankers interviewed also stated that they do not track regulatory compliance costs within their banks' internal cost structures because it is too time-consuming, costly, and so interwoven into their operations that it would be difficult to break out the specific costs. They did, however, note that they can identify direct costs associated with regulatory compliance, such as compliance personnel salaries, employee training, consulting fees, external and internal audit fees, and specific software and hardware costs.

A majority of the bankers interviewed also reported that their banks are increasingly relying on third-party consultants and service providers to assist with interpreting and implementing new or changing rules and regulations, citing their inability to understand and implement regulatory changes within required timeframes and their concern that their method of compliance may not pass regulatory scrutiny.

Consolidation in the Community Bank Sector

Community banks are more sensitive to increased compliance costs than larger financial institutions, particularly those perceived by the market and regulators as being "too big to fail." These increased compliance costs, along with the recent economic instability, have fueled overall declines in banks' net-interest income. Many financial institutions have responded by increasing their fees and eliminating customer services such as free checking.

Financial institutions find themselves facing not only more regulations but more aggressive enforcement by regulatory agencies, which further increases compliance costs. According to trade associations that represent community banks and credit unions, supervisory agencies have been more critical in their examinations, less tolerant of minor compliance infractions, and quicker to downgrade examination ratings. As a result, more financial institutions have been subject to enforcement actions in recent years. Defending against negative

[3] Bureau of Labor Statistics, U.S. Department of Labor, *Occupational Outlook Handbook, 2012-2013 Edition,* Financial Examiners, *available at* http://www.bls.gov/ooh/business-and-financial/financial-examiners.htm.

supervisory findings and implementing the required remediation absorbs management time and financial resources.

If compliance costs increase past the point of economic sustainability, many smaller institutions may merge with larger entities. Already, many community banks have disappeared during the consolidation trend of the past three decades. The FDIC's Community Banking Study found that the number of federally insured banks decreased from nearly 18,000 in 1984 to over 7,000 in 2011. Of the banks that exited the industry during that time frame, 17 percent failed, 49 percent merged with an unaffiliated bank, and another 32 percent consolidated with other charters within their existing bank holding company. Banks that closed the study period with assets greater than $10 billion directly or indirectly absorbed 57 percent of the charters that exited the industry between 1984 and 2011.

Industry observers predict that if community banks are subjected to over-regulation, consolidation will continue. Community banks face particularly difficult challenges in raising new capital and dealing with the increased expense of complying with new rules, accounting standards, and reporting requirements. For this reason, some commentators have urged Congress to reject a "one size fits all" regulatory policy and instead adopt a tailored approach to regulation that considers the special requirements of community financial institutions.[4]

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[4]*See, e.g.,* William M. Isaac & Robert H. Smith, "Viewpoint: Burying Small Banks Alive," *American Banker,* Apr. 1, 2011, available at http://www.americanbanker.com/bankthink/regulations-are-burying-small-banks-alive-1035395-1.html; Barbara A. Rehm, "Editor at Large: It's Time to Right-Size Regulation," *American Banker,* Mar. 24, 2011, *available at* http://www.americanbanker.com/issues/176_57/community-bank-regulation-1034870-1.html?zkPrintable=true.