Testimony of

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Before the

United States House of Representatives
Subcommittee on Financial Institutions and Consumer Credit

Field Hearing on

"An Examination of the Challenges Facing Community Financial Institutions in Texas"

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Opening

Chairman Capito, Ranking Member Maloney and members of the Subcommittee, I am Cliff McCauley, Senior Executive Vice President of Frost Bank in San Antonio, Texas. Frost is a $19 Billion bank, with all of our offices in Texas, and has been in existence since 1868. I am responsible for Frost's Correspondent Banking line of business, and in that capacity, have the opportunity to deal directly, and communicate frequently, with community bankers throughout the state of Texas. Additionally, I am honored to have served as Chairman of The Independent Bankers Association of Texas (IBAT), and I remain very active with that organization.

We very much appreciate you convening this hearing to explore the challenges facing community banking at this juncture in history. As I began to prepare this testimony as well as my oral presentation, I was struck by the overwhelming number of significant issues impacting this sector of the financial services industry. My intention in this testimony is to highlight many of these challenges, and will be happy to further discuss any of these issues at the appropriate time, or follow up with you or your office.

Legislative Issues

Community banks play a key role in the economic health and vitality of communities across Texas and the nation. We as an industry continue to fund a disproportionately large percentage of agriculture and small business loans, and provide a meaningful alternative to consumers who opt not to bank with a large or not-for-profit institution. In the midst of a serious recession, the important contributions community banking makes to the overall health and well-being of our economy on both a micro and macro basis are becoming clearer as are the vast differences between our business model and that of the largest banks. Our member banks did not participate in, nor profit from, the excesses that contributed to the meltdown in the financial services industry. Yet sadly, we are paying dearly for the inappropriate behavior of others in the form of depressed real estate markets, increasing competition from government subsidized and too-big-to-fail competitors, additional regulatory burden, nervous customers and anxious regulators. The present economic conditions and regulatory environment only exacerbate an already difficult competitive environment. Key legislative issues for community banking in the 112th Congress include:

Regulatory Burden. The passage of landmark banking legislation in the 111th Congress, along with legislative and regulatory responses to address the financial crisis, have had and will have a significant effect on the community bank business model. Perhaps the most significant positive to come out of the debate on Dodd-Frank was the virtually universal acknowledgement that community banks "are different", are important and needed to be treated as such. We are hopeful that this recognition will translate into legislative and regulatory initiatives to assist – or at least unfetter - the community banking industry going forward.

In attempts to correct the bad behavior of other sectors of the financial services industry, community banking has frequently been "caught in the backwash." Many of our banks are struggling mightily to keep up with the virtually constant onslaught of new regulatory requirements and in some cases, a much harsher examination protocol. The absorption of added compliance expense, not to mention the difficulty in attracting and compensating the necessary staff, is much more problematic for a smaller institution. Ultimately, many of these institutions will simply opt to sell or merge with a larger entity as the cost of compliance continues to increase past the point of economic sustainability.

There is tremendous concern regarding the future, especially as the Consumer Financial Protection Bureau (CFPB) begins to exercise its very broad Congressional mandate. We urge both the CFPB and the prudential regulators to carefully consider the impact of any new regulations, guidelines or directives (as well as the cumulative effect of many seemingly innocuous requirements) on the community banking sector prior to issuance. Any new regulatory initiatives should be measured and not inadvertently increase regulatory burden and costs, disrupt the marketplace nor create disincentives for legitimate borrowers and lenders.

IBAT is currently working with the Independent Community Bankers of America (ICBA) and other interested parties to generate support for “The Communities First Act” (**H.R. 1697** and **S. 1600**). This important legislation provides for meaningful and necessary regulatory and tax relief for the community banking sector. We have long advocated a “bifurcated” industry, and encourage serious consideration of a separate regulatory scheme, and perhaps a separate charter for non-complex, “stick to the basics” community banks. We are absolutely committed to ensuring a viable future for the community banking industry, and look forward to working with those who share in this passion.

Regulation Q. In an eleventh hour amendment to the Dodd-Frank Act, over 70 years of banking practice was discarded without debate or discussion. The repeal of Regulation Q will now allow the payment of interest on business checking accounts. With the removal of this provision, community banks will not only see margins decline, but will be competing against the too-big-to-fail giants for funding based upon rate, thus impacting credit availability for small business and agriculture borrowers across the country. Additionally, without these “fixed rate” deposits, community banks will be hard-pressed to invest in longer term bonds issued by their local government entities. As a viable option to this significant change, we encourage support for **H.R. 2251** which directs an amendment to Regulation D to allow for up to 30 withdrawals per month from traditional money market accounts.

I had the pleasure of testifying in Washington, DC earlier this month on the detrimental impact of the repeal of Regulation Q on the community banking sector, small business borrowers and small public entities. I appreciated that opportunity, and am hopeful that Congress will seriously consider addressing this “below the radar” but critical issue in the near term.

Overdraft Protection Programs. The majority of community banks offer some type of overdraft protection to their customers and are once again paying the price for the abuses of a few, primarily large banks. We support clear and concise disclosure and an opportunity to opt out of any program. However, we strongly oppose any legislation or regulatory fiat mandating price controls, prohibition or limitation of fees for a service rendered, or arbitrary limitations on any transactions between a customer and their financial institution of choice.

Legislation or regulatory mandates limiting numbers of checks or other debits eligible for such programs could result in higher costs to consumers as they deal with returned check fees, negative credit score implications and possible criminal prosecution. Consumers should be permitted to make an informed choice, and have the opportunity to take advantage of this convenient, short-term unsecured option to higher priced alternative financial products when necessary and appropriate.

SEC Registration Threshold. Many community banks are at or near the 500 shareholder threshold that requires expensive and time-consuming legal and accounting fees. We believe this creates a significant impediment to raising additional equity capital to promote safety and soundness, fund growth and allow for additional lending to consumers and small businesses.

We support **H.R. 1965** and **S. 1941** that would raise this threshold from the current 500 shareholders to 2000. Additionally, it raises the SEC "deregistration" threshold from 300 to 1200. We applaud the House of Representatives for passing **H.R. 1965** by a resounding 420 – 2. We regret that the Senate version has been caught up in political debate, and has not yet been subject to a vote.

H.R. 2167 would raise the threshold to 1,000 for all companies, including banks, but would exclude both employee stock ownership plans and SEC defined "accredited investors" from the calculation triggering registration. While we believe the registration threshold should be higher, H.R. 2167 is an improvement over current law.

Debit Interchange Price Fixing. One of the most potentially damaging provisions of Dodd Frank is the so-called "Durbin Amendment". This government price fixing section requires the Fed to set interchange rates based upon a narrow definition of recoverable costs. While there is a "carve-out" for smaller institutions, we believe that such is simply not workable over the long-term, and will result in higher bank fees to consumers and less availability of payment options. Bottom line: It will cause some of our smaller institutions to simply cease offering this product to their customers.

Subchapter S Preferred Stock. Community banks have had the ability to operate as Subchapter S entities since 1996. Nearly one-third of all banks are Subchapter S corporations. This has proven to be a significant tool to allow such banks to compete and continue to serve their respective communities. We will be working on legislation to allow these entities to issue preferred stock to enhance their capital position, contributing not only to safety and soundness but also to their ability to grow and extend additional credit to their communities. Additionally, when policymakers advance higher income tax rates, it is important to realize these rates would directly impact all Subchapter S banks and small businesses that pay the individual income tax.

Non-Resident Alien Deposits. The Internal Revenue Service is reportedly close to issuance of a final rule requiring the reporting of interest earned on the deposits of non-resident aliens in domestic banks. We were opposed to a similar initiative in 2002, and remain staunchly opposed to the latest iteration of what we believe to be ill-advised public policy. It is my understanding from press accounts that these deposits are already leaving the United States in anticipation of a change in treatment, and if the rule becomes final, expectations are that billions of dollars in deposits will be withdrawn to avoid possible retribution in the home countries of these bank customers.

Given the tenuous economic recovery, it would seem that any public policy resulting in an outflow of liquidity and lendable funds would be questionable at best.

Regulatory Issues

Our community bankers are increasingly overwhelmed attempting to deal with the aftermath of a financial crisis that we neither contributed to nor profited from. The resulting carnage of this exercise in excess has cost our constituency dearly in the form of increased regulatory scrutiny and costs, competition with enormous entities that are perceived by the public as "too big to fail", declining collateral values, an artificially low interest rate environment, and a plethora of other frustrating – and expensive – consequences.

The crush of compliance – present and anticipated - with hundreds of new regulations subsequent to Dodd Frank is an ongoing frustration and source of increasing expense for those in the community bank sector.

Regulatory Environment – Safety and Soundness. While certainly not escaping entirely, we have been fortunate in Texas to have come through the economic downturn in reasonably good shape. A number of factors have contributed to this, including a sustainable yet not unreasonable level of appreciation in both commercial and residential real estate; a healthy business environment; a diversified economy; a very conservative home equity law; and, perhaps most importantly, a number of bankers, businesspeople and consumers who experienced the severe downturn in the 1980's and had no appetite to repeat that debacle.

Consequently, the complaints we most often hear from bankers are not generally regarding safety and soundness examination practices, but rather the focus on compliance issues.

That fact notwithstanding, we are on record as supporting **H.R. 3461**, The Financial Institutions Examination Fairness and Reform Act, and appreciate Chairman Capito and the more than 105 cosponsors of this bill. As we have stated, the discussion of these issues is important, and this bill has provided a reason to engage in important dialogue.

With that said, it is important to also state that generalities regarding regulators are as inappropriate as generalities regarding "banks". There are some amazing men and women in the bank regulatory agencies, and we appreciate the very difficult job they do. As in any economic downturn, the general regulatory environment has no doubt tightened, and will continue to find equilibrium as conditions improve.

Regulatory Environment – Consumer Financial Protection Bureau. The regulatory centerpiece of the Dodd Frank Act is the creation of the Consumer Financial Protection Bureau (CFPB). This completely new agency effectively replaces the Consumer Affairs Division of the Federal Reserve in writing consumer regulations, and it will conduct compliance exams for banks with over $10 Billion in assets. Although not examined by the CFPB, most community banks will be significantly affected by this new consumer-centric entity that is essentially divorced from the practical safety and soundness regulation of banking.

In addition to the existing seventeen consumer regulations, the CFPB has been given the authority to regulate practices that are "unfair, deceptive, or abusive acts and practices" (UDAAP). Regrettably, the term "abusive" was not defined in Dodd Frank, leaving the CFPB broad discretion to interpret this concept. In fact, it is not clear whether the CFPB will issue rules and interpretations or merely identify UDAAP on a case by case basis. This lack of clarity has many bankers concerned that this new power could be used to set fees and rates and to eliminate perfectly legal products that might not meet a consumer advocate's notions of "fairness."

Unfortunately, the creation of UDAAP authority has been layered on top of the already existing authority in the prudential regulators of banks to examine—and sanction—"unfair or deceptive acts or practices" (UDAP) as defined in the FTC Act.

We have been encouraged by the outreach of the CFPB to the community banking sector, and will continue to provide input and comments on pending issues.

Basel III. The typical community bank balance sheet is fairly simple. Our securities portfolios are primarily made up of lower risk investments with an emphasis on U.S. Treasuries, mortgage backed securities issued by U.S. government agencies and high grade municipal securities. Accounting rules preclude active trading of these accounts without mark-to-market treatment, and sadly a number of our banks have learned about "Other Than Temporary Impairment" (OTTI) and the immediate impact on the income statement and capital as a result of their investment in FNMA preferred shares.

While it could be argued that an unrealized gain in a securities portfolio would enhance a bank's capital structure, there is little doubt among our bankers that such would (and should) be viewed as "temporary" by most regulatory authorities and not be considered as "real" capital. There is similar thought that conversely, a temporary interest rate driven impairment to capital could result in a bank dropping under mandated minimums, resulting in prompt and harsh regulatory response.

If community bank "Available For Sale" (AFS) securities are required to be marked to market for capital adequacy purposes, many may elect to move a number of these securities to the "Held to Maturity" (HTM) category. This could prove counterproductive as not only will possible flexibility to maximize earnings be compromised, but challenges meeting potential new and more stringent liquidity requirements may also come into play. Additionally, with the apparent zest of some in the accounting elite to rush toward a full-blown mark-to-market standard (a terrible idea for community banks by the way), there is no guarantee that HTM securities will not eventually face the same treatment.

Commercial Real Estate. Examiners should focus on the performance of commercial real estate loans in a bank's portfolio rather than impose arbitrary concentration calculations on the portfolio. The analysis of those loans should include objective criteria including loan-to-value calculations, the age of loan, and the borrower's total relationship with the bank. Given their conservative loan underwriting and pricing, community bank commercial real estate lenders should be not be restricted by arbitrary concentration ratios but rather their loan portfolios should be evaluated based on quality.

Without rational regulatory flexibility, community banks will be unreasonably restricted from this activity. The ultimate losers will be the small businesses that are so dependent on community bank lending.

Fair Lending. Community banks in Texas and across the country are unequivocally committed to nondiscriminatory lending. However, recent actions by some of the regulatory agencies and the Department of Justice (DOJ) have forced community banks to defend themselves from questionable charges of discrimination and racial bias based upon statistical technicalities. A number of small banks have been referred to the DOJ, or subject to harsh regulatory scrutiny based solely on rigid and highly suspect statistical analysis without regard to reasonable interpretation or meaningful review. Once a referral is made, the bank is guilty until proven innocent. Importantly, a fair lending referral to DOJ means negative publicity, no branching activity, and a hold on mergers and acquisitions.

As a result, community banks have had to hire statisticians and attorneys skilled in defending them from fair lending violations for the slightest statistical aberration or isolated, technical oversight. The banks find themselves in a regulatory "limbo" until the case is resolved, and that can take months or years. Access to a reasonable appeal process is nonexistent, denying these institutions of due process—a fundamental American right. That has had a chilling effect on credit availability in small community banks whose customers have demonstrated the most need for fair access to credit.

Mortgage Lending. Dodd Frank will impose burdensome and expensive requirements that increase the cost of residential mortgage credit and decrease its availability in Texas and across America. For example, there simply is no compelling reason for requiring escrow accounts on in-portfolio residential mortgage loans which are a staple for community banks across America. Inflexible loan to value ratios and repayment ability criteria are likely to have the effect of putting home ownership out of reach of many Americans.

Community bankers do not engage in irresponsible and predatory lending. Instead, they listen to their customers and offer mortgage loans that are priced fairly and tailored to their specific needs. These are not cookie-cutter loans from some Wall Street lender. They are the loans the local consumers want; not the loans Wall Street or the secondary market has told them they can have. These are not high-priced loans. They are prime loans at rates that are fair both to the lender and the borrower. Rather than expand the mortgage loan market and provide meaningfully choices to the borrowers, Dodd Frank will further concentrate lenders and limit choice.

The repeal of Regulation Q will further exacerbate the mortgage lending dilemma once community banks no longer have a dependable fixed rate deposit base to make these all important fixed rate loans within their communities.

It is sadly becoming more and more common to hear small town bankers state that they will no longer make mortgage loans due to the increased costs, liabilities and compliance requirements. This is a perverse result indeed, and another prime example of a "fix" with unintended consequences.

Closing

Community banks are concerned about the expansion of regulations and the associated compliance risk. With the expanding burden of regulations in both dollars and time, community banks see the compliance hill getting steeper every day. Increasing the costs to the bank inevitably leads to increasing costs to the consumer and a stifling of economic growth.

We are facing a significant decline in interchange revenue subsequent to the Durbin amendment and declining overdraft protection program income and flexibility due to stringent regulatory guidance. Most recently, we now have the "opportunity" to pay interest on commercial demand deposits, which will create additional earnings pressure, significantly alter the longstanding business model of most community banks and negatively impact our ability to invest in longer term loans and securities. Mortgage lending has become too expensive, risky and complex for many smaller banks, and some have simply stopped providing these loans to their communities.

To say that we have been "caught in the backwash" and face unprecedented challenges would be a monumental understatement.

The level of frustration among most community bankers is at an all time high, and I fear near the breaking point. There is frequently discussion of smaller banks seeking buyers, as the costs and "hassles" of complying with the ever-increasing regulatory burden is not only an irritant, but makes the profitable operation of a small bank virtually impossible.

There have been some initiatives to further "bifurcate" the regulatory scheme, recognizing the very significant differences between the business models and risk profiles of the too-big-to-fail giants and the rest of the industry. IBAT has floated the concept of a “community bank charter”, and continues to work toward helping to create an environment in which community banking can flourish . . . along with the customers and communities they serve.

The community banking industry has served this country well for decades, and will continue to provide a significant engine for economic growth and job creation if allowed to do so without undue government intervention or excessive regulatory burden. The federal bank regulatory agencies have the flexibility to implement regulatory reform directed at ensuring the continued success of community banks. Congress certainly has the ability to take bold, decisive and timely action to ensure the future viability of this important sector of the financial services business. We urge you in the strongest possible way to consider the unique needs of community banks, the importance of our sector of the financial services industry to the thousands of communities we serve and the myriad of challenges we face in this difficult economic and regulatory environment.

I sincerely appreciate the opportunity to testify today, and am grateful for the Members and their staffs who made the trip to my hometown. I will look forward to further discussion.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Phillip Cliff McCauley	FROST BANK
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	
P C McCauley	

Please attach a copy of this form to your written testimony.