Written testimony of Martin R. Cole, President & Chief Executive Officer of the Andover Bank before the U.S. House Financial Institutions and Consumer Credit Subcommittee April 16, 2012

Madame Chair, Members of the Subcommittee, Congressmen:

Background

My name is Martin Cole. I am president of the Andover Bank. We are a state chartered community bank with 330 million dollars in assets. I have 105 colleagues in the bank. We operate eight branch offices. Seven of those branches are in Ashtabula County which borders Lake Erie and Pennsylvania.

I very much appreciate your coming to Ohio to hold this hearing and for your invitation to testify today. My theme will be the need to find the regulatory balance that best serves the public. My premise is that today's bank regulatory scheme, particularly for community banks, is very much out of balance seriously damaging both the industry and the communities we serve.

I will try to offer two perspectives of damaging distortion to the U.S. financial services marketplace.

Regulatory structure is inconsistent and outdated

Viewed from enough distance to gain perspective, it becomes apparent that our federal financial regulatory structure remains seriously flawed. A brief look at history may offer insight. At one time the average consumer or small business essentially had only one resource for financial services, a traditional bank or savings & loan. As a consequence, policy makers viewed banks as vital to the public's interest and Congress enacted a series of attempted safeguards. Deposit insurance and on-site regular examination provide two examples. It is important to recognize that banks pay the entire cost for both. The taxpayer does not pay a cent.

As we know though, the marketplace constantly innovates. Active regulation can block or slow innovation. If one path is blocked it will blaze another. It will invent more efficient delivery systems. Significant government costs for banks, both explicit and operational, pushed the marketplace to invent non banks to avoid those costs. The marketplace has radically changed. Our system of protecting the consumer has not kept pace. By failing to apply similar standards to functionally equivalent products and services, government effectively subsidized bank competitors.

This cost discrimination against banks continues. Let me give two examples. Under the new Consumer Financial Protection Bureau regime, banks will continue to pay for their examinations. On the other hand, the Federal Reserve is mandated to pay for supervision of those non banks the CFPB will regulate. Many of our competitors remain exempt from CFPB jurisdiction.

Another subsidized competitor is the credit union. My understanding is that Congress codified the exemption from federal and state taxation based on service to the economically disadvantaged. Yet today, Ohio's average credit union customer enjoys a family income substantially greater than that of the average bank customer. Credit unions are not subject to the Community Reinvestment Act and its requirement to meet the credit needs of low and moderate income communities. Credit unions argue they should not be taxed because they are non-profit. Mutual savings & loans are non profit. They are owned by their customers. Ohio has more mutual thrift institutions than any other state. They are taxed. Food and farm co-ops are taxed.

Importance of consistency

To evaluate the adequacy of our federal financial regulatory structure, you must consider the convergence of the larger financial services industry. Congress recognized that with the Gramm, Leach, Bliley Act. What Congress did not do then, and did not do in the Dodd Frank Act, is to establish the principal that functionally equivalent financial products and services should be similarly regulated. Simply put, bank supervision is far more intrusive and expensive to banks than government regulation is any of our non-bank competitors. My point is that competition is the best protection to the consumer <u>if</u> rules requiring fair treatment of customers are well crafted and <u>if</u> they apply equally to all competitors.

Let me try to reinforce the importance to the public of equivalent regulatory oversight with a painful Ohio example. In the years and months leading up to the collapse of the mortgage market and home prices, federal mortgage lending laws theoretically applied to mortgage brokers. But since here in Ohio they were unregulated, no one enforced the laws.

Those of you from Ohio know all too well the result. We suffered from rampant predatory lending as criminals and idiots slipped through the gap in enforcement. When Ohio belatedly decided to license brokers, its process included criminal background checks. As I understand the numbers, an estimated 2,000 brokers who had been operating never applied for licenses. Of the roughly 10,000 who did, 14% were found to have criminal backgrounds. It is worth noting that the announced non-bank focus of CFPB is big companies. These mortgage brokers were generally small but there were a lot of them and the wreckage the corrupt ones created was huge.

Bank examinations are too insular.

I am a community banker. My bank's primary marketplace is a single county. For my bank to prosper, my customers need to have jobs with a future and they need to see a quality of life in this county that makes them want to remain and help build our community.

Let me start with safety and soundness exams. As a small bank, my sustainable competitive advantage must be that I know my customers and my community. I know my customers' abilities. I know their histories. Thus I can safely make a loan that another bank, because of its distance from the customer has to rely solely on credit reports and scores would rationally deny. Across Ohio there are thousands of successful businesses, some have grown large, that exist only because of the initial insights and hands-on help of a community banker. For that process to work, I and my colleagues must be skilled. Equally important, the regulatory process must allow us to use those skills in the exercise of informed judgment. Congress must not allow unnecessary, redundant rule or regulation to cripple my ability to respond quickly and efficiently to legitimate needs of my customers.

Today, what I hear from peers is they feel that bank examiners are not allowed to respect the judgment of skilled bankers. Perhaps examiners are reluctant to use their own judgment for fear of being criticized by their supervisors or by Congress. Whatever the cause, the consequence is that bankers face a barrier against working with struggling customers. I understand why it is attractive to an examiner to rely on objective evidence, for example a third party appraisal, to conclude a loan is substandard. We ask a lot of an examiner to look through a banker's eyes to judge whether a business can survive with a helping hand. However, when that does not happen we kill businesses that might otherwise survive.

Let me be clear that I believe the financial services industry should be regulated. I have enormous respect for my regulators, the Ohio Division of Financial Institutions and the Federal Reserve, and for their examiners who regularly come into my bank. Their job is very important and very, very difficult. Congress, bankers, and bank examiners share the same goal - a safe, sound bank serving its customers and community well. My bank examiner has an almost impossible job today. The system is broken. Forgive me for being blunt, but I believe some of the blame is Congress'.

Leading up to this economic crisis our country had a regulatory structure riddled with holes and inequalities. Dodd Frank has not fixed much and it is bringing me huge new burdens aimed at problems I didn't have. Moreover, the Congressional hearings probing the causes of the crisis had unintended consequences. While the banking agencies all made mistakes, most examiners in most cases did admirable work during extraordinarily difficult economic conditions.

Understand that sometimes, when a banker works with a troubled business that business still fails. However, if a regulator forces the bank to pull the plug when the bank thinks the business might be saved, it becomes certain that business will fail. When Congress fails to commend a talented regulator taking measured risks in the public's interest how can we fairly expect examiners to take any risk not matter how important to the public? Many examiners, despite the disincentives, deserve medals for working with banks to help their customers survive. I don't remember any examiner getting one.

One result of the mixed message Congress sends the agencies is inconsistent messages examiners give to banks. The regulators tell us to help our problem borrowers but then they classify performing loans because an appraisal shows lower collateral value.

Consumer Compliance Examinations

Let me turn to consumer services. As a community banker I will succeed or fail based on my reputation. I will also maximize my profit with a lifetime relationship with a customer. We work very hard at treating our customers fairly and in helping them make decisions that our best for them. We understand there are "bad guys" in the marketplace. The public does need consumer protections. However, for a smaller bank every change in the rules is expensive. Even a small change requires me to reprint forms and marketing materials, collect and destroy old ones, reprogram computers, and train employees. That's fine if the consumer gets a benefit that outweighs that cost. Far too often he or she does not.

Please understand how extraordinarily complex compliance has become. I'll offer just one example. We recently opened a new branch about ten miles across the county line. Being in Lake County means I now have to file Home Mortgage Disclosure Act reports. I wish I had understood that before I built that branch.

We had 72 HMDA reportable files audited. There are 25 fields per file which have to be reported. Consequently, there were 1800 fields which had to be completed. We work very hard to be careful and accurate. We are allowed a maximum of 7 errors total. The standard is 99.6% accuracy even if the mistakes have no negative impact. Failing that standard is very expensive because everything has to be re-filed.

Now consider that I have always had full, regular, on-site compliance examinations. Examiners have full access to my files. They look at applications, denials, and all the data I have on the applicant. Thus, they have everything needed to detect any discrimination. A HMDA report cannot include information that can prove illegal discrimination. Yet, I am required to file it because I built one branch. And now I am told I will have to geo-code my small business loans too. I have key people filling out reports instead of working with customers.

As a result of our last compliance exam and the onslaught of what we believe to be additional regulation coming, we have hired a full time compliance officer (about $60,000 with salary and benefits) plus we are paying a consultant $1200 per day for about 2 days per week to help us with compliance issues. We anticipate even more costs in the future.

We have been assured by "policy makers" at the Federal Reserve, Richard Cordray of the CFPB and even in the writings and speeches of Chairman Ben Bernanke, that they are "sensitive' to the concerns of the smaller community banking institutions and claim to recognize the difference in "how we do business" from the bigger financial institutions. They also claim to realize that we were not the cause of the "mortgage crisis". However, at the "field level" we are not experiencing the "sensitivity". The increasing burden is already crushing. It will drive smaller financial institutions to merge into larger organizations with the resulting loss of diversity and competition.

Loan evaluation system
The Ohio Bankers League, which represents Ohio banks and savings & loans from the smallest to the largest, operates on-line exam evaluation system. It is new. Its purpose is to provide useful feedback to the agencies to help them improve their procedures and training. The on-line system preserves banker anonymity to gain their candor.

Evaluations of recent exams should give us all cause for concern. 42% of the participating banks reported that their examiners were neither flexible nor were open to the exchange of views with their staffs. 13% reported examiners applied supervisory standards or economic assumptions that had not been shared with the bank prior to the examination. Less than half of the banks believed their examinations had resolved issues and recommended corrective actions in a "fair and reasonable" manner.

As one specific example, I highlight a complaint I regularly hear from other bankers. When a banker changes terms of a loan to help a customer recover, the result is the loan being classified as a TDR, which stands for temporary debt restructuring. Reserves are increased to recognize the possibility of failure. But when our efforts work, when the business or consumer gets back on its feet, the TDR classification today will still remain in place tying up money no longer needed in reserves and urgently needed in the communities we serve. It seems the regulators forget that the "t" stands for temporary. Consider the inconsistent message. Bankers hear "Work with your customers". Yet, they can be penalized if they do.

Financial Institutions Fairness and Reform Act
In closing I would commend two bills to your attention. The first is sponsored by the chairwoman and ranking minority member of this subcommittee, H.R. 3461. We are encouraged by its clear focus on timely, fair, effective examination. In the interest of time, I will comment on only two of its provisions: a new more practical mechanism to appeal examination decisions, and a requirement for timely feedback from examiners to banks.

Each of the bank agencies has made a good faith effort to create an appeal process to identify and overturn bad decisions in individual exams. Nevertheless, each is fatally flawed because its appeal process is entirely internal. Each regulator tells its banks we should not fear reprisal if we appeal. I am sorry but since the reviews are internal, we all do fear reprisal, and vitally important oversight does not take place.

Your proposed Office of Examination Ombudsman would create at least two significant benefits. It provides a process where reviewers are completely independent of the examiners. Reprisal against a whistle blower would be illegal. As a result, I believe bankers would be much more willing to file an appeal when one was justified. A better flow of information, and an independent review, will make exams better. This new ombudsman would create a mechanism to effectively detect and eliminate enforcement differences between agencies. It could identify and spread best practices.

I have read testimony by the regulators opposing this provision. I confess I find it a bit ironic that these agencies, which exist because of the importance to the public of independent review of the actions of banks, object to independent review of their actions.

The bill's provisions requiring timely reports of exam findings to banks are needed. I will provide an example of the problem. Dodd Frank transferred the supervision of the federal thrift institutions to the OCC. Working with a new agency, those exam reports are particularly critical to these banks, yet final reports often come six months or more after the examiners have left the bank. Thus a bank is left little time to learn from the final report findings before they face a new exam.

The Community First Act

And finally, while I understand that H.R. 1697's content is too diverse to be considered by a single committee, I would ask for your review of those provisions under your jurisdictions. We must get much more rigorous in detecting where redundant regulation or regulation designed for larger, more complex institutions severely harms the ability of a small bank to respond to the legitimate needs of its community. We need regulation tailored to help small banks use their strengths to serve their customers well.

I would like to conclude with a comment from the exam evaluation system. As I mentioned the system protects anonymity so I don't know who this banker is. However, many Ohio community bankers will identify with what he or she wrote.

"It would appear that the mandate is elimination of community banks. We were not responsible for the banking crisis. If anything we were responsible for working to help communities across the country survive it. One size cannot fit all. There must be common sense used when a community bank is examined. Our bank has never lost money nor had a deficient loan loss reserve. We are not perfect but we have an experienced management team with a history of taking care of the communities we serve. We along with similar community banks do not deserve 'gotcha' examinations. We should be able to see our regulators as partners not adversaries."

In closing, I want to specifically thank Congress for raising the shareholder threshold for being considered by the SEC a public company. That single change will make it far easier for smaller banks like mine to raise capital in the future. We are at 460 shareholders. We have individuals on a list that would like to buy our stock. We can now proceed with capital expansion plans without fearing additional costly regulatory requirements.

I am grateful for your interest in Ohio and its communities. I would be happy to respond now or in the future to any questions you might have.