Testimony of

R. Daniel Blanton

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions & Consumer Credit

of the

Committee on Financial Services

United States House of Representatives

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Chairman Capito, Ranking Member Meeks, my name is Daniel Blanton, Chief Executive Officer of Southeastern Bank Financial Corporation and Georgia Bank & Trust, in Augusta Georgia. I am also the Vice Chairman of the American Bankers Association (ABA). I appreciate the opportunity to be here to present the views of the ABA regarding regulatory relief for small financial institutions. The ABA is the voice of the nation's $14 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11 trillion in deposits and extend nearly $8 trillion in loans.

Georgia Bank and Trust is a $1.775 billion community bank established in 1989. We have 12 branches serving the Augusta area and extend $975 million in loans to our local communities.

Today, our diverse banking industry is made up of banks of all sizes and types, from small community banks to community-based regional banks, to large money center and global banks. This depth and breadth is required to meet the broad array of financial needs of our communities and customers. Our $16 trillion economy requires a diverse U.S. banking system.

Community banks make up 95 percent of all U.S. banking organizations and have been the backbone of all the Main Streets across America. Our presence in small towns and large cities everywhere means we have a personal stake in the economic growth, health, and vitality of nearly every community. A bank's presence is a symbol of hope, a vote of confidence in a town's future. When a bank sets down roots, communities thrive.

The sad fact is that over the course of the last decade, 1,500 community banks have disappeared. This is why hearings like today's are so important. It is an opportunity to change the dialogue from just talking about how important community banks are to what can be done to stop

the rapid decline in the number of community banks and start taking action to assure we have a healthy and vibrant community bank sector.

There is a widespread appreciation for the benefits community banks provide to their communities across the country. Yet, many actions taken by the banking agencies have hurt, not helped community banks. For example, at the same time policy makers were urging banks to make more loans to help boost the economy, regulators were clamping down in an effort to drive all risk from the system. At the same time that banks were trying to reach out to their local businesses, the growing list of new rules and regulations meant more compliance officers and fewer customer-facing employees. At the same time banks were trying to deploy the precious capital they had, regulators were telling them to boost capital-to-asset ratios which often led to less lending.

During the last decade the regulatory burden for community banks has multiplied tenfold, with more than 50 new rules in the two years ***before*** Dodd-Frank. Dodd-Frank is already adding to that burden for all institutions with 5,933 pages of proposed regulations and 8,002 pages of final regulations (as of May 29, 2014) and we're only half way through the 398 rules that must be promulgated and is poised to add hundreds more affecting all banks. Managing this tsunami of regulation is a significant challenge for a bank of any size, but for the median-sized bank with only 40 employees, it is overwhelming.

Today, it is not unusual to hear bankers—from strong, healthy banks—say they are ready to sell to larger banks because the regulatory burden has become too much to manage. These are good banks that for decades have been contributing to the economic growth and vitality of their towns, cities, and counties but whose ability to serve their communities is being undermined by excessive regulation and government micro-management. Each bank that disappears from the community makes that community poorer.

It is time to move from good intentions to changes that have tangible results. We applaud the efforts of Congress to help community banks. In particular, I would like to thank Chairman Capito, Representative Duffy, Representative Kilmer, Representative Luetkemeyer, Representative Perlmuter, Representative Pittenger, and Representative Royce for introducing H.R. 3240, H.R. 3374, H.R. 3913, H.R. 4042, H.R. 4626, H.R. 4986, H.R. 5062, the OFR Accountability Act, and the draft TILA reform bill. Many of the bills being discussed today are a strong first step toward relieving the burden felt by community banks and ensuring that the community banking model remains viable. While no single piece of legislation alone can relieve the burden that community

banks face, many of the bills under consideration today could begin to provide much needed relief. We urge Congress to work together—House and Senate—to get legislation passed and sent to the President that will help community bankers better serve our customers.

One issue that is of particular importance is the Department of Justice program ***Operation Choke Point*.** This program is requiring banks to act as policemen and judges, holding them responsible for the actions of their customers without due legal process. Banks must shut down the accounts of customers that Justice suspects to be illegal, often with no formal court order or legal proceeding. Bankers cannot be guarantors of the lawful nature of their customer's operations—they have neither the compliance capacity, the financial capacity, nor we believe the legal obligation to take on that assurance. However, the risk of regulatory or enforcement retribution is a potent deterrent against banking any customer that the government decides is unworthy of payment system access—even though the government itself does not take direct action in court to prove its case against the targeted customer.

Another important issue is *the* ***treatment of Mortgage Servicing Rights (MSRs) in Basel III***. Many community banks sell a portion of their mortgage loans, but retain the servicing rights to these loans. Retaining the servicing rights allows a bank to maintain a relationship with their local customer by continuing to be the primary touch point in regard to their loan. The harsh treatment of MSRs under Basel III will force many community banks to sell these rights to non-banks. This is a loss for both the bank, which is no longer able to maintain a long-term relationship with their community, and for consumers who will see their loan serviced by a third party.

In the remainder of my testimony, I want to first briefly describe the reasons for the concern that I and my community bank colleagues have about our current regulatory environment. Following that, I will provide details about specific actions that can be taken, including comments on the legislation being considered by this subcommittee. The ABA stands ready to work with this subcommittee to make changes that will secure the future of one of this nation's most important assets: Community Banks.

I. The Costs To Implement New Regulations Are Substantial, Weighing Most Heavily On Community Banks

Community banks, as do all banks, work hard every day to meet the credit and financial needs of their customers and communities. Community banks have a presence much greater than their total assets suggests. According to FDIC's Community Banking Study released in December 2012, community banks accounted for just 14 percent of the U.S. banking assets in our nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. In 629 U.S. counties—or almost one-fifth of all U.S. counties—the only banking offices are operated by community banks. Without community banks, many rural areas, small towns and urban neighborhoods would have little or no physical access to mainstream banking services

The ability to meet local needs has not been easy with the increased regulatory costs and second-guessing by bank examiners. During the last decade, the regulatory burden for community banks has multiplied tenfold and it is no surprise that nearly 18 percent of community banks disappeared in that period.

Unfortunately, the cumulative impact of years of new regulations and the proliferation of non-bank and non-taxed and subsidized competitors (such as credit unions and the Farm Credit System) are combining into a potent mixture that will surely, if left unchecked, lead to more and more consolidations of small banks.

Make no mistake about it, this burden is keenly felt by all banks, but particularly small banks that do not have as many resources to manage all the new regulations and the changes in existing ones. Besides the real hard dollar costs, there are important opportunity costs related to the products and services that cannot be offered or offered only at higher costs to our customers. In dramatic illustration of this point, a 2011 ABA survey of bank compliance officers found that compliance burdens have caused almost 45 percent of the banks to stop offering loan or deposit accounts. In addition, almost 43 percent of the banks decided to not launch a new product, delivery channel or enter a geographic market because of the expected compliance cost or risk.

Furthermore, research by the Federal Reserve over the years has confirmed that the burden of regulations falls disproportionately on smaller banks. The Federal Reserve Bank of Minneapolis has estimated that hiring one additional employee to respond to the increased regulatory requirements would reduce the return on assets by 23 basis points for the median bank with total assets of $50

million or less. To put this estimate in perspective, ***such a decline could cause about 13 percent of the banks of that size to go from being profitable to unprofitable.***

As a $1.7 billion bank, we are better able to spread out some of the compliance costs than our smaller brethren. For the median-sized bank in this country with $173 million in assets and 40 employees, the burden is magnified tremendously. I was shocked to learn recently about a $70 million bank in Kansas that has three and a half FTE compliance employees out of a total of 23 employees. He was particularly frustrated to have 15 percent of his staff dealing with government regulations that do nothing for lending in his small community. Besides internal audits, banks now have to have outside audits for compliance which is a significant expense for smaller banks. Then, the regulators spend time auditing the audits. Checkers checking checkers is a costly and wasteful exercise that provides no value-added for the safety and soundness of the bank and does nothing to protect the bank's customers

II. Many of the Bills Considered Today are an Important First Step to Providing Relief For Community Banks

ABA applauds this subcommittee for holding hearings like today's and seriously addressing the challenges faced by community banks. I will touch on how the bills being discussed today can help provide much needed relief for community banks.

Mortgage Servicing Asset Treatment Under Basel III Should Be Corrected

ABA supports H.R. 4042 introduced by Rep. Blaine Luetkemeyer and Rep. Ed Perlmutter. This legislation would delay the implementation of the Basel rules on MSAs until the impact of the new rules can be studied and better alternatives explored.

Many banks that make mortgage loans also engage in servicing, which primarily consists of collecting mortgage payments and forwarding them to the "owner" of the loan; collecting insurance and tax payments; and addressing problems such as late payments, delinquencies, and defaults. Banks commonly sell mortgage loans into the secondary market but retain the right to service the loan (called "servicing retained"). This strategy is an important way for banks to maintain valuable connections with their customers, while managing interest rate risk by selling long-term credit

assets. Servicing mortgage loans for investors is a specialty of many U.S. banks and has provided a strong source of fee income for decades.

Banks are retaining less mortgage servicing due to Basel III's unfavorable capital treatment of mortgage servicing assets ("MSAs"). As a result, Basel III is unintentionally increasing the concentration of servicing held by less regulated, non-bank firms such as mortgage companies, REITs, hedge funds, and private equity firms that are not subject to the new capital restrictions. The long-term relationships that banks and their customers have established should not be penalized by Basel III's punitive capital treatment of MSAs.

Banks should be encouraged to service the loans that they make to their customers. The Basel III rules should not create an environment that drives servicing out of banks by making it more difficult for banks to hold servicing assets.

H.R. 4042 stops the negative effects until the impact can be fully examined. The bill requires the regulators to study the risk of holding MSAs; the recent history of MSAs during the financial crisis; the impact of the new rules both on the ability of community and mid-size banks to compete and on the structure of the mortgage servicing business; and alternative regulatory approaches that could be implemented. The bill requires this analysis to be done within one year of the date of enactment and suspends the current MSA capital rule during that period. The bill does not apply to the large international banks that Basel III was meant to address.

Costs and Benefits Should be Weighed for Any New Regulation

ABA supports H.R. 3913 introduced by Rep. Sean Duffy. This bill would ensure that regulatory agencies consider promotion of efficiency, competition, and capital formation before issuing or modifying certain regulations. Too often regulations are piled on, without regard to whether the cost of the regulation is justified by the goal it seeks to achieve. This bill would compel regulators to weigh the costs and benefits of new regulations, as well as provide a statement with their considerations.

Confidentiality of Information Should Be Protected

ABA supports H.R. 4626 introduced by Chairman Capito. This bill would apply the same confidentiality standards to information shared with state regulators as is currently applied to information shared with the Federal Reserve.

Operation Choke Point Should Be Ended

ABA supports H.R. 4986, introduced by Rep. Blaine Luetkemeyer which directly addresses and solves the problem created under "Operation Choke Point." Banks are in the business of providing financial services for law-abiding customers, and they share a common goal with law enforcement of maintaining the integrity of the payments system. Our members are committed to combatting the financing of terrorism, money-laundering and other serious financial crimes. Banks already keep records and report suspicious activities to law enforcement; however Operation Choke Point makes banks responsible for policing their customers, ensuring that all of them are operating legally. Banks should not be judge and jury on whether their customers are operating legally.

Through the Bank Secrecy Act (BSA) and its subsequent legislative extensions, Congress established the role that banks play to accomplish this mission. It assigns banks the obligation to ***keep records of transactions*** and ***report suspicious activities*** (and certain types of cash transactions) to enable law enforcement to do their jobs of investigating and prosecuting financial crimes against those that initiate them. This statutory division of responsibility creates a cooperative partnership between the financial services industry and the government that respects those separate roles and preserves judicial due process for those suspected of financial crime. The policy is for banks to serve, observe and report; not to police, expel or drive underground.

Banks devote enormous personnel and technological resources every year to fight financial crime to meet the unfunded Congressional mandates of the Bank Secrecy Act and its related laws. All depository institutions combined filed close to ***one million suspicious activity reports*** (SARs) in the past year alone, covering such subjects as mortgage fraud, identity theft, counterfeit debit and credit cards, and wire transfer fraud. These SARs are intended to help federal and local law enforcement identify and develop cases in the fight against financial crime. However, as we have noted in past testimony, there is a fundamental lack of accountability for law enforcement's use of this and other BSA data.

Unfortunately, regulatory pile-on has converted the straightforward BSA/AML mandate to identify customers, keep transaction records and report suspicious activities into the government directed bank surveillance Act with over 350 pages of examination procedures, plus regulatory guidance. This regulatory drift has been further leveraged by the banking agencies to impose additional layers of regulatory and reputation risk on banks performing normal banking services on businesses for all types engaged in interstate commerce.

For one, the FDIC expects our members to differentiate across the patchwork of legal requirements applied to the businesses they bank and will criticize banks whose controls do not ensure that their customers—and even their customers' customers—are operating in compliance with applicable state and federal laws. Without notice and comment, the FDIC has imposed its guidance ***with the force of law*** by making it the basis for BSA enforcement orders that mandate adherence to its terms. This results in an impossible and statutorily unfounded standard, extending far beyond the division of responsibility between banks and law enforcement to protect the legitimacy of the payment system.

On top of this regulatory groundwork, the Department of Justice has initiated Operation Choke Point that starts with the premise that businesses of any type cannot effectively operate without access to banking services. DOJ pursues banks to shut down accounts of merchants targeted by the DOJ without formal enforcement action or even charges having been brought against these merchants. Thus, in the absence of any court order or other legal enforcement proceeding against the actual fraudsters, the program targets the bank for facilitating transactions of a customer.

DOJ identifies the banks to investigate using the very SARs the banking industry has filed in fulfillment of its role to report suspicious activity. Rather than use such leads to investigate, determine culpability and directly prosecute the perpetrators, the DOJ has instead turned the industry's reporting efforts onto the reporters themselves.

Taken together the banking agencies and the Department of Justice are placing on banks the burden to differentiate between proper or improper conduct of their customers, and to close "high-risk" accounts or face unacceptable levels of regulatory criticism or retribution. This ratcheting up regulatory and reputation risk forces banks to de-risk their business lines by terminating customers whose operations may be entirely legal but who have risky profiles. This regulatory environment undermines our industry's efforts to support local businesses and grow our national economy. It also undermines customers whose economic viability is severed by government blacklisting without recourse to judicial due process.

Our concern with Operation Choke Point is not its goal of fighting financial fraud, but rather the policy premise upon which the initiative is based, the faulty legal foundation it asserts, and the manner in which it is applied. We believe that it is time to renounce Operation Choke Point and recalibrate the BSA/AML regime to restore the intended division of responsibility between the

financial industry's reporting role and law enforcement's role of prosecuting the perpetrators of fraud and financial crime directly.

Accordingly ABA supports H.R. 4986 which embodies the following principles:

- Stops the improper application of FIRREA Section 951 by limiting it to the original purposes of protecting banks from frauds committed against them.
- Reinforces the safe harbor for banks engaged in suspicious activity reporting by protecting them against assertions of liability for the knowledge they obtain about customers who are accessing normal banking and payment services.
- Recognizes the partnership role of the financial industry while respecting the rights of its customers by properly applying the law enforcement information sharing process established under the USA PATRIOT Act's section 314(a).
- Holds law enforcement agencies accountable for demonstrating the utility of SAR and other BSA data reporting that vindicates the unfunded costs imposed on the financial system providers to meet their reporting obligations.
- Prevents law enforcement or regulatory agencies from enforcing, or imposing through supervisory process, any financial institution operating requirements for conducting normal payment services for customers in the absence of rule-making establishing such standards.

We believe that we can combat financial fraud more effectively working together with our regulatory agencies and law enforcement than we can by making our industry surrogate targets for the real wrongdoers.

Conclusion

An individual regulation may not seem oppressive, but the cumulative impact of all the new rules plus the revisions of existing regulations is oppressive. The regulatory burden from Dodd-Frank must be addressed in order to give all banks, and especially community banks, a fighting chance to maintain long-term viability and meet the needs of local communities everywhere. The consequences of excessive regulation are real. Costs are rising, access to capital is limited for community banks, and revenue sources have been severely cut. It means a weaker economy. It means slower job growth. With the regulatory overreaction, piles of new laws, and uncertainty about government's role in the day-to-day business of banking, meeting local community needs is difficult at best.

Community banks are resilient. Banks like mine will find a way to succeed. But the headwinds we face daily with excessive red tape makes our job much harder and hurts the communities we are

dedicated to serve. With Congress's help in lifting some of the burden, community banks are set to thrive and turn the economic tide in favor of our communities. We need to move from simple, good intentions to action that creates tangible results.