ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

Testimony of

William A. Loving

President and CEO of Pendleton Community Bank

Franklin, WV

On behalf of the

Independent Community Bankers of America

Before the

United States House of Representatives

Committee of Financial Services

Subcommittee on Financial Institutions and Consumer Credit

and

Subcommittee on Insurance, Housing, and Community Opportunity

Hearing on

"Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards"

November 29, 2012

Washington, D.C.

Opening

Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez and members of the subcommittees, my name is William A. Loving, Jr., and I am President and CEO of Pendleton Community Bank, a $260 million asset bank in Franklin, West Virginia that serves four rural markets in West Virginia and one Virginia community. I am also Chairman-elect of the Independent Community Bankers of America and I testify today on behalf of its nearly 5,000 members. Thank you for convening this hearing on a topic of existential importance to the community banking industry, the Basel III proposed capital rules.

We are grateful to the many members of the Financial Services Committee who have sent letters to the banking regulators expressing their serious concerns about the impact of Basel III and the standardized approach on community banks. It is no exaggeration to say that these rules could bring about the demise of the community banking industry within a decade. No topic has caused such alarm among community bankers in recent memory – as demonstrated by their estimated 2,000 individually-written comment letters on the proposed rules and their potential impact on their communities. In addition, nearly 15,000 individuals have signed an ICBA petition urging the banking regulators to provide an exemption for banks with assets of less than $50 billion. Today, we urge Congress to support such an exemption and protect the community bank model – one essential to communities all across our great nation.

In this testimony I will detail community banks' concerns with Basel III and the standardized approach, but let me summarize those concerns here. The proposed rules penalize customized lending without regard to asset quality. This strikes at the community bank competitive advantage – customized, relationship-based lending – in an industry that is increasingly dominated by a small number of large banks offering commoditized lending. A second broad objection is this: New, unnecessarily high capital requirements are simply not viable for community banks because we have extremely limited options for raising new capital, unlike our larger competitors. Without access to the public markets, community banks must rely on other limited means to raise new capital. In particular, mutual community banks, which are among the safest institutions, must rely exclusively on retained earnings to raise capital. With historically low interest rates, compressed interest margins make it very difficult to accumulate retained earnings. Finally, the proposed rules will introduce volatility into regulatory capital where stability is an important indicator of financial health.

Basel III was meant to apply to the largest, interconnected, internationally active and systemically important institutions. Community banks, with their simple capital structures and conservative funding and lending practices, have nothing in common with these larger institutions. Applying the same regulatory capital standards to community banks – in a one-size-fits-all fashion – in addition to the many other new regulations that are becoming effective, will simply make community banking a losing proposition for many, triggering thousands of bank sales. Mass consolidation will make the banking industry less competitive for consumers and businesses. The small towns and rural areas currently served by community banks for credit will face curtailed access to credit and economic stagnation.

Let's not take a step that will fundamentally alter the nature of the financial services industry. Our national economy needs a diverse, competitive financial services sector with large and regional banks as well as thriving community banks 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 and sustaining a vibrant community banking sector is an important public policy goal. Basel III and the standardized approach contravene this goal, posing an existential threat to community banks.

The case for a total exemption for community banks from Basel III and the standardized approach is illustrated by two particularly troubling provisions.

Standardized Approach Risk Weights

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 – there are eight different risk weightings for residential mortgages – the new risk weights will be exceedingly difficult to comply with without incurring significant software upgrades and other operational costs. Mutual banks will be disproportionately impacted because, as thrifts, they hold more mortgage loans than other community banks. Customized home loans like balloon loans – a staple of community banking – as well as second liens will be severely penalized with new capital constraints during a fragile housing recovery. Under the proposed standardized approach, balloon loans would move from their current 50% risk weight to a potential mind-boggling 200% risk weight all while being fully secured by real estate. Balloon loans are the best mortgage option for many community banks and their customers for any number of sound reasons. For example, a loan may be ineligible for sale into the secondary market because it's collateralized by an irregular, rural property without adequate comparables. I'm happy to hold such loans in my portfolio but the only way I can protect my bank against interest rate risk is to structure the transaction as a balloon loan with a five to seven year maturity or an Adjustable Rate Mortgage (ARM), a product which carries its own set of customer concerns and regulatory reporting issues. Without the balloon loan option, many rural customers will be unable to finance home purchases or home improvements. I and other community bankers have safely offered balloon loans for decades. Because I retain these loans as well as other loan types in portfolio, I have a vested interest in their performance and I take care to ensure that they are underwritten to the highest standards. I am not aware of any data whatsoever that demonstrates that balloon loans are more risky than other types of credit.

Second liens like home equity loans and home equity lines of credit help to provide borrowers with the flexibility they need and are a major contributor to economic growth throughout the country. Although these loan products are often cited as an example of the past economic excesses of reckless homeowner leverage, prudently underwritten second liens serve a very important and vital role in the lives of homeowners and the overall economy. These loan products are frequently used by homeowners to finance property improvements, send a child to college, and start a small business.

The new proposed risk weights strike right at the heart of the community banking model. Our direct knowledge of the community and the borrower allows us to underwrite loans tailored to their unique needs – loans that larger lenders are unwilling to make.

Treatment of Accumulated Other Comprehensive Income

The Basel III proposal requiring banks to include in regulatory capital accumulated other comprehensive income (AOCI) will significantly misrepresent community banks' capital positions. AOCI, a component of shareholders' equity that for most community banks represents unrealized gains and losses on certain investment securities, is currently excluded from regulatory capital and its inclusion will introduce unnecessary volatility into a community bank's capital position. Most community banks, including Pendleton Community Bank, have large positive AOCI balances as a result of historically low interest rates. Today's low interest rate environment, coupled with the "flight to quality" on U.S. government debt by risk adverse investors, has driven up the value of debt securities and increased unrealized gains in many portfolios. These sources of unrealized gains are not sustainable. When economic growth accelerates and interest rates inevitably rise, debt securities will drop in value and AOCI will quickly turn negative. This pending shift in AOCI says nothing about a bank's ability to absorb losses and should not be reflected in its regulatory capital. To use my bank as an example, a 300 basis points increase in interest rates (a reasonable scenario given the magnitude of the fall in rates since 2007) would cause my bank's bond portfolio to show a net paper loss of $2 million. My bank's tier one capital would drop 11.03 percent and the bank's tier one risk based capital ratio would decrease 9.92 percent – from 14.01 percent to 12.62 percent if AOCI was included. While the ratio would remain above minimum regulatory levels, both now and proposed, many other community banks would experience much larger paper losses and sharper drops in capital and ratios. Even banks such as mine that would not become undercapitalized will be forced to reassess their business strategies and plans for growth to preserve capital. The expected rise in interest rates is just one source of fair value change that will cause capital volatility. Changes in credit spreads and other market developments will have a similar impact. To avoid becoming undercapitalized, banks will need to maintain an additional capital cushion of 2 to 3 percent, depending on the economic environment.

Larger banks have tools at their disposal, such as interest rate derivatives, to minimize the impact of AOCI on regulatory capital. This gives the larger banks a competitive advantage over community banks because they can more readily absorb the overhead necessary to engage in derivatives trading. Community banks have limited ability to carry interest rate derivatives on their balance sheets due to the increased resources needed to maintain these risk mitigation activities. Because of this disadvantage, community banks are disproportionately impacted by the inclusion of AOCI in regulatory capital.

The inclusion of AOCI in regulatory capital will undermine community bankers' ability to maintain capital levels that are not only adequate but stable – an important indicator of bank health to the public, depositors, borrowers, investors, counterparties, and regulators.

I've highlighted the impact of just two provisions – risk weights and the inclusion of AOCI in regulatory capital – to illustrate why community banks must be exempt from Basel III and the standardized approach. Many additional provisions are nearly as troubling, and the cumulative impact, as I have stated, would effectively bring about the end of the community banking industry within a decade. There's just too much wrong with this rule for it to be adequately addressed with a few discreet amendments. Only a full exemption will adequately address our concerns and ensure the long-term viability of our industry.

ICBA Recommended Modifications

Absent a total exemption for banks with less than $50 billion in assets, ICBA strongly favors the following modifications to Basel III to simplify the rule and better align the proposed capital standards to the unique strengths and risks of community banking:

- Banks under $50 billion in assets should be exempt from the standardized approach for risk weighted assets. The standardized approach's complex and punitive risk weighting for residential mortgages could force community banks out of this line of business.
- Unless it can be empirically shown that these assets are risky, the proposed substantially higher risk weights for balloon mortgages and second mortgages should be reduced to their current Basel I levels. Basel I risk weighting better reflects the high-quality nature of this asset class.
- AOCI should continue to be excluded from the calculation of regulatory capital for banks under $50 billion in assets to avoid harmful and unnecessary volatility in capital adequacy.
- If AOCI is not excluded from the calculation of regulatory capital for community banks, then changes in the fair value of all obligations of the U.S. government, mortgage-backed securities issued by Fannie Mae and Freddie Mac, and all municipal securities should be exempt. These securities are deemed to be risk free and are essential to maintaining a healthy housing market. For community banks, this change would greatly simplify the process of computing AOCI and significantly reduce capital volatility.
- Consistent with the Collins Amendment of the Dodd-Frank Act, bank regulators should continue the current Tier 1 regulatory capital treatment of TruPS issued by bank holding companies with consolidated assets between $500 million and $15 billion. This change would reflect Congressional intent and reduce the capital burden for community banks. Many community banks have based their long-term capital planning on the permanent grandfather provisions of the Collins Amendment. Four hundred eighty five institutions with between $500 million and $10 billion in assets depend on TruPS for 13.33 percent of Tier 1 capital.
- Consistent with the proposal for bank holding companies, the Federal Reserve should exempt all thrift holding companies with assets of $500 million or less from Basel III and the standardized approach or provide a policy rationale for why they are not exempt.
- The allowance for loan and lease losses (ALLL) should be included in Tier 1 capital in an amount up to 1.25% of risk weighted assets and the remaining balance of ALLL should qualify for inclusion in Tier 2 capital so that the entire ALLL will be included in a community bank's total capital. Delinquent loans are essentially "double reserved," taking into account both ALLL and the proposed rules' significantly higher capital requirements for such loans. Our recommended change will at least give proper recognition to the loss-absorbing capacity of the ALLL.
- Mortgage servicing assets should be subject to the current higher deduction thresholds because they do not pose a risk to community bank capital. The punitive deduction thresholds set forth in the proposed rule will discourage community banks from retaining

servicing rights and will accelerate consolidation in the servicing industry. Community banks provide high quality, personalized servicing that reduces foreclosures. They should be encouraged to remain in the business.

- Community banks should be exempt from the provisions of the capital conservation buffer because they have no vehicle, such as the equity markets, for raising capital quickly. This is particularly important for the 2300 Subchapter S community banks. Subchapter S owners owe tax on the bank's earnings and they rely on distributions, which would be put at risk by the provision of the capital conservation buffer, to pay these tax bills. Alternatively, the phase-in period for the capital conservation buffer should be extended by at least three years to January 1, 2022 to provide community banks with enough time to meet the new regulatory minimums.
- The proposed risk weights for equity investments should be substantially simplified so community banks will not be discouraged from investing in other financial institutions such as banker's banks, which are key business partners in community bank lending.
- In the absence of a full exemption from the standardized approach, any changes to the risk weights should be applied prospectively to give community banks enough time to comply.
- Regulators should make accommodations to ensure Basel III and the standardized approach do not negatively impact the nation's minority banks and the diverse and sometimes economically stressed and underserved communities they serve. Minority banks should be preserved and promoted.
- If Basel III and the standardized approach are to apply to community banks, then they should also apply to credit unions. The credit union tax exemption already gives them a significant competitive advantage over tax-paying banks. That advantage should not be exacerbated by allowing credit unions to comply with much less rigorous capital standards that will allow them to offer low rates on loans and rates on deposits.

Again, the most sensible and prudent policy, the policy that would avoid severe unintended consequences, would be an outright exemption for financial institutions with assets of less than $50 billion. Basel III was originally intended to apply only to large, complex, and internationally-active institutions. Applying Basel III more broadly in a one-size-fits-all manner would harm all consumers and businesses that rely on credit and the impact would be especially harsh in small communities and rural areas not served by larger institutions.

ICBA encourages this committee to consult our October 22 comment letter to the banking regulators for more detail substantiating the above views. (The ICBA letter is available at: http://www.icba.org/files/ICBASites/PDFs/cl102212.pdf.)

Closing

Thank you again for convening this important hearing and helping to raise the profile of a significant economic policy issue with far reaching and perhaps unappreciated implications. Your letters to the bank regulators, both in their thoughtful quality and their sheer number, have made a significant impression. We look forward to working with this committee to obtain a full exemption from Basel III and the standardized approach for banks with less than $50 billion in assets.