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AN EXAMINATION OF THE CHALLENGES FACING COMMUNITY FINANCIAL INSTITUTIONS IN TEXAS

FIELD HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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AN EXAMINATION OF THE CHALLENGES FACING COMMUNITY FINANCIAL INSTITUTIONS IN TEXAS

Wednesday, March 14, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., at the City Council Chambers of the Municipal Plaza Building, 114 W. Commerce Street, San Antonio, Texas, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito and Canseco.

Chairwoman CAPITO. This field hearing will come to order. I would like to thank, first of all, the beautiful City of San Antonio for hosting us. It's my first personal visit to the City, and it's just lovely. And I think it's obvious from my quick observations that it's very family-friendly and a great and safe place to visit and enjoy the wonderful restaurants and beautiful scenery and the Riverwalk. So thank you so much for having us here.

And by way of introduction, my name is Shelley Moore Capito. I'm the chairman of the Financial Institutions and Consumer Credit Subcommittee of the Financial Services Committee in the House of Representatives. I hail from the great State of West Virginia. There are a lot of West Virginians living in Texas, I know that, and there are a lot of similarities between West Virginians and Texans. We're good-hearted people, so I'm very, very happy to be here. I'm going to kind of walk you through the process of what we're going to do today, and then we'll proceed.

We're having a field hearing. And what this does is it gives us a good flavor, a slice-of-life understanding of what we're doing in Washington, bringing Washington to San Antonio, but also we're going to take back what we're hearing today to Washington and formulate policy that will enhance your ability to do business and to grow here in Texas.

So Mr. Canseco and I will each give an opening statement, and then our witnesses will be recognized for a 5-minute opening statement. We will then have a couple of rounds of questions where each one of us will be recognized for 5 minutes. And the hearing should last until around 12:15.

I want to thank my colleague, Mr. Canseco, for inviting me here, and also for his great leadership on our committee. He may be a

freshman in name, but in reality, he is a force in our committee and in Congress, and I really appreciate his leadership. And I know it's not easy; I have a great appreciation for how far he travels every week to serve. So, you're really lucky to have him.

The title of this morning's hearing is, "An Examination of the Challenges Facing Community Financial Institutions in Texas." We have a panel of witnesses who will provide us with an overview of the landscape for community banks and credit unions in Texas.

This Congress, our subcommittee has conducted a series of hearings on the evolving regulatory environment for community banks and credit unions. We have heard a consistent concern from witnesses that the growing regulatory burden for community banks and credit unions is making it more difficult to grow the economy and help communities recover from an economic downturn. We have also heard concerns about the inconsistent application of examinations by the Federal financial regulatory agencies.

The recent trend of financial institution failures is largely due to the financial crisis and the slow economic conditions in communities across the country; however, this is not a recent phenomenon. Since the early 1980s, there has been a consistent trend of consolidation in the banking industry.

According to the FDIC, in 1984, there were 14,884 banking organizations across the country. And as of February of this year, there were only 7,349, nearly half the institutions that there were 28 years ago.

Now, consolidation is not necessarily bad if you're doing it on your own terms of when you want to do it, and in some ways, it allows healthier institutions to grow. However, we must ensure that our Nation is served by a diverse financial system that includes community banks, credit unions, regional banks, and national banks. Each entity is tailored to serve the specific needs of different populations. This morning's hearing is an important contribution to this dialogue, and I appreciate our witnesses' willingness to testify in front of this subcommittee.

I would also like to say in terms of observations that I have already made since I have been here in Texas, the role of the community bank and the ability to understand and work with the individual communities is something that I think there's a great concern about in rural areas like I live in, in West Virginia, and like you have in Texas. We can't lose that valued asset in our local communities through consolidation or overburdensome regulatory regimes where a community bank cannot meet or our financial institutions cannot meet the challenges of the regulations.

So with that, I would like to now introduce our host. My dad was in Congress in the 1950s and 1960s. In these little cards that I now have from the 1950s and 1960s, he always characterized himself as the hardest-working Congressman, but I'm going to characterize your Congressman, Mr. Quico Canseco, as the hardest-working member of my subcommittee. I now recognize Mr. Canseco for the purpose of making an opening statement.

Mr. CANSECO. Thank you very much, Madam Chairwoman. And I appreciate very much you coming down to San Antonio and holding this very important hearing. I also want to thank you for your tremendous leadership on the Subcommittee on Financial Institu-

tions and Consumer Credit. Welcome to San Antonio. And I'm sure that you'll find us very, very hospitable. I want to also let the City of San Antonio know that we're very, very grateful to be having this hearing here in our City Council chambers. It's a beautiful building and a very beautiful environment.

I want to also thank our witnesses on the panel today. We have representatives from San Antonio, Laredo, Del Rio, Fort Stockton, and El Paso. I thank you all for being here, and I look forward to your testimony and our discussion today which is very, very important.

America has for many years been home to the most competitive and dynamic financial sector in the world. This is in large part due to the diversity of institutions that provide loans and help increase capital formation in the private sector of our economy. Unlike other nations where a small number of mega institutions typically dominate the entire industry, in America the vast number of community banks, credit unions, and other small lenders offer a different business model that often fits with the needs of small towns and communities, especially here in Texas.

The community-oriented model focuses on relationships, service, and flexibility with its customer base usually standing in stark contrast with the model offered by larger counterparts.

While community banks and credit unions oftentimes lack the geographic diversity and deep pockets of the too-big-to-fail banks, they remain vital to the economic well-being of millions of Americans and American businesses.

Here in Texas, business owners, farmers and ranchers, families, and others rely on local lenders in small towns such as Del Rio and Fort Stockton to help grow their businesses, create jobs, and enhance the overall quality of life in their communities.

As someone who has spent years in community banking, I'm intimately familiar with the importance of this model and the need to preserve it. Unfortunately, in recent decades this model has become threatened due to a variety of factors such as rising compliance costs, economic booms followed by tremendous busts, and perhaps most importantly, the tendency of policymakers to paint all institutions with the same brush. These have disproportionately affected small financial institutions and threatened to turn our financial system into one controlled by a very small number of banks.

As one participant at a recent community bank conference put it, "I think this country will be a very scary place if there are only four or five banks providing credit." I couldn't agree more with that statement. The numbers tell the story—30 years ago, there were over 14,000 community banks in the United States. Today, there are fewer than half that number. It has recently been estimated that the Dodd-Frank Act will require companies in the United States to spend 22 million manhours for compliance each year. Undoubtedly, this is time that will cost community banks and credit unions greatly.

The Sarbanes-Oxley Act of 2002 also had a similar disproportionate effect and impact. And, of course, over 13 million of our fellow citizens remain unemployed, so community banks and credit unions currently face a struggling economy on top of a heap of new regulations.

And so, Madam Chairwoman, I hope today's hearing serves to highlight some of the biggest challenges faced by small financial institutions here in Texas, and what we discuss today, what Congress should do in order to lift the regulatory burden that is currently crushing banks and credit unions. The focus must be on fostering a competitive environment where small financial institutions can continue to play a vital role in our economy. I yield back, and I thank you.

Chairwoman CAPITO. Thank you.

We will now turn to the panel. What I'll do is introduce each of you individually right before you give your statement.

Our first witness is Mr. Robert Glenn, president and chief executive officer of the Air Force Federal Credit Union. Welcome.

STATEMENT OF ROBERT A. GLENN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AIR FORCE FEDERAL CREDIT UNION

Mr. GLENN. Thank you, Madam Chairwoman. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, Air Force Federal Credit Union is very pleased to have an invitation to appear before the subcommittee today for this hearing.

In the course of my oral summation, I'm going to try to cover briefly about our credit union, about credit unions in Texas generally, and to explore some of the challenges that our credit union has faced in regulatory compliance, and also to discuss our views of our examination process and how our industry is consolidated.

Air Force Federal Credit Union was chartered in November of 1952 as Lackland Federal Credit Union. At that time, we had 10 members who each initially deposited $5 into the credit union. We ended up in 2011 with over 36,900 members and total assets of $342 million. We have 142 employees. We have 131 who are full time, and 11 who are part time.

We're probably one of the larger credit unions in the State of Texas because in Texas, there are 536 credit unions. The average size of a credit union in the State of Texas is $135.7 million, and they represent 7.8 million members.

In the State of Texas, 427 of those credit unions have less than $100 million in total assets. The average credit union size of that group is only $21.8 million in total assets. The total average number of employees in each of those credit unions is eight full-time employees, and one part-time employee. If a credit union the size of mine with 142 employees is having problems meeting compliance, you can imagine what kind of difficulty a credit union with only 8½ full-time equivalents would have. By the way, the State of Texas only has 13 credit unions that are over $1 billion in total assets, and none of them are over $7 billion in total assets. None of them fall under the examination requirements of the CFPB.

We all have limited resources, and that's why compliance is such a challenge for smaller institutions. We don't have lots of money, we don't have lots of time other than the time that we have there to serve the folks that we're designed to serve, our members and our customers, and we also use a lot of third-party vendors. And when we're trying to comply, we have to get those third-party vendors to line up their processes with the new regulations, and they have to help us in our compliance activities.

I want to go into a couple of regulations that were particularly challenging. One of the most challenging for us was the Credit Card Act. The Credit Card Act had a number of different facets that were challenging to us, for example, the constant due date. Under the practice before the Act, the due date would move a couple of days either way depending on when the statement would be prepared. And the statement was being prepared based upon how cost-effective it would be to cycle the statements throughout the month. Preparers of statements could reduce their cost, hold down the cost to consumers ultimately, they pay for everything, and we were able to avoid weekend preparation of statements. It didn't make sense to prepare statements on Saturday night when you can't put them in the mail on Sunday morning. At least if you do put them in the mail, they're not moving to the ultimate consumer.

And you have to wonder also about—if some of the other aspects of that regulation required, for example, to change dates or rates. If you had to change a rate, you had to provide additional notice. We send lots of notices to our members, all different kinds of varieties. We have past-due notices, notices of payments that are coming due, we have statements, we have NSF notices, notices for everything that you can imagine, and they're all additional pieces of paper. And we hear from our members that they throw most of those away. So you wonder what good an additional notice is going to serve.

I know in our household we have probably three or four credit cards. During the course of the passage of this particular piece of legislation, we received nine separate notices regarding the changes that they were implementing before the Card Act went into place. And then subsequently, we have had numerous notices on each of those accounts. They didn't really mean anything because we pay the account off every month in our household. And if you do that, the change in rate is a nonissue.

We had additional information that was required to be placed on the statements, particularly on the first page of the statement. This new information was to show people how long it would take them to pay their account off if they paid just the minimum payment, and if they paid a slightly larger payment, how they could pay it off more quickly. This extended the length of the document, it caused more pages to be produced, it extends the amount of money required to print, and so forth.

And I see a red light blinking, so I need to stop here.

[The prepared statement of Mr. Glenn can be found on page 41 of the appendix.]

Chairwoman CAPITO. Thank you. We do have a little timer here, and it gives us 5 minutes. I'm not going to be so bold as to come to San Antonio with my own hammer and hammer you down right at 5 minutes. But if it gets really long, I might try to do it. Thank you.

Our next witness is Mr. George Hansard, president of Pecos County State Bank. Welcome.

STATEMENT OF GEORGE H. HANSARD, PRESIDENT/CEO, THE PECOS COUNTY STATE BANK, FORT STOCKTON, TEXAS

Mr. HANSARD. Thank you. Chairwoman Capito and members of the subcommittee, just a couple of observations. First, I have to say that this is probably the first time I have sat between two credit unions. And as a banker, it's somewhat difficult. Second, I'm just a West Texas small-town banker, and thank you for putting my name on the back so that I remember who I am.

Again, my name is George Hansard. I'm the president and CEO of The Pecos County State Bank in Fort Stockton, Texas. Pecos County State Bank is a $150 million community bank that was started approximately 80 years ago in Fort Stockton, Texas. Fort Stockton only has a population of some 8,000 people. And we have a location in Sanderson, Texas, which has a population of 750 people. We are truly community bankers.

I have been the president of the bank for 6 years, and I have been employed with community banks for over 32 years. I appreciate the opportunity to address issues which I believe have adversely affected community banks for the last several years. The most important aspect that my board asked me to relay is the inflection of my voice so that the subcommittee will understand the frustration that we have seen.

Several months ago, we at Pecos County State Bank stumbled across our bank's policy manual from 1986. That policy manual was 100 pages long. Today, our same policy manual is over 1,000 pages, which requires a full-time compliance officer and also a real estate clerk to remain abreast of regulatory changes to ensure that we remain in compliance and their interpretation thereof.

Community banks have been the life blood of this country, and they're responsible for more small business successes than any other resources, including government programs. What's troubling to me and to my bank is the impact of government regulation that has been based not upon common sense but on politics.

Today, only 25 percent of Dodd-Frank has been implemented. What has Dodd-Frank done to Pecos County State Bank? For one, allowing a consumer the opportunity to determine whether the bank may assess a charge on an overdraft. That overdraft is created by a debit card that consumer used. In the old days of check writing, no one had a problem with the bank assessing that overdraft. The check was often handed over to the local county attorney for collection or prosecution, and that customer had to pay additional fees on top of the bank fees, and in some instances, may have had a criminal record. Now Dodd-Frank places no responsibility on that consumer for his or her actions. And in my opinion and the opinion of most community banks, this is simply price fixing and has no rational basis.

Twenty years ago, a community bank the size of Pecos County State Bank did not have a compliance officer nor did it have a real estate clerk to handle the regulations which covered real estate transactions. Now with Dodd-Frank, how many more staff members will a community bank be forced to employ? These staff members actually provide nothing to the bottom line of the bank. We're not sure, but we do know that from over 3,000 pages of law, our policy will surely double and our staff to handle these complexities.

At Pecos County State Bank, I find it interesting that my lending staff has not increased in the 11 years that I have been with the bank, and we have been able to double the outstanding of our loans with the same lending staff. But during that same time period, we have had to add two employees simply to handle government regulation. And if I have to double that staff due to Frank-Dodd, that will constitute 10 percent of my entire staff.

Another aspect of Dodd-Frank are the appraisal requirements. In my 32 years of banking, and I think many other bankers will agree, the banker who puts his hands on his collateral makes good loan decisions. Contrary to popular belief, community banks have no desire to make bad loans. Bad loans not only impact the bank's bottom line, but they also negatively impact the banker's job, the community, and are also negative to a borrower. And a bad loan makes a good customer a bad customer. Dodd-Frank takes that evaluation process completely away from the community banker, and the community banker must place trust in someone else putting their hands on that collateral.

I do not believe in not being involved in evaluating collateral taken to secure a loan. Maybe loans sold in the secondary markets still need independence, but not loans which the banker must live with. Would you purchase a home without being involved in deciding the purchase price?

Further, a real life example of Dodd-Frank occurred in our bank. We had used our real estate processor to also perform our real estate appraisals. She is a licensed, State-certified residential appraiser. Dodd-Frank put a stop to this even though Dodd-Frank allows that appraiser to receive a copy of the residential sales contract which clearly states the sale price, the downpayment, the loan amount and terms, but it does not allow that appraiser to be involved in any type of loan processing, which is the same information she would get from the sales contract. We believe that having a knowledgeable appraiser/processor with loyalty to his or her employer, makes for a more reasonable appraisal instead of those alleged in Dodd-Frank. I had to tell her she had to make a choice. I lost that important employee. She chose to remove herself from the everyday process of regulations which was based upon politics and not rationale. What does her family think now?

Is there a solution? I'm sure that the politicians who wrote the legislation believe they are writing it in the best interest of their constituents and there is a reason for much legislation, but Dodd-Frank, with all of its amendments, is far-reaching and overreacting. I strongly believe that the postponement and repeal of Dodd-Frank is fair to the county as a whole. Dodd-Frank may have good intentions, but these intentions are misguided, certainly to community banks which do not sell their loans in the secondary market.

Community banks did not participate nor did we profit from the excesses that contributed to the recent economic meltdown in the financial and housing industry, yet we are paying a high price for the actions of a few large institutions. These institutions have no fear. They're too-big-to-fail. In fact, their only concern is how large their bailout will be. We as community banks do not, nor have we ever had this luxury.

Community banks are different from megabanks. Community Banks have been closed all over this country, and all the megabanks have been bailed out by taxpayers' expense. The rationale that it is fine to close community banks and to bail out megabanks is inherently irrational. Don't you think community banks are as important to that community as the megabank is to its country? I can tell you that community banks and their boards are at an all-time high in their level of frustration. Something must be done that makes good common sense.

Again, I appreciate the honor and the opportunity to voice my opinion on such an important issue, not only for the community banks, but for the country and its future. Thank you.

[The prepared statement of Mr. Hansard can be found on page 55 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Ms. Maria Martinez, president and chief executive officer of Border Federal Credit Union. Welcome.

STATEMENT OF MARIA J. MARTINEZ, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BORDER FEDERAL CREDIT UNION, DEL RIO, TEXAS

Ms. MARTINEZ. Good morning, Chairwoman Capito, and good morning, Representative Canseco. Thank you for the opportunity to testify at today's hearing. My name is Maria Martinez. I'm the president and CEO of Border Federal Credit Union (BFCU) located in Del Rio, Texas, headquartered there. We have a community charter, and we serve 13 counties, most of which are underserved. BFCU has a low-income designation, and we're also classified and certified by the U.S. Treasury as a Community Development Financial Institution. We have over $107 million in assets and approximately 22,000 members.

One of the current challenges affecting community credit unions today is the current limit of 12.25 percent of assets on the amount of member business loans a credit union can make. This cap can be increased to 27.5 percent as proposed by H.R. 1418. This cap restricts us from being able to fully serve our members, limiting the opportunity of many Texans.

Border FCU would like to enter the business lending market, but we are reluctant to do so. The start-up costs and requirements that we must comply with in order to offer small business loans exceeds the ability of many credit unions to cover their costs when faced with such a low gap. Also, we don't want to start a business lending program only to turn away members once we reach this low cap. Telling our members that we cannot make the loan because Congress has imposed this artificial cap is no comfort to our member who qualifies for the loan and has come to us for help.

Raising the cap or eliminating it completely will open up credit to small businesses in our communities and create jobs. The lack of credit for small businesses slows the economy's recovery. Member business lending by our community credit unions is a vital solution to our current economic needs.

Another challenge we face is the excessive regulatory burden. There is no doubt that the increasing amount of new laws and regulations that credit unions face have become overwhelming. As the

credit union president, I spend many hours reading each new law and regulation. I can't afford to hire lawyers to interpret them for me. Most of these laws and regulations are created to address a problem caused by organizations other than credit unions. Yet, the regulators continue to impose the same requirements on small credit unions as they do on the largest financial institutions in the country. This just doesn't make sense.

Consider, for example, the outdated requirement of posting physical disclosures at our ATM locations. Changing the physical signs to electronic disclosures displayed while using the machine could avoid serious problems such as vandalism and the wear-and-tear on the equipment. Or, for instance, the 400-page proposed rule on remittances that will require us to reconsider our ability to open the service to our members.

New regulations require more policies to be implemented by the credit union, expensive modifications to computer systems and the training of staff and our volunteer board members. It is particularly challenging for small credit unions. Unfortunately, we have seen too many small credit unions merge due to the increasing regulations. Far too often, I hear that they just couldn't keep up with the volume of changes in rules and laws, and that is the major factor for the decision to merge.

When Congress and regulators need to crack down on bad actors, they should apply the changes to that specific industry and business type rather than imposing this on credit unions.

Another challenge is the exam process. At times, it seems there is a separation between the policy as stated by the regulatory leadership and what occurs locally during the exam. We all know that the exam process is part of operating a financial institution, but it is also important that examiners not overregulate or exceed their authority. Examiners have tremendous powers. If a credit union believes that an examiner has acted unreasonably, they have very few realistic options. Passing H.R. 3461, which addresses the exam process, would be a positive step in balancing the relationship between the regulator and the regulated.

And, finally, it is important that consumers be equipped to deal with the conflicts, financial products, and issues they face today.

Border FCU serves an underserved community, an area where oil and gas exploration is booming, and we also serve a military base. We offer free programs such as home counseling services, budgeting workshops, and volunteer income tax preparation. Our volunteer staff educates our youth on financial literacy at local schools, and we offer a youth financial summer camp. All of these programs are designed to create financial awareness.

I ask the subcommittee to continue to support financial literacy programs. As communities grow and jobs are created, programs must be accessible to consumers within the industry to assist them with financial education. We all know that an educated consumer is the best client of any institution.

Madam Chairwoman and Representative Canseco, thank you for coming to Texas and holding this hearing. This concludes my testimony.

[The prepared statement of Ms. Martinez can be found on page 59 of the appendix.]

Chairwoman CAPITO. Thank you very much.

Our next witness is Mr. Cliff McCauley, executive vice president, correspondent banking, of Frost Bank. I understand this is a former Frost Bank—

Mr. MCCAULEY. You are correct.

Chairwoman CAPITO. —building. It's beautiful. Welcome.

STATEMENT OF CLIFF MCCAULEY, SENIOR EXECUTIVE VICE PRESIDENT, FROST BANK, SAN ANTONIO, TEXAS

Mr. MCCAULEY. Thank you. Chairwoman Capito, Representative Canseco, I am Cliff McCauley, senior executive vice president of Frost Bank, where I have worked for over 30 years. My current responsibilities include leading our correspondent banking line of business, where I have the opportunity to work with financial institutions all over the State of Texas on a daily basis. I would like to welcome you to my hometown of San Antonio and express my gratitude for you holding this hearing. And as you mentioned, these chambers also have a special meaning as this building served as the Frost Bank headquarters for many years prior to the construction of our headquarters just next door.

In my role of working with community financial institutions for over 25 years, I have been a part of many business cycles that have affected the banking industry and have seen the corresponding attempts to prevent the downturns from happening again. There were many sweeping regulatory changes after the banking crisis of the 1980s when nearly half of the community institutions in this State disappeared. These new regulations were put in place to prevent the next crisis but did very little in retrospect as numerous institutions grew into what we now know are too-big-to-fail.

The regulatory burden that was put in place then is nowhere comparable to the overkill we're experiencing today, and in my opinion will have about the same effect of past attempts to rein in the too-big-to-fail institutions while punishing the community institutions that have historically played by the rules.

If Dodd-Frank is allowed to stand and proliferate as a monster regulatory overhaul, only the largest institutions will be able to navigate its requirements, and the community institution model will continue to diminish.

The cost of regulatory compliance is simply staggering. I'm not talking about efforts to keep an institution out of trouble; I'm talking about a well-meaning community institution that has no intention of being unfair to members in their own town. These smaller institutions spend a disproportionate amount of money and time to just meet the reporting and manpower requirements of this new regulatory overkill.

I personally know of two community banks that simply threw in the towel and sold out after being beat up by regulators about not having enough high power talent in their compliance position, a position they tried fervently to fill but were unable to attract someone of that caliber to relocate to their rural community. That bank was purchased by a larger one in a metropolitan city and no longer has the local service or long-time employees who understand that community.

If the community banking model becomes an endangered species as the megabanks take advantage of the consolidation caused by regulatory burden, it would be very detrimental to many communities, small businesses, and local public entities.

As we have seen in the past, when a large institution buys out a smaller local entity, they tend to pick and choose the profitable pieces that fit their model and abandon the parts that don't. In many cases, the pieces that are discarded are the locations in smaller markets, and there's evidence of this today as some too-big-to-fail banks are simply closing local offices because they no longer fit their model.

Jobs are lost as duties are moved to the acquiring office, and the local community knowledge and service is lost forever. If consolidation continues, as I wholeheartedly believe it will, and there is not a local entity to pick up the pieces, that local community will undoubtedly suffer as a result. It is often noted that small businesses are the job engine of this country. It is also a well-known fact that community institutions cater to those small business customers to meet their needs and help them grow their entities. Without a strong community banking presence in so many smaller and rural areas, the future outlook for those businesses decline as opposed to prosper.

There are too many problematic provisions of Dodd-Frank to cover today, but there is one provision that I continually try to bring to light, and that is the repeal of Regulation Q. The ability of banks to pay interest on business checking will further strengthen the too-big-to-fail banks while being detrimental to the community banks and small business borrowers. This repeal has only negative effects for smaller institutions and businesses while providing the too-big-to-fail banks an opportunity to buy the deposits from relationship-based institutions. This provision along with the scores of other new regulations and the yet to be determined impact to the CFPB simply spell incredible difficulty for the community banking model. Unless there is at the very least an attitude change by certain regulators away from a "Gotcha" mentality and enforcement activities, this country will see hundreds and eventually thousands of the community banks that serve their area be forced to sell out to a larger entity with more resources to fight the daily battles of overzealous regulatory reform.

I appreciate the opportunity to be here today, and I would be happy to expand on any of my comments or answer any questions. Thank you.

[The prepared statement of Mr. McCauley can be found on page 69 of the appendix.]

Chairwoman CAPITO. Thank you very much.

Our next witness is Mr. Les Parker, chairman, president and chief executive officer, United Bank of El Paso Del Norte. Am I saying that correctly? Welcome.

STATEMENT OF LESTER LEONIDAS PARKER, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, UNITED BANK OF EL PASO DEL NORTE, EL PASO, TEXAS

Mr. PARKER. Thank you, Chairwoman Capito, and Representative Canseco.

My name is Lester Leonidas Parker. I am president, chairman, and chief executive officer of United Bank of El Paso Del Norte.

We're a $177 million minority community bank in a community of some 900,000 souls, primarily Hispanic, and we're proud of that.

For the past 7 years, our bank has been the principal SBA lender in our SBA district. And we have built a solid record of supporting small business. Indeed, we focus only on small businesses and professional practices and do very, very little consumer business whatsoever.

I started in commercial banking in 1962, 50 years ago in September this year. I was fortunate, and America has been good to me, I was able to earn a college degree and go on to graduate school and such. I was a captain in the Army during the Vietnam conflict. And you will hear a little more about that later because it's relevant.

I have started three small businesses, two micros, and one partnership. I have also been fortunate to start three community banks, all of them successful, and I have cleaned up one bank that was about to be closed by the FDIC. My present bank was started 11 years ago, and it's owned by people from a broad cross-section within our community—the first time that has ever happened in El Paso.

I believe the House of Representatives in Washington is the closest thing we have to the voice of the American people up on that hallowed hill. Because of that, I really am honored to be here before your committee. I believe you have the means to help ensure that communities across America are able to retain their major facilitator of economic growth, and that's their local community bank.

The business model of community banks focuses principally on the communities in which they are headquartered. The business model of the too-big-to-fail banks focuses nationally and internationally and has long-range objectives and desires that really don't match up with those of community banks.

We have as community banks a strong sense of duty, obligation, and commitment to those friends, neighbors, and fellow citizens we have in our community, and we think that is very, in fact, manifestly important.

Our bank maintains very, very good ratings with the regulatory agencies, both State and Federal. We have very clean portfolios of loans and investments. We have the lowest nonperforming and past-due ratios in our entire area and have maintained those for several years now. We are diligent about running a very good bank that is a genuine service and a genuine resource to our community, and we have received a number of accolades because of that. We are a simple, non-complex organization, yet the direct compliance costs in the bank have increased 240 percent over the past 5 years far exceeding the growth of the bank, its loans, investments or deposits. That compliance cost figure includes only the direct cost of specific managers while working on regulatory compliance, the new cost of a skilled compliance officer, and the cost of myriad outside, third-party auditors and reviewers to ensure that our compliance efforts are adequate. It does not count the other costs of implemen-

tation, the annual training that I must do with all employees and the compliance activities that they have throughout each week.

When we were examined by the Federal Reserve during the fall of last year, the examination preparation commenced in July as we began to provide huge amounts of data to them. We have less than 800 loans in our bank; we have less than 3,000 accounts. The reason is because we're a small business bank. A bank normally of our size would probably have 14,000 accounts.

Everything is on computer, so we downloaded our entire bank, if you will, to the examiners in Dallas, Texas. They had almost 3 months to massage that data. And when they came in, they had 16 people who stayed for 2 weeks and set about to absolutely micromanage everything they could. It's obscene.

I have a friend who is a community banker in a small town south of Fort Worth. The town has 1,700 people. She has been with that bank since she was a clerk. She now runs it and owns it, and the bank is $40 million in size. She has 13 people, including herself. In her last examination, she had six examiners from the OCC who stayed a month. She has about the same small number of accounts and loans as we do. She's also very well rated. I fail to see why that kind of emphasis is now put on small institutions.

I see the red lights flashing, but let me tell you one thing. I had the pleasure of serving our county, and I commanded a combat nuclear outfit. I had enough firepower to take a small country off the map of the world. I can tell you, we had excellent ratings. We had a Presidential unit citation. We were overseen by the Department of Defense, the Department of the Army, the Defense Atomic Support Agency, and the entire staff of the United States Army. Everybody is nervous about nuclear weapons. I don't like them personally, but I think they probably have a use somewhere. We had less than 20 percent of the regulation to control those monstrous weapons than we have in our little bank to control what we do. So I leave you with this: 40 years ago, I did not see problems in banks and banks falling like flies, and yet the level of regulation and the cost of regulation was far, far less than it is today.

As I see it from my standpoint, we will see community banks continue to decline in number. We simply cannot afford the high costs of Federal regulation. And as one banker, I will tell you this, my major risks are not credit risks, risks of theft, risks of some robber coming in with a gun in my office; my number one risk is Federal regulatory risk. And I have a greater risk of harm to my bank, to my stockholders from the Federal Government than I have from anything else in this whole world. That is obscene. Thank you very much.

[The prepared statement of Mr. Parker can be found on page 78 of the appendix.]

Chairwoman CAPITO. Thank you very much.

Our next witness is Mr. Ignacio Urrabazo, Jr., president, Commerce Bank. Welcome.

STATEMENT OF IGNACIO URRABAZO, JR., PRESIDENT, COMMERCE BANK, LAREDO, TEXAS

Mr. URRABAZO. Thank you, Madam Chairwoman, and thank you, Representative Canseco for letting me participate in this important

forum. My name is Ignacio Urrabazo, and I'm the president of Commerce Bank in Laredo, Texas. We're a basic classical community bank situated in South Texas.

Commerce Bank has about $550 million in assets, and it was established in 1982. We're a subsidiary of International Bancshares Corporation (IBC). IBC is the largest bank, minority bank in the continental United States with about $11.7 billion in assets.

By way of background, I'm currently on the FDIC Advisory Committee for community banking. I'm also on the executive board and I am the treasurer of the Texas Bankers Association. I serve in a variety of committees for the American Bankers Association, and I'm also a former chairman of the board for the National Bankers Association, which is the largest minority banking trade association. I have been in banking for over 42 years.

This morning, I would like to focus on three things: fairness; the current regulatory climate; and the impact to banks and consumers from the regulators.

As they say, a picture is worth a thousand words, so I have included in my pages a presentation that provides a visual of what compliance looks like today in our bank, and it's complex, and I'll leave it here for the record.

There's no need to rehash the causes of the unprecedented financial meltdown that occurred in 2008, 2009. I do want to say that the regulators were clearly a part of the problem who got very little blame.

In my lifetime, the FDIC fund has been broken twice, several decades ago with the S&L crisis, and just recently with the subprime crisis. Unfortunately, the industry received virtually all the blame, and the regulated agencies by and large received a pass. As an old banker—not that old, but older—I have to tell you that the regulators failed every bit as badly as the industry, and they have never been called to judgment.

As seen in prior economic cycles and prior periods of crisis, policymakers and regulators overreact to the cyclical problems that occur all the time. Congress' holistic approach to fix everything in the financial sector has created unnecessary and inflexible rules. The Dodd-Frank Act, in my view, is a perfect example of a horrible overreach. The Dodd-Frank Act, which is 848 pages long, is an outline directed at the bureaucrats, and it instructs them to make still more regulations and create more bureaucracies; it, in fact, can be a multi-headed monster.

This action by Congress is unprecedented. I would like to remind the committee, the laws that set up the American business—the banking system in 1864 ran for 29 pages. The Federal Reserve Act of 1913 ran for 32 pages. The banking act that transformed American finance from the Wall Street crash, commonly known as the Glass-Steagall Act, spread out for 37 pages. I ask you, how in the world will our community banking system survive under the weight of the Dodd-Frank Act?

Community banks across the country will be destroyed by the regulators creating additional regulations on top of existing regulations. Community bankers are frustrated with the unknown and the additional costs required for compliance and implementation. This has come to banks when we're trying to survive the worst eco-

nomic crisis in the last 50 years and at a time when our interest margins are shrinking, not to mention the elimination of fee income through the Durbin Amendment and the elimination of overdraft fees.

These fees are critical for the survival of community banking. It is a key noninterest income that helps provide many of our banks with the additional products and services that the consumers need.

The Dodd-Frank Act has not been fully implemented, but we have already seen its effects. While the Dodd-Frank Act has some necessary provisions that are required for systematic risk and certain complex financial products, we again see that the good intentions for the short term will have unintended horrible consequences for the long term.

Let me talk about some issues that I see having major consequences not only for community banks, but more importantly for the consumer.

First, in the area of compliance and fair lending, we're seeing examiners becoming totally inflexible and rigid in the interpretation of fair lending laws, all in the name of fairness and equality. In order for a bank to avoid a violation of fair lending laws and a referral to the DOJ, we have put in place very inflexible and rigid underwriting standards to avoid criticism.

On the surface, this sounds very appropriate, but in the trenches we are now rejecting many long-time customers who pay well, but do not qualify under these new standards, because of the credit scores or the debt-to-income ratio. The same concept applies to the pricing of these loans. Some of these customers have had long-time relationships with the bank, but everybody has to fit in the box. If you don't fit and the bank makes the loan, you become an exception. If you become an exception and create an outlier, you must justify the reason for making that loan, and then the examiner will ask for similar exceptions to other outliers that are in a protected class.

This applies to mortgage loans and consumer loans. The result, exceptions create enormous fair lending risks, so banks stop making exceptions. Furthermore, the FDIC has stated as a policy, the FDIC does not want loan officer's discretion in consumer lending. You must fit in the box. The bottom line is, we are declining loans at record levels, and worst of all, alienating our customers and damaging our reputation.

In addition to the above, the costs involved in monitoring and living with such regulatory tests as regression analysis has become burdensome and unclear. Banks provide data, and the regulators will run regression analysis on women versus men; Hispanic versus White non-Hispanic; unsecured loans for women versus men; unsecured loans for Hispanic versus White non-Hispanic; vehicle loans for women versus men; vehicle loans for Hispanic versus White Non-Hispanic, and various other combinations.

If there are no significant variances or a disparate impact in the underwriting standards or the pricing, then the regulator will continue to cut and slice the portfolio into other combinations, such as one branch against another branch or even one officer against another officer of different branches until the regulators have exhausted every conceivable iteration as they are clearly practicing

"Gotcha" examination tactics. Smaller banks will be forced to hire outside consultants to gather and analyze the data at greater costs because they do not have the resources to handle these difficult and complex tasks internally.

All banks are different, all consumers are different. It is very, very difficult to place everybody in the same box. Rules are a poor substitute for good judgment. Policymakers are now attempting, in effect, to force good judgment out of a process of creating rules that embody their view of what is correct or what is right. We have no discretion.

The second issue, and I'm going to go quickly through this, is the CFPB's review of overdraft programs and their impact on consumers. The CFPB has initiated new inquiries in overdraft practices and their impact on consumers, and they are soliciting feedback on a prototype "Penalty Fee Box" on the consumer's checking account statement. Last year the Fed, the FDIC, and the OCC all promulgated their own guidance and rules to supervise overdraft programs.

Many community banks incurred significant costs instituting new forms, new operating systems, new disclosures, and training to comply with Reg E and Reg DD to establish full transparency and ensure customer consent on the opt-in provisions, all based on consumer choice. Now, the CFPB wants to review the same programs. What this means for banks is new rules and new guidance. The overdraft programs serve as a safety net for consumers, and it's a service that is widely demanded by our customers. It should be noted that the consumer has complete control and can revoke their opt-in status at any time.

Overdraft protection satisfies a unique and important need for consumer credit marketplace. Restricting access will not eliminate the need that the consumers have for it, but it could limit their access to it as banks begin to realize it's too burdensome and too expensive to maintain, and carries too much regulatory risk. I have included a recent study by Todd Zywicki for the record that thoroughly studies the overdraft protection system.

The third issue, quickly, is that consumer complaints will now play a larger role with the CFPB and will have a significant impact on my costs and many possible dangerous consequences. The major concern to banks is the Unfair, Deceptive, or Abusive Acts and Practices, UDAAP section. Banks will clearly have to be familiar with customer complaint programs, if for no other reason than to prove that the bank takes such concerns seriously. Banks will have to identify patterns of complaints and establish procedures to review such patterns as well as individual complaints. Management systems will have to be established and monitored.

Ridiculous and far-fetched allegations will surface to the bank. The definition of "abusive" will be solely at the discretion of the CFPB, the DOJ, and consumer groups. At IBC, we have recently spent several hundred thousand dollars to buy a consumer complaint system to help manage these complaints, which is a huge burden on the bank.

Other areas of concern are higher capital requirements, costly record-keeping and reporting requirements, standardized plain vanilla products that will be required, changes in mortgage disclo-

sures, escrow accounts, mortgage credits to curtail that QRM is implemented, municipal advisors. New rules in bank's investment portfolio and other situations having to do with safety and soundness examinations have become extremely difficult.

In summary, community banks are facing stiff challenges for the next few years. As interest margins shrink and fee income becomes more difficult to obtain, the regulatory burden will overrun small community banks causing them to either merge or consolidate with larger banks or just go out of business.

Most large banks are not interested in small rural banks, and rural banks do not want to become a part of a large holding company; they are at a loss.

At the national level, the decrease (sic) of banks has decreased. As one who has worked in community banks for over 4 decades, I maintain that despite policymakers' good intentions in implementing regulations, they are ultimately detrimental to a bank's ability to grow and create capital in other communities and to build communities through job creation.

Thank you for involving us in this important forum where we can share the experience of community banks. I hope other perspectives, which are based on our day-to-day interactions with consumers, help illuminate the need to lessen the burden on community banks and consumers who already are negatively impacted. Without community banking, we will no longer be the America that created the largest economy in the world. We have already lost over 11,000 community banks since 1985; we cannot afford to lose any more. Thank you.

[The prepared statement of Mr. Urrabazo can be found on page 88 of the appendix.]

Chairwoman CAPITO. Thank you very much.

Our final witness is Ms. Janie Barrera, president and chief executive officer of ACCION Texas, Incorporated. Welcome.

STATEMENT OF JANIE BARRERA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ACCION TEXAS INC.

Ms. BARRERA. Thank you very much. Good morning.

On behalf of the board of directors and staff of ACCION Texas, welcome to San Antonio. We thank you for hosting this conversation on the challenges facing financial institutions in Texas. As a not-for-profit organization, we partner and work with a broad spectrum of voices and practitioners in economic development. I hope to share insight and expertise in the challenges and opportunities that face you as policymakers.

San Antonio is the headquarters for ACCION Texas. We began our work here in 1994 and have now become the largest microlender in the United States, serving Texas, Louisiana, Arkansas, Missouri, Alabama, Mississippi, Tennessee, and Kentucky, some of the poorest States in our country. We have provided over 12,000 business loans, and disbursed over $121 million to over 8,000 small businesses. ACCION currently has an active portfolio of $25 million, and we have a 95 percent repayment rate. The average credit score of our borrower is 575. We are also a registered Community Development Financial Institution, a CDFI.

This year marks our 18th anniversary. As we reflect on the challenges of financial institutions that are considered nontraditional, we recognize the importance of oversight and diligence. At the same time, we must remember that we need intermediaries that deploy funds to individuals who are not 100 percent ready for traditional banks. ACCION, along with the 800-plus CDFIs across the country, provide a solution by providing gap financing. With the funds we lend to business owners, our work creates a culture of commerce via banking and savings.

Over our history, we have been significant beneficiaries of the U.S. Treasury CDFI Fund, the Department of Commerce, the Department of Agriculture, and the Small Business Administration. Since 1996, the CDFI Fund has awarded ACCION Texas over $8 million in a combination of grants and loans for loan capital, all of which was deployed, on average, within 12 months of receipt. And since 2000, ACCION has received $3.5 million from the SBA for microloans and technical assistance. These funds, with other public and private financing, have been essential in our expansion beyond our initial office in San Antonio to 18 offices across our footprint.

These tumultuous economic times have had a substantial impact on our lending, both positive and negative. While many perceive Texas as having a strong economy, small business still felt the brunt of low consumer confidence in sales and volatility in the market. As traditional credit markets have tightened and loan approval criteria have become more restrictive at the bank level, we have witnessed an increase in demand.

ACCION's loan originations in 2011 were almost $15 million, an increase of 14 percent from the previous year. At the same time, the number of applications received in 2011 increased by over 1,000. This signaled to us that because of this increase, there's a need. However, we were not able to help all the small business owners because of the drop in applicant quality. People waited too long to come to us, and the capacity to repay the loan was no longer there.

We have seen a consistent annual growth in our portfolio. The ever-increasing demand for our services and the associated costs to keep up with the demand continue to provide challenges from a liquidity perspective. We continue to rely heavily on fund raising to support our growth since we are a financial institution without depositors. A current example is our pending $2 million CDFI Fund request to provide loan capital for continued expansion of our services in the Delta. We view our heavy reliance on fundraising as a significant risk for our organization. We are working hard to diversify our support base into new areas such as individual donors. But it is clear, to ensure that funding capacity exists for microentrepreneurs, Federal support plays a key role.

Please allow me to describe ACCION's role in economic development.

ACCION is an alternative lender. The average credit score of our borrowers is 575, the average loan size is $15,000, and the loss rate is 5 percent. We make loans from $500 up to $250,000. And we are part of the SBA pilot loan program that guarantees loans up to 85 percent.

We exist to combat predatory lending. And we exist to help individuals achieve the American dream through loans that will not rob them of the ability to create an opportunity for themselves.

We are regulated by our designation as a CDFI and a CDC.

ACCION currently adheres to compliance measurements that are required by Treasury and the SBA.

ACCION supports the delineation between CDFIs and the traditional lending institutions. And ACCION is committed to being transparent and being accountable.

It is my hope that this commentary will prove to be beneficial as you evaluate the current and potential state of challenges and opportunities facing organizations like ACCION. We, along with our borrowers, have benefited greatly in public and private financing. Thank you very much.

[The prepared statement of Ms. Barrera can be found on page 38 of the appendix.]

Chairwoman CAPITO. Thank you very much.

I would like to thank all of you for the depth of your testimony and your—we're supposed to be reading your face and your voice. I think we have a good reading on that. I must begin with the questions. I'm going to kind of throw this out, so anybody who wants to answer this—some of you have alluded to this in your testimony, but it's one of my little things that really gets me about the Dodd-Frank Act. In Section 1021(b)(3), it directs the CFPB to "Ensure that outdated, unnecessary and unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens." In other words, if this bill is going to come in or the CFPB is going to come in and put new regulations on, you have to scrape out the old ones, the outdated, the outvoted, and no longer efficient burdens.

We wrote a letter to Secretary Geithner asking him to delineate where he had actually identified burdensome and outdated regulations, and he gave us two, one of which was the creation of the CFPB, which we kind of couldn't figure that one out, and the other one was changes to the Bank Secrecy Act, a similar obscure thing. So I would like to know—he did admit in his testimony that they had not really put this as a high priority and made this something that they really—this is one of the reasons—this is one of the ways that Dodd-Frank was sold to several Members of Congress. So, I would like to ask each of you in your institutions, in your examination processes or as you're looking to meet the compliance regulations, has there been any change in terms of removing the old and putting in the new, or is it just putting the new on top of the old? So, anybody who wants to answer. Mr. Parker?

Mr. PARKER. My experience has been, Madam Chairwoman, that it's simply a matter of putting the new on top of the old. As with many of the laws that we see in the Federal Government, there's no sunset provision for a lot of these regulations, and they simply, as we say out in West Texas, get piled higher and deeper just like a lot of stuff that we see out there.

Chairwoman CAPITO. Ms. Martinez?

Ms. MARTINEZ. I think that some of those regulations are as confusing to us as a community institution as they are to the examiners. A lot of times, they come in and they're confused on what

they're supposed to be examining us on. So they go back to the old rules, and then they have to visit the new ones because we're very much informed on the new ones, so we want to comply with what's up and standing in Congress at the time. And so, it makes it very confusing when we have to comply with it because they're not trained. This is a lot—it's a lot for them too.

Chairwoman CAPITO. Would anybody else like to—yes, Mr. Urrabazo?.

Mr. URRABAZO. Talk about some old rules, we had a recent examination where the flood insurance just popped out. That rule has been there forever, and we have complied with it as much as we could. But all of a sudden, they do a very detailed, excruciating examination of flood insurance on everybody who has real estate anywhere, so we had to do a lot of expensive work and compiling of data on an existing rule that was there but that for years and years was—maybe really looked at it—they kind of superficially looked at it, then all of a sudden, they just come in and do a full-blown examination on flood insurance.

Chairwoman CAPITO. I can speak to that personally as I live on the 8th floor of an apartment condominium in Washington, D.C., and I refinanced like a lot of people across the country did, and I got hung up on whether I had flood insurance on the 8th floor in Washington, D.C. So it's probably exactly the same thing.

Mr. URRABAZO. Exactly what I'm talking about.

Chairwoman CAPITO. And it then became a question of whether the condo association had enough reserves to be able to pay if the parking garage were to flood. Anyway, it's exactly what you're saying. And it took an extra 2 weeks because—actually, probably more than that, and a few lawyers, I'm certain, to get that all straightened out, which adds to the cost of everything in the compliance.

Mr. HANSARD. Chairwoman Capito?

Chairwoman CAPITO. Yes.

Mr. HANSARD. One regulation you might pass on to the Treasury Secretary is the Patriot Act. I think all the banks have been affected by the Patriot Act, and at one time, it may have had its place. But to sit down and say that certain professions are high risk—and Congressman Canseco, I beg to apologize right now because an attorney is considered high risk in banking regulation. I agree some of them may be, but to make that broad statement is simply unfair.

We have quit issuing money orders in our bank because of the regulation. We have a lot of people who are low-income individuals who come in and pay their bills with money orders. We quit issuing money orders because of the regulation, that we have to run basically a background check on them, and that background check is a list that the Federal Government has put out, not that anyone else has put out. And to tell you a real live situation, several months ago, I was in a convenience store trying to fill up my pick-up truck with diesel, and for some reason my debit card wouldn't work, so I had to go inside. Inside at the counter was a woman buying $5,000 worth of money orders with hundred dollar bills. She finished her transaction, and she went out to her car—and this is in Fort Stockton, Texas—and got into a solid black Mercedes with the darkest tinted windows you have ever seen, with California li-

cense plates. And there is no regulation for that convenience store to get any type of identification nor is there for the United States Postal Service, which sells money orders, to require any kind of identification, but there is on banks. Those regulations are outdated.

To open up a new account, we have to put our customers through all types of scrutiny. And it takes hours and hours and hours to go through the process that we have to take. My poor new accounts personnel who used to have to have one password basically to get into our new accounts system now have eight passwords because they have to get to OFAC and all these other things that we are required to have because of the Patriot Act. Money is not being laundered through the banks. It's being laundered through private businesses; it's not through the banks. In my 32 years of banking, I cannot tell you of a single instance that I have seen money laundering. And I would ask these other bankers if they have seen it.

Chairwoman CAPITO. I'm going to ask one more question, then I'm going to yield to my colleague. And this will really warm everybody's heart on the panel and in the audience, I think. The 2010, 2011 edition of the Bureau of Labor and Statistics Occupational Outlook Handbook states that, "Increasing financial regulations will spur employment growth both of financial examiners and of compliance officers by 31 percent over the years 2008 to 2018." In the list of the top 30 fastest growing occupations in the United States, in which I noticed home health aide was, for obvious reasons, as we're all aging, in the top five. Compliance officers is one of the top five fastest growing—financial compliance officers is one of the fastest growing occupations in this country.

So we have heard a couple of things. We heard from Mr. Parker that his cost has gone up over 200 percent, we heard from Mr. Hansard who said that he had five—or if you had to hire—you have your real estate person and a compliance officer you know you're going to have to hire. Ms. Martinez said she only—you have eight people total at your bank, or at your credit union?

Ms. MARTINEZ. No. We have 107 employees.

Chairwoman CAPITO. 107. So are 8 in the compliance area; is that what your said?

Ms. MARTINEZ. Pretty much. We have 13 managers who deal with compliance; each one is respective of their area.

Chairwoman CAPITO. And what about you, Mr. Glenn?

Mr. GLENN. We have one compliance officer, but there are about 20 people who have—invest themselves at various levels. We estimate the cost of compliance, just in salary and compensation alone, to be about $600,000 a year.

Chairwoman CAPITO. Okay. That's money that's not going to the small business owner or the consumer to buy a car or to send your child to college. Mr. McCauley, do you have a—quantify on that?

Mr. MCCAULEY. Yes. Ten years ago, our direct compliance department consisted of four people, today it's over 30, and that is direct. That's not including the people in accounting and all that who support it. So it's incredible.

Chairwoman CAPITO. And I'm not sure if in your testimony you specifically said—Mr. Urrabazo?

Mr. URRABAZO. Yes. We have—the same thing as Frost, we had a smaller group, I can't remember, maybe 7 people in compliance maybe 4 or 5 years ago. We now have 48 people working in direct compliance. And it also includes the BSA people and the money laundering people. But all compliance, in general, 48 people. Our budget in there, direct, probably is about $4 million to $5 million. Indirect is probably around $6 million or $7 million.

Chairwoman CAPITO. And, Mr. Parker, I kind of skipped over you; you told us 200 percent more—

Mr. PARKER. We have 37 people in our bank, and 9 of them are directly involved in compliance.

Chairwoman CAPITO. If I had asked you that question 5 years ago, would that have been a different answer?

Mr. PARKER. I'm sorry?

Chairwoman CAPITO. If I had asked you 5 years ago what the proportion was of your compliance officers to your employees, would it—is that consistent?

Mr. PARKER. It would not have been 25 percent. It might have been less than 10 percent.

Chairwoman CAPITO. Is this an issue for you, Ms. Barrera?

Ms. BARRERA. It's is, Madam Chairwoman. Actually, I was just thinking about the fact that even though we're a not-for-profit, not regulated, we have two people in compliance just so that we can make sure that we're honoring the things we should be honoring.

Chairwoman CAPITO. Yes. And how many total employees do you have?

Ms. BARRERA. We have about 100 employees.

Chairwoman CAPITO. A hundred employees. So you think about that, the diversion of resources into—now we have already heard the old regulations and the new regulations—it's no longer just the new regulations—I think this is stymied, is part—I don't think it's the whole reason, obviously, but it does contribute to the inability to get the growth that we want to have.

The other issue, and then—I'm just going to make a statement on this—has to be the talent pool. It's not like you could walk into a bank and say, "Hire me as a compliance officer," and then all of a sudden you're going to be able to sit down and make a judgment as to whether your financial institution is compliant. There has to be a lot of training. If you're lucky enough to get somebody who already has experience, you're basically picking them off from one of your competitors, most probably, or somebody who has moved into the community, so this has to be a huge issue going forward.

I think this is maybe a little bit about what Ms. Martinez was saying on the examination side, the same thing. The examiners have a whole new portfolio, and they're not up to speed on everything they need to be doing. So it's really—I sense your frustration, and I hope you sense ours. I think we have a lot of objective data showing this is a burden that—at the end of the tunnel which is supposed to be more financial growth, more lending, better protection for consumers who—and particularly those in the lower and mid-lower who can't protect themselves—are these folks dropping out of the banking system altogether? They can't get a money order at your bank and they're going to the local five-and-dime to get it, which there probably aren't any five-and-dimes anymore—I'm dat-

ing myself—but the local 7-Eleven or something, what kind of a lifestyle change is that going to bring to those folks who really need the stability of a good financial—with the financial literacy and a financial understanding, which I think includes either being a member of a financial institution, credit union or a bank so that you have that stability. So with that, I'm going to let Mr. Canseco ask his questions.

Mr. CANSECO. Thank you, Madam Chairwoman. And thank you, all of you, for participating in this panel. Just to follow up on what Madam Chairwoman was bringing up, I know that in some of our communities—Del Rio, Pecos County, and I don't know about El Paso or Laredo—there is a drain on the talent pool in order to get those vital resources where you need—for compliance officers; is that correct? Yes?

Ms. MARTINEZ. One of the things that is very challenging for us is, because we're so remote from the bigger cities, we cannot have the pool of personnel that we normally require. So we end up hiring from the bottom up, and we train them. It's very expensive to send them to outside training, so we concentrate a lot on webinars. It is great to have webinars, but you don't get the same kind of input that you would get when you would go and really sit down in a classroom style. So it's very expensive for those of us who are very remote from the major cities to send somebody for training and to maybe even develop that to be in management level positions.

Mr. CANSECO. A lot of your compliance officers—and this is a question for anyone who wants to chime in—are really not producing anything for the bank other than working for the government; would that be a correct analysis? Weigh in on that, Mr. Parker or Mr. Urrabazo?

Mr. URRABAZO. Congressman Canseco, let me just say that talking about personnel and qualified people, not only is it a problem to find them, not only is it a problem to take them to Laredo, Texas, but the biggest obstacle, even if you find some very highly qualified people, is it is very, very difficult to compete or to get head-on with the FDIC when they have a staff of statisticians with Ph.D.'s doing regression analysis on your data, and they can cut and slice that data in many, many ways. And when you go talk to them about any kind of analysis, our best person there with all kinds of background in compliance cannot compete against a Ph.D. with a statistics background, two or three of them at the same time, it's impossible to beat them.

Mr. CANSECO. We have talked a lot about compliance and new rules and the burden that it poses on your banks and the cost of that compliance, but one thing that I haven't heard yet, and I would like all of you to weigh in on it, and that's how this ultimately affects your customers because after all, that's what you're in business for; how does this cost of compliance affect your customers?

Do you want to start, Mr. Glenn?

Mr. GLENN. I guess the best example is the way they changed the way you process mortgage loans. We used to have a rule of thumb that the closing costs for a borrower were about 3½ to 4 percent of the loan amount. That would cover all of the outside

costs, including the origination fee. That number has gone up about 50 percent, and it has also extended the amount of time that it takes for a member to close the transaction. It used to be you could close a mortgage loan in something like 30 days. It's not unusual to see 75 to 90 days for a member to receive their money. That's not good for the economy, and it's not good for the consumer. I don't know who it's good for except the printers. I don't know.

Mr. CANSECO. Mr. Hansard?

Mr. HANSARD. I don't have a lot to add to that except that we have not seen any benefit to the consumer. The more regulation that we see, the more time that I have to spend on paperwork instead of being able to sit across from the desk and talk to that consumer. And as I said, I like putting my hands on the collateral and going out and visiting my customers, and that time is very, very limited.

Mr. CANSECO. Ms. Martinez?

Ms. MARTINEZ. I used to spend more time on developing programs for the members, new programs, new products and services. And now, I spend the majority of my time reviewing laws and regulations.

Mr. CANSECO. Mr. McCauley?

Mr. MCCAULEY. You talk about fair lending; there are several different elements of that. But we are relegated now to having to make everybody fit into a box. There's no more flexibility, there's no more risk-based pricing, there's no more advantages to somebody to have a clean credit score. If I'm going to make a loan, I have to make it—either it's an up or down decision, and there's no flexibility based upon it. So you're not really benefiting the customer. A lot of customers are getting turned down because they don't fit in the box where before you had the flexibility to work with someone. The customer is not being benefited now because everybody has to fit in the box, and they all pay the same amount. There is no risk-based pricing, no reward for having a clean credit score, paying your bills, taking care of your business. So, no, there's no benefit to the consumer especially at all.

Mr. CANSECO. Mr. Parker?

Mr. PARKER. We have seen loan products go away. The last bank I started is nearly a billion dollars in size now and had a thriving mortgage section in it. That's gone. That's a resource gone from our community. There are a number of other products, as Cliff McCauley said, that do no longer exist. We're being told by people who have never been in business of any sort, who have never been in business anywhere, how to run a business because they know best because they have learned from books.

When I taught on a university level, I can tell you, I taught people the basics. And I told them that when they went out to pursue their careers, they would then get the second part of their education. Unfortunately, we're having regulations written by people which are then being checked by examiners, none of whom have ever been in the private sector, so they have no clue about the variety and the richness of the human animal that we serve in business. We are all different, and that's what's so wonderful about being in a country like America where we're all mongrels of a sort. We really are all different, and we all have different needs and dif-

ferent desires. And you know what? Community banks used to be able to meet most of those before current regulations. That's going away. That's one thing.

Two, I have for your edification this thick pile of papers—I didn't enter it into the testimony—but this is just a sampling of all of the disclosures we must make. We have a joke in the bank that whenever the House Financial Services Committee comes into session, they ought to be required to read this before entering into any business whatsoever. I'll tell you what, when we pass this out as required, it has been vetted, saucered and blowed, but our customers don't read it. They throw it away. And, indeed, since only about—according to the national experts—13 percent of the population is functionally fully literate enough to understand this mess, I can understand why we see our trash cans fill up with these papers after we open accounts, after we do loans, this, that, and the other. That's the consumer telling us what they think of this.

Mr. CANSECO. Mr. Urrabazo?

Mr. URRABAZO. I think it has been already discussed, but I want to give you some examples of how some of these compliance issues affect the consumer. I think I discussed that everybody has to fit very clearly in that particular box. And I'll give you an example of a very good customer of the bank who has been with us for at least 25 years, and he's our maintenance person. He came in for a loan, a consumer loan, to buy a truck. He had had some credit problems a couple of years ago through some kind of divorce issue, so he couldn't qualify under that particular issue. So I declined the loan, he didn't fit in there, even though I know very well that—he works with us, and I'm the one who pays him, he's our maintenance person, but he did not qualify under that box. I did not want to make an exception because I have to find some other exceptions to that.

The funny thing about this, he's a good customer of the bank, has been with us—paid us every time on time because I debit his account every month. After I pay him, I debit it out. So I have no problems with that. The funny thing about this is that the next day, I had another customer who came in for a renewal, and this person was marginal at best. I had had some problems in collecting from this gentleman for the past 3 or 4 years; it's a $3,000, $4,000 loan. And as I renew the note, he doesn't come into this box anymore because I have the note, I cannot tell him to go away anymore. But what's funny about this is when I gave him a price on the loan, he now has a lower price than the one I had before because now he has to fit into this little box. So before I was charging him, let's say, 12 percent, and now I have to charge him 13 percent. And I can almost see his face when he left the bank and was being renewed laughing at the bank because he says how in the world can I be such a bad customer and they gave me a better rate now. This is the fallacy and the joke about all this. You will not fit everybody in that same box.

Chairwoman CAPITO. Ms. Barrera?

Ms. BARRERA. Congressman, I think the other issue, the question that needs to be asked, in terms of consumer protection is regarding the predatory lenders. What are the regulations there? How can we—you have heard examples already of people not being able to be served either by the banks or even by us. So our competition

really is the predatory lenders and pawn shops and people out there making loans if, can you breathe, here it is, and here's your loan, and you're going to pay 300 percentage points on it, or something on it because you're just—it's volume for them and scalability, right? So I think questions need to be asked along those businesses as well.

Mr. CANSECO. Thank you. I will say one thing—what we're hearing here is that the whole business model of a community bank, knowing your customer, working with your customer, accommodating to your customer into the needs of your institution in order to work together to build your community, is being eroded because of rules and regulations and laws such as Dodd-Frank. The ability to visit with a customer and work with that customer now having to fit into a box is going to really chase them away. And that's a sad testament to what we have here. But I thank you all very much for your answers. And I yield back for the time being.

Chairwoman CAPITO. If you all don't mind, I would like to ask a couple more questions. I would like to know—I kind of alluded to this, Mr. Parker, when I asked you if I had asked you that question 5 years ago, what the difference might be. I would like to know if your relationship with your regulators has changed and—over the last, say, 3 or 4 years, and how—you have all alluded to this in your individual testimony, but if you could get a little more specific or have anything you want to add on that issue, on the changing, evolving relationship, are there—who said that—I think it was you again, Mr. Parker, who said that there were eight people in the bank for weeks and weeks—has it changed for you, Mr. Glenn? We'll just go through the panel.

Mr. GLENN. Our examiners have always been fairly cordial, but they are taking a much more exacting tack with us. And I think it's—I view it more as a response to some heat they're feeling from the legislature, and not all of that is unjustified, but they are looking at things closer. I had one odd thing happen during our last exam. Our credit union has about $100 million in investments. And all but three of those securities are Federal—all of them are Federal agency or Treasury securities, but we classify all of the securities, except for three that we hold, as "held material." And one of the things that they told us we had to do was start classifying them as "available for sale."

The reason he said that we had to have this classification as "available for sale" was because there might be a liquidity issue. And I said, "I have 20 percent liquidity. Exactly how much liquidity do I have to have?" And he couldn't give me an answer to that, just that I needed to have these things "available for sale." And I asked him, I said, "Now, let me make sure I understand this. The reason that you have them available for sale is to raise liquidity, but if I classify the investments as available for sale, I have to mark them to market every month and that can adversely impact my capital, and wasn't that exactly some of the problems that caused some difficulties in our corporate credit unions?" And he didn't have a response, but I still have to mark them to market—now classify them as available for sale until 10 percent of my portfolio is like that.

Chairwoman CAPITO. Wow. Mr. Hansard?

Mr. HANSARD. I have a few comments, but I have to be careful about what I say. I have two branch applications in process right now.

Chairwoman CAPITO. That's another issue, but—not you specifically.

Mr. HANSARD. At our last FDIC exam, we had 16 examiners in the bank for 2 weeks. One examiner, all he did was work on a trust exam. We have a very, very, very small trust department. It has one account that totals $200,000, and that examiner spent 2 weeks and grilled me for hours over that one account. What was interesting to me is that they had just left a $2½ billion bank, which was the largest in their territory, and only 2 examiners were sent to a $2½ billion bank while I had 16 examiners in mine.

Ms. MARTINEZ. The area that we service is a low-income area. The majority of the people there, their credit scores average between 550 and 570, so they are very low credit scores. We currently don't do risk-based lending. However, the examiners have been on my case for about 3 years that we need to do risk-based lending.

My answer to that was that every single member who walks in is risky because of the risk we take with that person being that their credit scores are so low. We also have a low-income designation which, really, when an examiner comes in, they need to take that into account because of the area that we service. And a lot of times, I think they forget that. They forget that having a low-income designation is because you're serving a different part of the country that requires probably more work on it, but they don't realize that they still want to go back and make sure that we adhere to some of the regulations that they have, which we always do, and we document everything.

I have been very blessed. The examiners that I have had, we are able to work with them, they always work with me. Just like Mr. Glenn was saying, one of the things that a lot of the times they don't understand is the investment area, they don't, when it comes to the investments, because we do agency securities. And they come in, they don't understand it, so they just create a lengthy process on reviewing those. But I also have heard that some of the other smaller credit unions have had some issues, especially when they have that low-income designation.

Mr. MCCAULEY. To answer your question, has the relationship with the regulators changed, I'm going to answer that on more of a global basis based upon work with other financial institutions, and the answer is unequivocally yes, whether it be—especially in the area of target exams, whether it be an overdraft, fair lending or safety and soundness, it's primarily centered with the Federal regulators, and—bring in a group maybe that's not within the territory of the district of that Federal examiner but from another State, another area, it's almost as if they feel like the local group is, what we call here brother-in-law in the local institutions, they don't believe that there isn't a problem, and they come in with really an attitude of, we're really going to get you this time.

And I have heard that from many, many bankers, real estate target exams, from a group out of California saying, "You don't understand what's about to happen to you because we know everything because we saw it." And so, yes, I think it has eroded, but it's

mainly on the Federal level. From what I'm hearing, it's the Federal regulators, and what is, I guess, really considered be a disconnect, and that there are edicts coming from the wizard behind the curtain in D.C. Nobody wants to own up to who that is, but from the standpoint—it's mainly a Federal-centered issue.

Chairwoman CAPITO. All right. Thank you. Mr. Parker?

Mr. PARKER. I think I can answer your question directly, and I will tell you that we have two kinds of regulators, and I don't say this because Commissioner Cooper is here. Our State regulators approach things very differently than their Federal friends do. The State regulators appear to take a little more common-sense approach. They are just as diligent. In fact, I haven't seen a diminishment of diligence. I have seen some pretty good hard work from them. They call them as they see them, and they're very fair.

The Federal people, on the other hand, are a very different group. And they fall into two categories. One, they're the safety and soundness people who come out, in our case from the Federal Reserve Bank in Dallas. They have become much more attuned to nitpicking. They will go back not only to current regulations, but we may be hit with a violation of the law, the regulation, the guidance, the SR letter, and then the commentary to the regulation, and I have to tell you, the last three of those have nothing whatsoever to do with the law. I finally got them to admit that, yes, indeed, they are merely opinion.

I have talked in my testimony about some rather egregious examples, and I won't go over that again. The ones that are particularly deadly are the compliance people. The consumer compliance people that we see are on an absolute mission, and they glory in the fact that they could refer you to the Department of Justice. And the comment from the Department of Justice is, "Go ahead, because we have all the lawyers in the world, and we have a lot more money than you do." That's the attitude, and that's not proper. It's particularly not proper coming from our government.

One last thing I might tell you, and I mentioned this in my testimony, the last several exams—I have talked to the examiners—we have had good relations with these folks for years—and they are genuinely afraid—people in the regional and the field offices are genuinely afraid of the people in Washington, and I have never seen that before. That is some of what's driving what we see today.

Mr. URRABAZO. I would just like to basically repeat, I think Les Parker said it very clearly, I think there are different types of examinations. And, again, I think the State examiners are more practical, more realistic. They're firm, but they understand the dynamics of our particular area, of our particular economies, whether it's a booming economy in Laredo, it could be a recession going on as opposed to what the national is. So they understand, I think, the dynamics a little bit better. I think they understand the type of customer we have, the type of situation. In our case, we have a lot of deposits out of Mexico. They understand that. I see a difference then with the Federal examiners, whether it's the Fed or the FDIC, and I do think that what Les is saying is very, very correct. I think they're very, very skittish. I think they go back to the regional office for guidance, if you want to call it that, and sometimes even the regional office in Dallas refers this to Washington. And by the

time it gets to Washington for some clarification on a fair lending issue, it already has become a bad deal because nobody wants to make a decision on this. And then the referral to the Department of Justice is the last part of Washington to clean their hands on anything of this sort.

I do know, though, that we also have various examinations, for instance, the safety and soundness exam, a compliance exam, the BSA/AML type of exam, an IT exam. We have all kinds of exams going on. We have the internal auditors going, and we have the external auditors. We have—everybody—any particular month, I'll have somebody in the bank looking over some documents. But what amazes me, and I see the difference again between the Federal and the State, the Federal, for instance, I had a situation here a couple of years ago where they had one examiner stay one week in one type of investment that we had. We have what they call BOLI, bank-owned life insurance—it's an investment type of vehicle that we use—a $7 million investment in there, which is really not that much. He spent one week reviewing that particular investment. Every day, in the afternoon, he would come to my office to discuss it. At the end, nothing happened; he just passed on it. And I'm there looking at this thing every day because you have to be very careful—now, I will say, though, they're very professional, and they will never—there are never any arguments, but they were very professional in their approach, but I just don't understand what they did in one week on a $7 million investment, what we call BOLI, what he did. I just don't understand. I would have done that in 3 hours.

Ms. BARRERA. Our Federal examiners are there to look at our funding, how did we use the funding and so on. So it's a different kind of an exam, did we do with the funds what we said we were going to do.

Chairwoman CAPITO. I want to take the opportunity—I have a lot of other questions on the qualified residential mortgage, on the appraiser regime that has come through Congress as well, the CFPB complaint process, I guess, on their Web site. They have thousands, I think, thousands of complaints on their Web site, how are they framing these, how are they following up on them, is it a fair process—is there any retaliation if you accumulate more complaints than anybody else or certain types of complaints. I think that's something that we need to really—because as we all know, getting on the Internet and lodging a complaint is a really easy thing to do. And certainly we want to—you want to hear if things are going wrong.

The other thing I want to say is I have a bill out there that talks about examinations. It has three components to it, first, the timeliness of the reports, because we have heard from the hearings that reports are not coming in, in a timely fashion. Also, they're leaving the district office, so they're leaving your financial institutions and going to the district office with one sort of mindset, and by the time they come back from Washington, they have a totally different viewpoint on it, which sort of alludes to what you all are saying, that Washington is playing a heavier role or changing the viewpoints of the local examiners.

Second, it has some examination standards that come out of the areas of our country that have had—really been devastated by commercial real estate and residential real estate, property values dropping to try to make sure that you don't have to reclassify loans as long as the person is paying—I'm simplifying this a lot—but paying and all that.

And third, the independent review process, where if you have an appeal, that you're not appealing to the person who made the decision to overturn the appeal of their own decision. And we have set up an independent appeal process where an independent body would be able to oversee, would give you ease of—would give you a lot more objectivity, probably a lot more expediency, and you also would have—it's human nature that you're not going to want to overturn your own decision. So there have been reports of retaliation or some—not retaliation like we might think of it, but there are subtle ways to make decisions because you're in a subjective world. So we're trying to eliminate that.

Lastly I'll say, just for those of you who have a son or daughter who's a bank examiner, we don't think you're bad people. It's not about that. It's not a personal thing. It's about getting it right. And in our Georgia testimony, we did have the examiners on our panel. Today, we did not. But we are listening to them as well because they have a viewpoint to represent that we all, I think, in this room believe is very important at the same time. I know I have met many of you who started out as a bank examiner and then have gone into the banking profession, and then now as a head of the banking commission—am I saying—it's commission, isn't it—yes, here in Texas. So those are rich experiences I think for anybody to have in these kinds of positions, and I want to thank you for coming today. So, any final questions from my colleague?

Mr. CANSECO. I don't want to hog the microphone or the question queue, but I do have some questions, if I may. And just let me know, Madam Chairwoman, if I have overexceeded my time.

Let me ask you, Mr. McCauley, the FDIC is conducting a study in review of what type of institutions should be classified as a community bank. Currently, the general definition is a bank with less than $1 billion in assets, with a few exceptions. Now, your bank does business all over Texas but still has a community-oriented model in serving your customers; what factors does the FDIC need to take into account when determining the definition of a community bank?

Mr. MCCAULEY. This has been an age-old question on how do you define a community bank, and it has always been a moving target. The FDIC—it's not about size. It is really about your business model. There are so many banks now; there are over 30 banks over $1 billion in the State of Texas today, just because of the asset growth and deposits that are in the system today. So you can say there are a lot of big banks that I would tell you are community banks. We're just a big community bank. Look at the lines of business we're in. We didn't do subprime mortgage lending, we don't do indirect lending. We don't do a lot of the things that would categorize someone as a megabank. So the FDIC needs to take into account really looking at their business model, the lines of business that they participate in, I think their reputation with their cus-

tomer base, their long-term history of success within the lines of business that they choose to participate in and how well that they do it. You could look at some other metrics as far as their foreign activity and all of that, but I think that becomes—then you start getting more complicated on the definition. It's really looking at the business model, the lines of business that they're in and how they operate and how they support the communities that they're in.

Mr. CANSECO. So putting it in simplistic terms, it's like being in 6th grade and you have big kids and little kids and medium-sized kids?

Mr. MCCAULEY. Yes.

Mr. CANSECO. Okay. So I understand that Frost Bank has recently applied to become a State-chartered bank regulated by the State Department of Banking; do you feel this is a step that a number of community banks across the country could begin to take, given the greater knowledge that State regulators have about the areas that they serve?

Mr. MCCAULEY. Let me speak about our decision. First of all, it wasn't a hasty decision; this has been made over a long period of time. And it was really—we have always had a very good relationship with the OCC. We have been an OCC bank since 1898. So it's not a decision that you make flippantly, to make this kind of a change. However, as we talked about a little bit earlier, there's more of a disconnect now on the Federal level than there ever has been before. And while we have had that longstanding good relationship, we're a Texas-based bank. We plan on being here for a long time. We have been here since 1868, and we plan on being around for another 150 years. And we felt to serve our market, serve our communities, our customers better as well as our shareholders, it would behoove us to have a regulator that was closer to home that understands our markets, that we could have an open and honest dialogue with. Commissioner Cooper is very available to speak to all of his member base. I think you have heard the testimony—and I hear this all over the State—that—try to say, "We really don't like to be thrown under the same blanket as all banks"; well, I don't think that all regulators should be cast that way. Also, the State Banking Department has proven itself to be a fair and a communicative regulator. Now that we will also come under the direct regulation of CFPB being over $10 billion, balancing that Federal regulation with a State regulator we thought would be prudent.

As to the trend of other banks, I couldn't speak for them in their decision. I will say that I travel a lot. I have visited with literally hundreds of bankers since that decision has been announced, and everyone has been very supportive of our decision from both the national banks as well as the State banks. The only two negative comments came from attorneys, so I figured we probably made the right decision.

Mr. CANSECO. Thank you. Let's turn now to interchange fees, the Durbin Amendments. The final cap on those interchange fees for debit cards has been in place now for several months. While initial data show that—different results in revenue for large versus small banks, there's great concern within community banks that merchants will eventually route transactions to the banks with lower

interchange rates. Do you share these concerns, and are you aware of any attempt to do this already?

Mr. MCCAULEY. I absolutely share those concerns. Serving on the payments and technology committee for ICBA, we have had the opportunity to visit with many of the interchange providers, and they will tell you that it's going to be incredibly difficult over time to have a bifurcated system, to have a two-tiered system. While, yes, we are over $10 billion, we are directly affected by the Durbin Amendment, and it has been a significant decrease in interchange revenue for our organization. I don't think there's a community banker that I have visited with around this country who doesn't agree that it's eventually going to affect them directly. The merchants will find a way to route these. They're not going to pay a higher interchange fee for one institution versus another. I think right now there is probably kind of a cooling-off period, if you will, for the whole Durbin Amendment and nothing has happened. But I don't think anybody's confused that eventually it will, and it will, and I think every community bank agrees with that.

Mr. CANSECO. The customers, ultimately it's about the customers; how are the customers being affected by this?

Mr. MCCAULEY. Interchange revenue historically was utilized to benefit the consumer, and it's something that people don't really—they have a hard time realizing. Free-checking programs were put in place as a give-back. That was a way to support the consumer by giving them fee exclusive programs, free-checking. What that did is it brought a lot of unbanked or underbanked individuals into the banking system, which was part of the Federal mandate and what banks were trying to accomplish. That wasn't necessarily a profitable move for the banks, but it was something that we could leverage that interchange to those consumers.

You're going to see that change. Free-checking programs are gone. There may still be some in place by the banks under $10 billion or they have been grandfathered, but they will go away. Then, you're eventually going to see fees. I think we—you saw Bank of America's transparency was trying to do that; they removed that. But that was a shot over the bow that it's going to happen. So not only do you have the free-checking product going; you're going to have something that is going to the take place as far as the fee to the consumer. I don't think I have seen a roll-back in prices by any of the retailers that are benefiting from this, and so the consumer is not winning at the retail level nor eventually at the financial institution level because there are no free loans.

Mr. CANSECO. Thank you. How is my time? Okay.

Mr. Urrabazo, I have spent a good deal of time speaking with Treasury officials over their proposed rule on the deposit interest reporting. They seem to be prepared to forge ahead, and I'm afraid they're not listening to the concerns of a number of Texas banks. What are you currently hearing from some of your customers over your proposed rule, and what the effect is of a final rule going to have on banks throughout Texas?

Mr. URRABAZO. First of all, we did fight that battle about 10, 15 years ago, and we won it. The Treasury was trying to do the same thing, regulate the foreign deposits in our banks. Obviously, border banks are more effective than other banks across the country. So

the Treasury is only hearing a small group of banks, Florida, Texas, California, some of the money center banks in Chicago, maybe New York. The issue here is that there's no benefit to the Treasury or America. If they're trying to find the tax evaders—the U.S. tax evaders who are in Mexico, as they exchange lists one through the other, they're not in Mexico. There are zero or very few. So the issue really is a much bigger global approach of what they're trying to do, in my opinion.

The problem here is that, again, going back to the short-term situation, we're going to get affected detrimentally, especially in the border, as some of these Mexican citizens come to realize that their name will be set up in a list with an account number with an address and sent to their treasury in Mexico, and who knows what's going to happen at that time. Given the situation in Mexico, I'm talking about the violence and the drug cartels, if that list gets out of hand to some of those people or has been—into the black market, and that particular customer of ours becomes aware that list is there, then all of a sudden, he's susceptible to kidnapping and extortion and other kinds of information. And that's what they're afraid of.

The tax consequences are minimal for the Mexican citizen in Mexico. The tax system in Mexico is very, very different than our taxing system. Over there, if they pay 15 percent on their income, that's too much. So if you even take a scenario of, let's say, a million dollars that a Mexican citizen has here and we pay him, let's say, 1 percent, $10,000, and he's going to pay 15 percent tax in Mexico for that $10,000, which is $1,500, that is not the issue. The tax is not the issue. The issue is security. And that's why they're so concerned about this. The Mexican press has really, really built it up over there, and many of our Mexican customers are coming in, asking questions, and they're very, very afraid. So I think what's going to happen is going to be capital flight. That's the bottom line to all this, and all this money is going to go someplace else which is a safe haven.

Mr. CANSECO. And who will ultimately pay the price for this capital flight, is it your customers?

Mr. URRABAZO. Obviously, the banks. We don't have enough money to lend, liquidity problems that we might have. And, certainly, we don't have the ability to lend that money to our consumers, to our investments, to our small business people. We will not have that ability. We will have to shrink our portfolio significantly. So we're deadly afraid of this. But, again, the bottom line is there is no benefit to the United States, zero.

Mr. CANSECO. In your testimony, you described some of the frustrations you have with regulators over fair lending laws which can sometimes draw in the Department of Justice investigations; can you give us some further insight into the negative impact the regulatory approach over fair lending laws has over your bank, other community banks, and your customers. Very briefly, because I think I'm running out of time.

Mr. URRABAZO. Yes. Again, the fair lending laws are extremely delicate, and very, very serious, and we're very, very concerned about them, and we want to do the right thing. Fair lending sounds correct, but it's very, very difficult to put into one particular area

and put it in the same box and be fair to everybody. It's just very difficult. The issue is when it goes to Dallas, and then from Dallas it goes to Washington, and then from Washington it goes to the DOJ. And that's where you have to have an extremely—a lot of professional people, a lot of expert people who know what they're doing when it gets to those levels. And I'm talking about attorneys, etc., etc. I think that some of these cases are completely out of hand. When you talk about maybe 55 accounts that were in one particular branch that were out of whack with another branch by 75 basis points, and you're talking about an $11 billion bank and you're talking about 55 accounts, 55 mortgages, that's when it's really out of hand.

Mr. CANSECO. Thank you very much. One more question to Mr. George Hansard. Community banks provide the credit necessary for economic growth and job creation in communities such as Fort Stockton; have you given any thought to what your community would look like if there weren't institutions such as yours to provide credit?

Mr. HANSARD. I have given a lot of thought to it. If you just had the megabanks in Fort Stockton, Texas, all that you would see would be consumer loans, car loans, maybe credit cards, things like that. I believe that your small businesses that we work with every day would simply be nonexistent, the mom-and-pop operations that I think drive the communities, there wouldn't be that emphasis.

Mr. CANSECO. How would large banks fare in a community like Fort Stockton if they would come up and set up a branch there?

Mr. HANSARD. I would hope not very well. No, in a community like Fort Stockton, I don't believe that a large megabank would be well-accepted. Our model is all the bank that you'll ever need. We believe that. We handle consumer loans, we help people get credit card loans, we do a lot of small mortgages that we keep in-house. These are mortgages that would not qualify for the secondary market. And if that was squeezed off, we have a low-income community, and it would be very, very detrimental to our consumers.

Mr. CANSECO. And Fort Stockton is a community that wants to grow and has a solid business background, doesn't it?

Mr. HANSARD. Yes, sir.

Mr. CANSECO. And would you agree that the cost of all these regulations that we have been talking about ultimately are paid by the consumers and businesses that rely on your bank services?

Mr. HANSARD. I would say so. Anyone who doesn't understand that needs to go back to school, I would think.

Mr. CANSECO. Thank you, Mr. Hansard. I yield back.

Chairwoman CAPITO. I think that concludes our hearing. I think we have gotten a lot of very good information to take back to Washington. I would like to thank a few folks that I didn't thank in the beginning. I would like to thank my staff for putting this together and doing an excellent job. And I would like to thank Mr. Canseco's staff, both his district and his D.C. staff, for working with us to make this successful. And I would like to thank everybody who works in this building and has helped us, as well. Thank you all. And I would really like to thank Mr. Hansard's two young children who have sat through 2 hours of this. I know you're proud of your

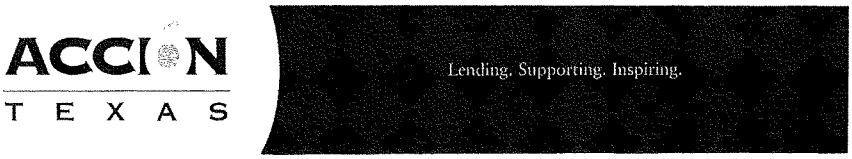
dad or you wouldn't be here. You're going to write a paper on this when you get home, right?

With that, this hearing is adjourned. The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

[Whereupon, the hearing was adjourned.]

A P P E N D I X

March 14, 2012



Date: Wednesday, March 14, 2012

Hearing: "An Examination of the Challenges Facing Community Financial Institutions in Texas", Presented to:

Hearing Host: the U.S. House of Representatives Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit

Planned Testimony: Janie Barrera President & CEO ACCION Texas Inc.

On behalf of the Board of Directors and Staff of ACCION Texas Inc., welcome to San Antonio. We thank you for hosting this bipartisan conversation on the challenges facing financial institutions in Texas. As a nonprofit organization, we partner and work with a broad spectrum of voices and practitioners in economic development – and today I hope to share insight and expertise in the challenges and opportunities that face you as policy makers.

San Antonio is the headquarters for ACCION Texas Inc. We began our work here in 1994 and have now become the largest nonprofit microlender in the U.S. We serve eight states, including Texas, Louisiana, Arkansas, Missouri, Alabama, Mississippi, Tennessee and Kentucky, some of the poorest States in our country. We have provided over 12,000 business loans, disbursed over $121 million dollars to over 8,000 small businesses. ACCION currently has an active portfolio of $25 million outstanding and has a 95% repayment rate. The average credit score of our borrower is 575. We are also a registered Community Development Financial Institute (CDFI).

This year marks our 18th anniversary and as we reflect on the challenges of financial institutions that are considered nontraditional, we recognize the importance of oversight and diligence. At the same time we must remember that we need intermediaries that deploy funds to individuals who are not 100% ready for traditional banks – ACCION along with the 800 plus CDFIs across the country provide a solution by providing gap financing. With the funds we lend to business owners, our work creates a culture of commerce via banking and savings.

Serving small businesses throughout Texas
Central Office: 2014 S. Hackberry Street San Antonio, Texas 78210 (t) 210-226-3664 (toll-free) 888-215-2373 (f) 210-533-2940 www.acciontexas.org

Over our history, we have been significant beneficiaries of the U.S. Treasury CDFI Fund, Department of Commerce, Department of Agriculture, and the U.S. Small Business Administration. Since 1996, the CDFI Fund has awarded ACCION Texas over $8 million in a combination of grants and loans for loan capital, all of which was deployed, on average, within twelve months of receipt and since 2000 ACCION has received $3.5 million from the SBA for microloans and technical assistance. These funds with other public and private financing have been essential in our expansion beyond our initial office in San Antonio to 18 offices across our footprint.

These tumultuous economic times have had a substantial impact on our lending, both positive and negative. While many perceive Texas as having a strong economy, small business still felt the brunt of low consumer confidence in sales and volatility of the market. As "traditional" credit markets have tightened and loan approval criteria have became more restrictive at the bank level, we have witnessed an increase in demand.

ACCION's loan originations in 2011 were almost 15 million dollars, an increase of 14% from the previous year. At the same time the number of applications received in 2011 also increased by over 1,000. This signaled to us the increase in need. However, we were not able to help some of the small business owners because of the drop in applicant quality. People waited too long to come to us and the capacity to repay the loan was no longer there.

We have seen a consistent annual growth in our portfolio. The ever-increasing demand for our services, and the associated costs to keep up with the demand, continue to provide challenges from a liquidity perspective. We continue to rely heavily on fundraising to support our growth. A current example is our pending $2MM CDFI Fund request to provide loan capital for continued expansion of our services in the Delta. We view our heavy reliance on fund raising as a significant risk for our organization. We are working hard to diversify our support base into new areas such as individual donors. But it is clear: to ensure that funding capacity exists for micro entrepreneurs, federal support plays a key role.

Please allow me to describe ACCION's role in economic development:

1. ACCION is an alternative lender. The average credit score of our borrower is 575. The average loan size is $15,000. Loss rate is 5%. We make loans from $500 to $250,000. We are part of the SBA pilot community loan program that guaranties loans up to 85%.
2. We exist to combat predatory lending. And we exist to help individuals achieve the American dream through loans that will not rob them of the ability to create opportunity for themselves.
3. We are regulated by our designation as a CDFI and CDC.

4. ACCION currently adheres to compliance measurements that are required by Treasury and SBA.
5. ACCION supports the delineation between CDFIs and traditional lending institutions.

ACCION is committed to being transparent and being held accountable.

It is my hope that my commentary will prove to be beneficial as you evaluate the current and potential state of challenges and opportunities facing organizations like ACCION. We, along with our borrowers, have benefited greatly in public and private financing.

Thank you for your attention and consideration.

STATEMENT OF

ROBERT A. GLENN
PRESIDENT AND CHIEF EXECUTIVE OFFICER
AIR FORCE FEDERAL CREDIT UNION

BEFORE THE
HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

HEARING ON AN EXAMINATION OF THE CHALLENGES FACING COMMUNITY
FINANCIAL INSTITUTIONS IN TEXAS
EXAMINATION FAIRNESS AND REFORM ACT

WEDNESDAY, MARCH 14, 2012

I. Introduction

Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, Air Force Federal Credit Union (Air Force FCU) appreciates the invitation to offer our views on the challenges facing community financial institutions in Texas.

In the invitation to testify, the Subcommittee has asked Air Force FCU to comment on the challenges facing community financial institutions in a number of different areas. Particular emphasis is to be given the challenges faced by community financial institutions in dealing with the increased volume and compliance costs of federal financial regulations; an overview of the role of community financial institutions play in Texas; the effect inconsistencies in the application of examination standards and guidance has on community financial institutions; and our thoughts on the future landscape for community financial institutions including the costs and benefits of consolidation in the industry.

This written testimony will provide background information about Air Force FCU, credit unions within Texas, explore some specific challenges that Air Force FCU faced in the implementation of some recent regulatory changes, provide comments about our examinations and our view of how industry consolidation will impact consumers.

II. About Air Force FCU

Air Force FCU was originally chartered November 3, 1952 to serve employees and military personnel, and employees of the Post Exchange of the Lackland Air Force Base who work in San Antonio, Texas; employees of the credit union; members of their immediate families; and organizations of such persons. Subsequent to that date, other groups were added to the Field of Membership, but in May 2010 we were approved for a single sponsor group that defined our Field of Membership (abbreviated) as all active duty military personnel (all branches of service), reservists, National Guard and Air Guard, Department of Defense civilian employees, Department of Defense contractor

employees working at or assigned to military installations within the states of Texas, Oklahoma, Arkansas, Mississippi, or Louisiana; military retirees and Department of Defense civilian retirees residing in the states of Texas, Oklahoma, Arkansas, Mississippi, or Louisiana; employees of the credit union; immediate family members of the foregoing groups; and organizations of such persons.

We provide consumer loans (including credit cards), mortgage loans, consumer deposit products and services and member business loans, member deposit products and services.

Our core values are the same core values as the military members we serve – Integrity First; Service Before Self; and Excellence in All We Do. We believe this alignment of core values uniquely positions us to perform our mission to: "Be the one financial Institution that best understands and meet the needs of our members, wherever they are." Simply put, we are all about serving our members – adding value to their financial lives.

When originally chartered we had ten founding members each of whom made a $5.00 initial share deposit. Today we have more than 36,900 members who own shares and equity valued at $331.8 million. At year-end 2011 our total assets were $342,423,115. Currently we have 142 employees – 131 full-time employees and 11 part-time employees.

III. Texas Credit Unions

The following data comes from the 5300 Reports that the National Credit Union Administration (NCUA) collected on credit unions in Texas as of December 31, 2011.

There were 536 credit unions which were headquartered in Texas. The largest of which held $6,544,458,049 in total assets and the smallest of which held $18,513 in total

assets. The average total assets of Texas credit unions were $135,740,851. There were only 13 credit unions in Texas whose total assets exceeded $1 billion.

There were 427 Texas credit unions with less than $100 million in total assets. The average assets of these very small credit unions is approximately $21.8 million and these institutions have on average 8 full-time employees and 1 part-time employee.

As will be noted later in this testimony, we have struggled at times to meet the compliance burden brought on by new regulations and by regulatory changes. It is hard to imagine facing these challenges with such limited resources. Truly the task must be daunting.

IV. Our Challenges and Concerns related to Recent Regulatory Changes

Our credit union has a proud history of compliance with regulations. We have always sought to be prompt and thorough. We are frustrated if we overlook even the smallest of details.

Our senior management team is comprised of ten individuals including myself. We have a Vice President for Compliance, who along with Vice Presidents who own certain products. They will coordinate modification of processes, staff training, coordinating changes to information systems, and coordinating third-party vendor responses. Often changes more complex than believed.

The burden of compliance is different with each regulation or regulatory change.

The Credit CARD Act of 2009

The Act had many provisions that were beneficial to consumers. In fact, there were many provisions that represented no challenge to our credit union at all because we were already doing business in ways that were aligned with the provisions. But as with

most any legislation, there were provisions that created challenges for us and with some considerable expense. Most of the expenses were centered in a few areas. In some instances one could argue that these expense-ladened areas provided limited benefit to consumers or were not used by consumers to their greatest advantage.

Let us consider a few specific provisions that were challenging to Air Force FCU.

Due Dates of Payments on the Same Day of the Month

Before the Act, card issuers sent a monthly statement. The date the statements were prepared was based on a cycle billing system that allowed the issuer to spread their statement production over an entire calendar month so they could contain costs. Statements were usually prepared within a few days of the same date each month and the payment due date was in relation to when the statement would be prepared (usually 25 days after the statement was prepared).

Statement preparers scheduled their work so that they controlled overtime and would avoid certain days of the week as production days. For example, if statements were to be mailed, why would you prepare a statement on Saturday? There was no mail service on Sunday and it would result in the statement laying in a Post Office rather than moving toward the person owing the credit card obligation.

The Act required the issuer to select a day of the month that payments would be due and to prepare and mail a statement no less than 21 calendar days before the payment was due. When we were discussing the options with our vendor, we discovered that the only way to insure that we met the mailing deadline was for the vendor to move to a seven day per week processing schedule. While it did not have an immediate impact on the cost of our statement production because of contracts that were in place, we are quite confident that when we renegotiate the contract's renewal there will be additional costs to us to allow the vendor to recover the expense they were required to carry in the past as well as to cover the added cost going forward.

Required Changes to the Form and Content of Statements

There was substantial programming required to layout the new statement format to comply with the regulation. Because many credit unions use outside vendors to produce their credit card statements, our sector of the financial services industry was largely dependent on third party vendors for compliance. Certain information had to be on the first page of the statement. Additional information about the how long the account would take to be paid in full was added to the first page. In some instances, this required the statement to be longer than formerly required which drove up statement production expenses. Again, all the cost of the implementation has not immediately shown itself in our expenses because of the contracts that were in place at the time.

This particular provision is one that was well intended but from our perspective may not be having the desired outcome. We have no industry wide data to support our assumption but we do have our data. It appears that cardholders either are not paying attention to the information provided or due to other factors are acting in ways much different than anticipated.

We track the payment behavior of our credit card accounts. Monthly we obtain a report which shows what percentage of the credit card portfolio paid varying amounts compared to their balance or minimum required payment. We use four payment categories: those paying the account in full, paying the minimum payment, paying an amount greater than the minimum payment, and paying amounts less than the minimum required payment.

Included below are two charts that cover the same months but three years apart. The first chart shows the payment behavior before the Act took effect, the second chart shows the same information after the Act was in effect. We use the same months in each case to remove the seasonal differences that might slant the information. For

each month we show the percentage of our card accounts that paid in each of the four categories.

The table below comes from November 2008 through February 2009 (before the impact of the Act).

	Paid In Full	Paid Minimum Payment	Paid Less Than the Minimum	Paid More Than the Minimum
November 2008	12.2%	6.9%	16.4%	64.6%
December 2008	11.5%	7.6%	17.5%	63.4%
January 2009	9.8%	11.2%	15.5%	63.5%
February 2009	11.3%	8.1%	14.3%	66.3%

The table below is data from the same report for the last four months (November 2011 through February 2012)

	Paid In Full	Paid Minimum Payment	Paid Less Than the Minimum	Paid More Than the Minimum
November 2011	10.6%	11.5%	9.3%	68.6%
December 2011	10.2%	11.5%	9.1%	69.3%
January 2012	10.2%	11.7%	10.0%	68.1%
February 2012	11.3%	10.1%	8.8%	69.8%

In comparing the two charts we see fewer account holders paying their accounts in full, substantially more account holders are paying only the minimum payment, fewer are paying less than the required minimum payment and there is an increase in those paying more than the minimum required payment.

Required Notices for Interest Rate Changes

Prior to the Act's implementation, we as well as many others had a feature to our credit card products called "Penalty Pricing." If an account went 60 days past due, the interest rate on their account would escalate to 18% or the Maximum Legal Rate that Federal Credit Unions could charge, whichever was less. This pricing mechanism was intended to prompt members who found themselves in a position to make choices about which account they would pay, to pay their Air Force FCU credit card first and avoid the higher interest rate. Our penalty pricing provision allowed the cardholders rate to return to normal after six consecutive months of prompt payment.

The Act required that we send notices 45 days in advance of a rate change before the rate change would become effective. This meant that when the account was 15 days past due, we were required to send a notice to our members telling them that if their account went without sufficient payment to bring the account current within the next 45 days, we would increase their interest rate.

Our processing vendor was unable to adjust their program timely. In fact, this aspect of compliance has been an extended problem. Until just a few months ago, we were required to manually create our notices to comply with the regulation. We were also required to manually monitor the timely payment to remove the cardholder from the penalty pricing scenario.

Time to Respond

The Act was to generally become effective nine months after enactment, but there were exceptions to that time period within the Act's provision. One such exception dealt with the effective date of the advance notice provision on changes to interest rates and other types of changes. That time period was 90 days. The Act was signed into Law on May 22, 2009.

The Federal Reserve promulgated Regulation Z, which put into place the rules covered in the Truth in Lending Act. The Credit CARD Act of 2009 amended the Truth in Lending Act and as a result the Federal Reserve was required to amend Regulation Z. On July 15, 2009, the Federal Reserve Board approved an interim rule implementing the changes required by the Credit CARD Act. The first compliance trigger date was August 20, 2009. This provided financial institutions only a period of 5 weeks to understand and implement the rule the Federal Reserve had issued.

While we understand the need for deliberate speed in making certain provisions applicable, the short time period created stresses on the rule making and compliance process, and ultimately will likely prove to have been a more costly process.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

There are many good provisions of Dodd-Frank which strengthen the Financial Services Industry and will properly constrain those institutions who brought our economy to the brink of financial ruin, but there are some provisions that do nothing to strengthen the industry and are counter to Consumer Protection.

The Durbin Amendment

One provision which we would like to highlight is the so-called "Durbin Amendment" (Durbin). As you are aware, this provision deals with interchange rates charged merchants for certain electronic payments. Some of Durbin are not applicable to credit unions the size of Air Force FCU, but the cost of Durbin will be felt by our members ultimately.

Under Durbin we are required to have multiple networks over which transactions may clear. Retailers will have the opportunity to select the network that is most cost effective for them. The fact that that transaction volume will be split over multiple networks will cause any volume discounts accruing to financial institutions to be diluted.

Merchants also have the right to steer transaction payments to products they prefer. Durbin does not require Merchants to select the payment method most beneficial to the consumer. There seems to be what we would call a "mistaken" idea that the merchants' preferences are aligned with the best interest of the consumer.

The interchange rule did not require networks to provide separate pricing for exempt and non-exempt institutions. Currently, the networks are adopting dual pricing, but many in our industry feel it is a matter of time before dual pricing goes away.

One concern that we have is that merchants will steer transactions away from the debit cards issued by smaller institutions. We believe we are already seeing this to a limited degree. Again our analysis is not made based on national statistics, but on statistics we keep on our operation. The first impact of Durbin was in July 2011. We compared monthly data from January 2006 through January 2012. We saw a consistently positive trend when we compared the same months from year to year, looking at debit card transactions, whether by number or by dollar volume. We had increases with an exception in only May 2009, until you get to July 2011. Since July 2011, we have only once had an increase in numbers of transactions compared to the same month the previous year, that being July 2011. We have had increases in dollar volumes of transactions using the same comparison only once in since July 2011 and that was in November 2011.

We have changed nothing in the way we handle debit card transactions since the beginning of 2010. How can we explain the sudden and clear change in the direction of activity? Is it only a coincidence that the change in direction happens when the Durbin Amendment takes effect? We have been looking for the cause. We would like to overcome the change in direction as interchange income from these transactions is a considerable contributor to our non-interest income. Presently, our assessment is that merchant steering may be a contributor.

An analysis of our checking accounts and debit cards shows: 94% of our checking accounts are free to our members. If we were to lose all of our interchange income we would need to impose fees on checking accounts of between $7.00 and $7.50 per month to maintain our current income levels.

Certainly, this is not something we would seriously entertain doing, but it does seem to support the level of fees being imposed by some large institutions that are being more severely impacted by the change in the interchange rule encapsulated in Durbin. While we realize it is too early to determine the full impact of Durbin we do believe it prudent to revisit the topic at some future time to determine the true benefit to consumers. The argument was that consumer prices would fall as a result of the adoption of Durbin.

We all need to be truthful about costs. The old saying that "There's no free lunch," is true. There are costs embedded in any payment system. Each party to the transaction realizes benefits from the payment arrangement, including the profit motive. Someone must pay for the infrastructure required to maintain the system. Ultimately, it will be the consumer who pays for the convenience.

The Consumer Financial Protection Bureau

In principle, we agree that consumers may be taken advantage of by some in the financial services industry. We also agree that consumers deserve protection from those unscrupulous individuals and entities. We do question, however, the need to create another bureaucracy that in most ways duplicates the effective efforts that were already in place in many instances.

From time to time, any business, no matter how well run will have an occasion where the business fails to meet the expectations of a consumer. Air Force FCU is no different in that regard. We pride ourselves in our service levels, but there are times where we are unable to meet the expectations of a member as we are forced to weigh the benefit of one member against the benefit of the whole membership.

In the almost six years that I have been with Air Force FCU, we may have had five or six instances where members felt compelled to write our regulator in regard to a particular position they held. Prior to the changes created by Dodd-Frank in this regard, such inquiries were directed to the Regional Offices of NCUA. There would be a letter of inquiry sent to the Supervisory Committee of the credit union. The Supervisory Committee would investigate the matter and respond to NCUA's Regional Office. The Regional Office would make a determination and would copy their response to the inquiring member to the Supervisory Committee so they would know of the determination. This usually would happen within a matter of a few days.

Once since the passage of Dodd-Frank we have had this type of inquiry. The letter of inquiry came from the NCUA Consumer Assistance Center in Alexandria, VA. We were provided a copy of our member's communication as had been the former practice. The research was performed by the Supervisory Committee and a response prepared and sent back to the NCUA Consumer Assistance Center. To date we have not heard further on the inquiry. We do not know of the position of NCUA with certainty, though we feel our action to have been proper, nor do we know if the member received any communication. Since this is a new process, we do not know if this is the Standard Operating Procedure or if there was a piece that fell through the crack so to speak.

We do know this. We had a process that seemed to work just fine. Now we have a different process with far more overhead. When we think of overhead, we think of expense. We believe that to be true in this case as well. We believe the CFPB can be a good effort, but like all agencies, there will be competition for more funding dollars.

V. Our Regulator – Fairness in Examinations

We believe NCUA to be a fair regulator when it comes to examinations. We do not always agree, but we do always work together to find acceptable solutions. We do not know if that can be said of all regulators, but we are confident in that statement about NCUA.

The NCUA, like Air Force FCU, has to be challenged by the activity of recent years. The economy is not performing as we would all like and as a result credit unions have challenges. Some of the challenges the credit unions faced were of their own doing. They entered new areas of business with limited experience and with little consideration of controlling the growth of the new business line. NCUA did warn against such practices. It does not take long for new business to overrun a small institution. It can take less time than the time between examinations. As a result, NCUA has increased the information obtained in the quarterly 5300 reports. We believe our regulator is on top of their game most of the time.

When regulators, including NCUA, are taken to task because there are failures during their watch, their natural tendency is to "tighten the reins." Some credit unions may view this as unfair; we tend to believe it is a response to criticism.

If you consider that over the past few years we have had economic challenges to overcome and a larger than normal quantity of new regulations that the regulator and the regulated have had to learn, you have to believe NCUA has been well-managed.

We also need to recognize that NCUA has a dual role, regulator and insurer. They are a relatively small agency but they have oversight to some degree of a similar number of institutions as do the banking regulators. The range of complexity in the credit unions is considerable. NCUA has adopted area specialists for more complex institution examinations. NCUA has adopted a risk-based examination process, which requires more resources in credit unions with greater levels of risk. You almost have to give them an "Exceeds Expectations" grade on their processes.

VI. Industry Consolidation

Industry consolidation appears to be something that will happen whether we want it to happen or not. We believe that there is a place for small institutions who serve niche markets. Unfortunately, the burden of regulations, the demands of consumers for

certain products that have high costs of entry and maintenance, and the cost of employees will likely make these small institutions more difficult to maintain.

Credit unions, like most other businesses, need to reach a certain size to gain efficiencies. Some will grow no matter what it takes. There will be some within the credit union community who feel compelled to convert to other charters to gain a business advantage. The business differences between credit unions and banks are the mutual structure, the limitation on whom credit unions may serve, and that the share insurance fund's funding mechanism and management. NCUA and our trade associations oppose such a move. Our belief is that NCUA opposes conversions because it upsets the stability of the share insurance fund. It is true that most losses happen to smaller credit unions and the larger credit unions in some ways are subsidizing the smaller credit unions with the level funding method. Our opinion is that those credit unions who decide to move charters have been credit unions in name only and likely for some time.

Credit unions are all about people helping people. As long as there are dedicated individuals dedicated to that purpose above all else, credit unions will continue to exist and thrive.

Testimony of

George H. Hansard

President/CEO

The Pecos County State Bank

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"

March 14, 2012

San Antonio, Texas

Chairman Capito and Members of the Subcommittee:

My name is George Hansard, President/CEO of The Pecos County State Bank in Fort Stockton Texas. Pecos County State Bank is a $150 million community bank with locations in Fort Stockton, population of 8,000, and in Sanderson, Texas, population of 750. We are truly a community bank. I have been the President of Pecos County State Bank for 6 years and I have been employed by community banks for 32 years.

I appreciate the opportunity to address issues which I believe have adversely impacted community banks in the last several years.

Several months ago, we at the bank (Pecos County State Bank) stumbled across the bank's policy manual from 1986 and were shocked to see that in 1986 the policy manual of a community bank was less than 100 pages. Today, our policy constitutes over 1,000 pages of Regulations which require a full time Compliance Officer and Real Estate Clerk to remain abreast of regulatory changes and to insure we remain in compliance, and their interpretation, thereof.

Community banks had been the life blood of this country and they were responsible for more small business successes than most other resource including governmental programs. What is troubling to me is the impact of governmental regulation which has been based upon politics and not prudent business.

Today only 25% of Dodd-Frank has been implemented. What has Dodd-Frank done to Pecos County State Bank? For one, allowing a consumer the opportunity to determine whether a bank may assess a charge to an overdraft created by a debit card used by that consumer. In the old days of check writing, which no one had a problem with. If insufficient, the check was handed over to the local County Attorney for collection or prosecution. The customer paid additional fees on top of the bank fees, and possibly had a criminal record. Now Dodd-Frank places no responsibility on the consumer for his or her actions. In my opinion and the opinion of most community banks, this is simply price fixing and has no rational basis.

Twenty years ago a community bank the size of Pecos County State Bank did not have a Compliance Officer, nor a Real Estate Clerk to handle the Regulations which covered real estate transactions. With Dodd-Frank how many more staff members will a community bank be forced to employ, which provide nothing to the bottom line? We are not sure but we do know that from over 3,000 pages of law our policy will surely double in size and our staff to handle the complexities. At Pecos County State Bank, I find it interesting that my lending staff has not increased in number in 11 years and we have been able to double the amount of loans we service. During this same time we have had to add 2 employees to handle increased governmental regulations. If I add 2 additional individuals to my staff for Dodd-Frank, I will have 10% of my employees working solely on regulations, again regulations costing small business. Let's face it, where does that expense land?

Another aspect of Dodd-Frank are the appraisal requirements. In my 32 years of banking, a banker which "puts his hands" on his collateral makes much better loan decisions. Contrary to popular belief community banks have no desire to make "bad" loans. Bad loans not only impact the bank's bottom line but they negatively impact a banker's job, the community, and are also negative to the borrower. A bad loan will make a good customer a bad customer. Dodd-Frank takes that evaluation process completely away from a community banker, the banker must place trust in someone else "putting their hands on that collateral". I do not believe in not being involved in evaluating collateral taken to secure a loan. Maybe loans sold in the secondary market still need independence but not loans which "that banker must live with". Would you purchase a home without being involved in deciding the purchase price?

Further, a real life example of the affect of Dodd-Frank occurred in our bank. We had used our real estate processor to also perform our real estate appraisals (she is a licensed state certified residential appraiser). Dodd-Frank put a stop to this even though bank examiners had expressed no problems with this relationship. What we find puzzling and unfair is that Dodd-Frank allows an appraiser to receive a copy of the sales contract which in Texas clearly states the sales price, down payment, loan amount and terms, but it does not allow an appraiser to be involved in the loan processing side of a bank. We believe having a knowledgeable appraiser/processor which has loyalty to his or her employer makes for more reasonable appraisals, instead of those alleged in Dodd-Frank. I had to tell her she had to make a choice. I lost that important employee. She chose to remove herself from the everyday process of regulations which are based upon politics not on what is rational. What does her family think now?

Is there a solution? I am sure that the politicians who write legislation believe they are writing it in the best interest of their constituents and there is a reason for much legislation, but Dodd-Frank with all of its amendments are far reaching and over reacting. I strongly believe that the postponement and repeal of Dodd-Frank is fair to the country as a whole. Dodd-Frank may have good intentions but these intentions are misguided, certainly to community banks which do not sell their loans in a secondary market.

Community banks did not participate nor did we profit from the excesses which contributed to the recent economic meltdown in the financial and housing industry. Yet we are paying a high price for the actions of a "few large institutions". These institutions have no fear, they are "too big to fail." In fact, their only concern is how large their bailout will be. We as community banks do not, nor have ever had this luxury.

Community banks are different from mega banks. Community banks have been closed all over this country and all the mega banks have been bailed out at tax payer's expense. The rationale that it is fine to close community banks and to bail out mega banks is inherently irrational. Don't you think a community bank is as important to its community as a mega bank is to its country? I can tell you that community bankers and their boards are at an all time high in their level of frustration. Something must be done that makes good common sense.

Again, I appreciate the honor and the opportunity to voice my opinion on such an important issue, not only for community banking, but for this country and its future. I would gladly provide additional information to you or your staff.

BORDER FEDERAL CREDIT UNION

www.borderfcu.com

Testimony of

Maria J. Martinez

President and Chief Executive Officer

Border Federal Credit Union

Before the

House Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"Challenges Facing Community Financial Institutions in Texas"

March 14, 2012

Introduction

Chairman Capito and Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing. My name is Maria J. Martinez and I am President and Chief Executive Officer of Border Federal Credit Union in Del Rio, Texas, a $107 million credit union serving approximately 22,000 members. Border FCU is a community credit union serving thirteen counties, mostly designated as distressed/underserved areas. Border FCU has a low income designation and it's also certified by the US Treasury as a Community Development Financial Institution. I am also a charter member and the Chairman of the Board of the Network of Latino Credit Unions and Professionals incorporated in 2006 to promote the credit union philosophy within the Latino community and with a vision to empower the Latino Community to build family wealth, develop economic opportunity, and secure financial stability. I have over 20 years of executive level experience serving credit unions.

I have been asked today to testify on the challenges facing community financial institutions in Texas. Of the many challenges, my testimony today will focus on the following:

- The Member Business Lending Cap
- Regulatory Burden
- Examination Issues, and
- The Lack of Consumers' Financial Education & Awareness

Attached to my testimony you will also find an overview of Texas economy and credit union operations prepared by the Credit Union National Association.

The Member Business Lending Cap

The current cap of 12.25 percent of a credit union's total assets is obstructing a crucial source of capital to small businesses at a time that it's desperately needed. This cap should be increased to 27.5 percent as proposed by HR 1418, introduced by Representatives Royce and McCarthy.

My credit union does not offer business loans currently. Why? Because the cap presents a significant disincentive to a credit union my size to begin making small business loans. At roughly $100 million dollars, my credit unions MBL cap would be about $12 million. In order to do business lending, I would have to hire business loan officers and establish a plan that could result in ending the program and laying off the loan officers after making only a few dozen loans. An expanded cap may provide more incentive for a credit union my size to engage in this type of lending. But beyond the impact this legislation may have on smaller credit unions, the positive impact that this legislation could have on communities throughout Texas and across the country is hard to deny.

Credit unions have been doing business lending for over 100 years – the first 90 years they did so without a cap. During the financial crisis, credit unions expanded their business loan portfolios. They stood with their members during the tough times. That is what credit unions do. Now, the credit unions that contributed the most to the growth of recent years are approaching the cap. Nearly 500 credit unions are making decisions daily to manage the cap. Some have stopped lending to new business members. Others have had to restrict what they lend. This is not happening because examiners are discouraging lending. It's happening because the law tells credit unions they have to stop. If the law isn't changed, the credit unions that helped keep small businesses going during the crisis will not be there to help them during the recovery.

The jobs this legislation could create are real. And you can have confidence that credit unions would lend the estimated $13 billion in the first year because credit unions

loaned to their members in the darkest hours of the financial crisis; they have the capacity and experience to stay with them in the recovery, if Congress gives them permission.

Regulatory Burden

For credit unions, our greatest challenges are the ever growing regulatory burdens in the wake of the financial crisis and statutory restrictions on member services.

Credit unions did not cause the financial crisis, but we have been affected by it. One of the drivers for credit union performance and stability during the financial crisis has to do with the structure of credit unions. As financial cooperatives, credit unions tend to be less risky and more member-friendly because the members – the users – of the credit unions are also the owners. Nevertheless, credit unions are being subjected to ever expanding consumer protection and safety and soundness regulation in the wake of the financial crisis. These seemingly unending changes in regulatory requirements make it more complicated for us to serve our members. It is not necessarily any one single regulation that is overly burdensome but rather the totality of regulations, the frequency with which the regulations change, and the sometimes varying application of the regulation by field examiners which sometimes conflicts with or expands upon the original intent of the regulation. For credit unions, the unending increase in the complexity of regulatory burden is all more perplexing given the health of the Federal Deposit Insurance Fund and the National Credit Union Share Insurance Fund, during the recent financial crisis.

To give you a sense of what we are up against in terms of regulatory burden, according to our national trade association, the Credit Union National Association, there are at least 27 rulemaking proposals pending at various agencies including the National Credit Union Administration, the Consumer Financial Protection Bureau, the Department of

Housing and Urban Development, the Federal Housing Finance Agency, the Financial Accounting Foundation, and the Internal Revenue Service. As these rules are finalized, my credit union may have to change the way that we offer products to our members; we will have to train our staff on the new rules; we will have to modify our forms. We will dedicate a significant amount of our members' resources complying with new rules. The flood of regulations creates an unnecessary burden without any measure of the effectiveness of these changes, and there is no end in sight.

We would prefer to spend our resources on promoting our mission of financial literacy and the development of new products to serve the needs of our members within our local communities.

While the new Consumer Financial Protection Bureau seems to be approaching its job with a watchful eye toward minimizing regulations and has sought ongoing input from credit unions on its work, concerns remain. One of the first regulations finalized by the CFPB has to do with remittances. It is over 400 pages long. My credit union does 10-15 international remittances per month. As this regulation is implemented, I question whether it will make sense for us to continue to offer this service to our members if this proposal goes through, even though this is something that a small number of my members depend on. While we only do a small number of remittances, I imagine that many of my colleagues across Texas and throughout the country will face a similar dilemma. When credit unions are forced to pull back services because of regulatory burden, the impact is felt disproportionately on those who have the most fragile access to mainstream financial services.

Of course, the CFPB is not the only agency writing rules with which credit unions must comply. The National Credit Union Administration continues to be active in the rule writing business, notwithstanding the relative health and strong performance of the credit union system, issuing proposed rules recently on troubled debt restructuring, emergency liquidity and loan participations.

The impact of ever increasing, rarely decreasing regulatory burden crisis can be seen vividly in the movement toward consolidation in the credit union industry. The cost of complying with all of the regulations is the same for a small credit union as it is for a larger one; however, smaller credit unions obviously have fewer resources and keeping up with the ever increasing burden is often the straw that breaks the camel's back.

I encourage you to continue your vigorous oversight of the various regulatory agencies to ensure that the rules that they promulgate are necessary and appropriate, that there is some measurement of their effectiveness, and that if there are rules which are outdated or obsolete, they are removed from the books.

One example of a change that should be made has to do with the requirement under Regulation E that ATMs carry a physical disclosure of potential fees associated with transactions in addition to an electronic disclosure. Sadly, some have taken advantage of the private right of action under this rule to deface ATMs and then sue the financial institution for noncompliance. I have heard some of my colleagues have taken extraordinary steps to document their compliance – even sending staff to photograph their ATMs on a frequent basis. This is an outrageously unfortunate cost of complying with a rule that serves little value to consumers in an age where an electronic disclosure of actual costs is universally available. The resources credit unions spend documenting compliance with this obsolete requirement should be put to better use serving their members. If the CFPB will not eliminate this requirement by rule, Congress should do so by law.

During the development of the Dodd-Frank Act, credit unions strongly supported a provision that requires the CFPB to review outdated, unnecessary and unduly burdensome regulations with an eye toward reducing regulatory burden. I hope that the Committee will ask the CFPB to regularly report on their efforts in this regard.

Examination Issues

The examination is a vital part of operating a financial institution. However, the process creates interpretation inconsistencies. At times, it seems there is a separation between the "policy" as stated by the regulatory leadership and what occurs locally during the exam. It is important that examiners not over-regulate or exceed their authority. Border FCU is very fortunate to have a positive professional relationship with our examiners that has allowed transparency in the exam to focus on safety and soundness. Yet, as field examiners try to interpret the will of the regulatory agency, and the agency is interpreting Congress directives, our credit unions get caught in the middle as we try to comply and interpret what's mandated in order to run a successful institution. It is important that examiners be consistent when treating regulations and guidance and that they have a respectful and professional relationship with credit unions.

I urge you to consider improvements to the examination process. Passing HR 3461, the Financial Institutions Examination Fairness and Reform Act, which addresses the exam process, would be a positive step in balancing the relationship between the regulator and the regulated. It will also encourage a more transparent and consistent examination process. Also, as you consider these improvements, please ensure that costs to implement these are not transferred to the credit unions.

The Lack of Consumers' Financial Education & Awareness

Finally, I would be remiss if I did not encourage the Committee to continue supporting financial literacy and awareness programs. It is important that consumers be equipped with the knowledge, confidence and skills necessary to make intelligent decisions when investing and/or borrowing funds. As communities grow and jobs are created, free or

low cost programs must be accessible to consumers within the financial industry to assist them with financial education.

As a society we must not only be ready to create jobs, but also diligently promote financial awareness so that when a person starts earning a paycheck they can make the best use of those funds. Consumers need objective information in order to avoid financial failure.

As a Texas community credit union, serving diversified areas consisting of underserved societies, areas where oil and gas exploration is booming and a military base, Border FCU has taken a proactive approach to provide financial education through free programs such as HUD counseling services, budgeting workshops and volunteer income tax preparation. Border FCU also targets financial education among the youth through volunteer staff that takes the junior achievement and National Endowment for Financial Education (NEFE) programs to the local schools and offers a youth financial summer camp.

I ask the Committee to support financial literacy programs. We all know that an educated consumer is the best client of any institution.

Conclusion

Madame Chairman and Members of the Subcommittee, thank you very much for coming to Texas and holding this hearing. I appreciate the attention that you're giving to these issues and credit unions look forward to working with you.

Overview of the Texas economy and Credit Union Operations

The Texas Economy

While far from unscathed, the state of Texas largely was spared from the most severe consequences of the global financial crisis and subsequent economic downturn. The combination of relatively fast population growth, a relatively large oil and gas sector, and housing markets that did not inflate as dramatically as those nationally all helped to temper dislocations in the state's economy.

Selected Economic/Demographic Comparisons
Sources: Bureau of Census, Bureau of Labor Statistics, Federal Housing Finance Agency, CUNA E&S.

	Texas	United States
Population growth:		
2000-2010	20.6%	9.7%
2010-2011 (Census Estimate)	2.1%	0.92%
Home price changes (FHFA All-transactions index):		
Decade prior to peak	+54%	+93%
Change since start of downturn	-5%	-16%
Change in past year	-1%	-3%
Unemployment Trends:		
Rate at start of downturn	4.4%	5.0%
Peak	8.2%	10.1%
Current rate	7.4%	8.3%
Change over past year	-0.8%	-0.8%
Employment Trends:		
Change vs. start of downturn	+123,000	-5.6 million
Change vs. year-ago	+205,000	+2.0 million

Note: Employment/unemployment is as of 1/12 for US; 12/11 for TX.

It is especially important to note that the labor market in Texas did not decline as severely and is improving faster than is the US labor market. Total non-farm employment in Texas is now above pre-recession levels. All but four of the state's twenty-five MSAs report unemployment rates that are below the national norm and all but one reports a year-over-year decline in unemployment rates.

Texas Credit Unions:

Texas is home to 535 credit unions, which now serve 7.7 million members and manage $73 billion in total assets. The state's credit unions are relatively small institutions. The median asset size is $20 million and the average size is roughly $115 million. In contrast the average Texas bank is over five times larger, with nearly $600 million in assets.

Despite both the competitive challenges arising from their relatively small size and the obvious economic challenges, Texas credit unions remained "in the game" throughout the crisis and continue to perform at a high level. Since the start of the downturn, loans at Texas credit unions have increased

25% and savings balances increased by 44%. Collectively, credit unions in the state have added over 725,000 members since December 2007.

Of course the Texas economy's relatively favorable performance over the past several years has translated into fewer dislocations in the operations of financial institutions in the state.

In all, only eight Texas credit unions failed since the start of the economic downturn. The failure rate in Texas credit unions is nearly identical to the national failure rate among all U.S. credit unions and the rate of failure is less than one-third of the 4.7% rate experienced by the nation's banking institutions.

Financial Institution Failure Rates* Since the Start of the Crisis (2008-2011) Sources: FDIC, NCUA, CUNA.	
Texas Credit Unions	1.3%
Texas Banks	1.4%
U.S. Credit Unions	1.2%
U.S. Banks	4.7%
* Number of total 2008-2011 failures as a percent of total institutions on 12/31/07.	

It's important to note that unlike the nation's banking institutions, credit unions – both nationally and in Texas – required no massive taxpayer bailout to remain solvent.

The capital ratio at Texas credit unions began the downturn at 11.2% - a historical high-point. Since then, consistently strong savings growth, relatively weak loan growth arising from household deleveraging and recession-related earnings pressures have combined to cause the aggregate capital ratio to decline to 9.7% by year-end 2011. Still, this average is nearly four percentage points higher than the level at which credit unions are considered "adequately capitalized" and nearly three percentage points above the regulatory level needed to be considered "well capitalized". Overall, 95% of the state's 535 credit unions are well capitalized with net worth-to-asset ratios of at least 7%.

While challenges still are evident, asset quality at Texas credit unions has remained relatively strong throughout the downturn. The 60+ day dollar delinquency rate remains elevated but declined from a cyclical high of 1.46% at the end of 2009 to 1.23% at the end of 2011. In contrast, the credit union delinquency rate nationally was 1.60% at year-end 2011.

Loan loss rates peaked at 0.95% in 2009 but declined to 0.89% in 2010 and 0.75% in 2011 at Texas credit unions. The 2011 loan loss rate is roughly 20% lower than the rates reported by all US credit unions (0.91%) and by the state's banking institutions (0.89%) in the year and is less than one-half the rate reported by banking institutions nationally (1.60%).

Testimony of

Cliff McCauley
Senior Executive Vice President
Frost Bank, San Antonio

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"

March 14, 2012
San Antonio, Texas

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.

Testimony of

Lester Leonidas Parker

Chairman, President and CEO

United Bank of El Paso del Norte

El Paso, Texas

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"

March 14, 2012
San Antonio, Texas

Chairwoman Capito, Ranking Member Maloney and members of the Subcommittee. I am Lester Leonidas Parker, Chairman, President and Chief Executive Officer of United Bank of El Paso del Norte. United Bank is a $177 million Minority Community Bank with three banking offices and one under construction, all in El Paso, Texas. The Bank is almost eleven years old and focuses exclusively on serving the financial needs of El Paso small businesses and professional practices. For the past seven consecutive years, it has been the largest SBA lender in the local SBA District and has also built a solid reputation as the principal small business loan provider in our far West Texas area. We do little consumer banking business and, indeed, have never advertised for the sale of consumer banking services. The Bank is owned by just under 500 El Paso shareholders from all economic sectors of our community, ranging from low income to wealthy, and we are the first commercial bank in El Paso history to claim that honor.

You may be familiar with the fact that El Paso is in very far West Texas, midway between Houston, Texas and Los Angeles, California with an area population of nearly 900,000 souls that is predominantly Hispanic in composition. It is contiguous with Juarez, Chihuahua, Mexico which suffers from great notoriety and violence; however our city is considered one of, if not, the safest in the Nation. El Paso does suffer from very low per capita income and is said to be the fourth poorest city in the United States. As a matter of note, we also sadly lay claim to having the poorest zip code area in the country. El Paso has a relatively diverse economy that is buffered by our proximity to Mexico and enhanced by the major U.S. military installation of Fort Bliss, by the University of Texas at El Paso, and by the new Texas Tech University Paul O. Foster School of Medicine located in a developing Medical Center of the Americas.

I started in commercial banking in 1962, nearly 50 years ago. Since then, I worked my way through school obtaining a BBA in Finance, an MBA in Economics, and a graduate certificate in Marketing. I was a Captain in the Army during the Vietnam conflict and have helped start and have operated three successful businesses -- two micro enterprises and one small business partnership. I have started three successful banks in El Paso (beginning in 1979) and have cleaned up a fourth bank that regulators were threatening with closure. I have taught both economics and finance on a university level, have served on a Federal Reserve Bank branch board for two terms, have been a two-term Director of the Texas Bankers Association, am in my third term as a proud Director of the Independent Bankers Association of Texas, and am presently in my third term on the Minority Bank Council of the Independent Community Bankers of America. Like most in this room, I have also served on community boards too numerous to name and have been blessed with walls and closets too full of awards for service to my community and profession.

I am honored to be before your Committee because I believe that you have the means to help insure that communities across America are able to retain one of the major facilitators of their economic prosperity: their local community banks. The business model of community banks focuses principally on the communities in which they are headquartered and where their owners, Directors and employees live. The fortunes of these often small banks rise or fall with the economic prosperity of the small towns and communities that they serve, and there is a strong sense of duty, obligation and commitment among those bankers to those friends, neighbors and fellow citizens living there. Contrast this with the

other major commercial banking business model of the large money center banks (with too big to fail status) which focus instead on national and international markets, striving for the economies of scale, size and financial performance that will result in dominance throughout financial sectors nationwide or around the globe. These two vastly different business models serve similar but distinctly different, important purposes in our National Economy and both now greatly need different regulatory approaches in order to serve this Nation's public good in the future. Should this not occur, you will see the numbers of community banks continue to dwindle as they sell out to flee what has become the almost unbearable regulatory financial burden and business risk now emanating from Washington, D.C.

To illustrate, our Bank maintains good ratings with the regulatory agencies and has very clean portfolios of loans and investments, with very few non-performing or past-due items. We are diligent about running a very good Bank that is a genuine service and resource to our community, and have received a number of accolades attesting to that in the past. We are a simple, non-complex organization, yet the direct compliance costs in the bank have increased 240 % over the last five years, far exceeding the growth of the Bank, its loans, investments or deposits. That compliance cost figure includes only the expense of managers while working on regulatory compliance, the new cost of a skilled Compliance Officer, and the costs of myriad outside, third party auditors and reviewers to insure that our compliance efforts are adequate. It does not include the other staff costs, to include compliance implementation, ongoing costs and training for all employees throughout each year, nor does it include assessments from state or federal governmental entities or the FDIC's tremendous increases in costs over the same term. Nevertheless, it is still more than one fifth of the after tax profit earned by my stockholders last year....their direct cost (beyond taxes) of doing business in the U.S.A., perhaps.

When we were examined by the Federal Reserve during the Fall of last year, the examination preparation commenced in July as we began to provide huge amounts of data and files to the federal examiners by electronic transmission. Most of our files are electronic, to include loan and investment portfolios, so the transmission while voluminous was still relatively simple. We have fewer than 800 loans and less than 3000 accounts of any type in the Bank, have very low fees and utilize simple yet efficient operations. When the examiners rolled in, there were 16 of them and they stayed for two weeks. Despite a thorough review of our files in their home office, they nevertheless set about diligently to find fault. They assessed our performance against requirements of not only federal law and regulation, but also against regulatory agency "Guidance", SR Letters (supervisory letters from Washington headquarters to the agency's regional offices) and agency commentary regarding the regulations. The burden of all requirements with which we were inundated, to include incredible minutiae, prompted us to seriously consider adding a much larger compliance staff in order to just keep up. During the exam's exit meeting with our Board of Directors, the "violations" were so insignificant and had so little to do with the safety and soundness purpose of the examination that our Directors were clearly baffled by the report's relevance. I have been told by examiners from several regulatory agencies that they worked very hard to find anything that could possibly be cited even if the bank being examined was well managed. They and their supervisors feared their Washington headquarters and were criticized if they turned in reports that were too clean. Does this strong, central control from

Washington then ignore local, perhaps even regional, differences important in the operation of our economy? I have reports from my fellow minority bankers and others indicating that this is in fact happening and is causing problems in areas already sorely stressed from the lingering recession. Our own experiences at United Bank helping small businesses survive the poor economy bears out these observations as well.

The bank regulatory system has become far too large and far too complex while trying to effectively administer laws involving financial institutions. Regulations which have been written may apply to all, but the practical application of the regulation itself often falls far short of the meaning and intent of the law for which it was written to implement. "Guidances", SR Letters and the like do little to improve matters, if at all. Major money center banks have far different risk profiles than those of community banks, particularly those that do not meet the definition of a "big" or a "complex" bank. When regulators try to apply the same basic standards to all, common sense flies out the window and it is invariably the community banks (and the communities that they serve) which suffer. Dodd-Frank mandates that smaller banks be treated differently than larger banks, but that is not happening today. Regulators, for example, have expressed their belief that community banks should have increased capital standards much like those of major money center banks and are tacitly enforcing those standards in their examinations. Dodd-Frank indicates clearly that smaller banks should not be held to such standards, but rather to the current requirements for well capitalized institutions. Is this an overreaction on the part of regulators or simply an "unintended consequence" to be overlooked? Leaving unintended consequences as a natural byproduct of today's over regulation by bureaucrats who, for the most part, have little or no experience in the private sector where making a profit in order to survive is critical, is a serious threat to small community banks which cannot survive many such "unintended consequences" of serious nature.

If regulators strive to eliminate all risk in community banks, then the banks will not survive unless directly supported by the government. Finance in capitalism demands that risks be taken in order to reap profits. However, we do train our successful bankers to avoid unnecessary risks while preserving assets and our depositors' money. The individuals fail if they cannot do this, a fate enforced by banks' stockholders and Boards of Directors. Yet, this seems to be very foreign to bank regulators of every stripe. The Federal Reserve, in describing proposed incentive compensation guidance, wrote: "Because of the presence of the federal safety net (FDIC? Too Big To Fail?), shareholders of a banking organization may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness." An astounding statement, indeed! Since stockholders of failed banks rarely, if ever, recover their investment in the bank, why would they allow any degree of risk that would likely lead to failure, much less any loss? It is only when those in the regulatory bureaucracy believe themselves to understand in depth not only business and capitalist markets, but also consumer actions, perceptions and desires that we see justification for the micro-managing direction that present banking regulation has taken.

You should be aware that community bankers quake when they learn of an impending Consumer Compliance Examination. Such exams are fraught with uncertainty and fear. This is because the

consumer examiners make no secret of the fact that they will be "compelled" to refer the bank to the U.S. Department of Justice should any evidence of discriminatory or disparate treatment of a "protected class" be uncovered. All well and good, but their methods often do not follow the norms of everyday commerce, nor the reality of how consumers or the average individual (regardless of income, credit score, race, color, creed, national origin, disability, etc.) behaves in a business transaction or negotiation. Real life situations are infinitely variable and the human beings with whom we deal in banking financial transactions usually abhor efforts to categorize them or to restrict what they wish to do simply because a regulator knows better than they how their life should go forward. Consequently, it is very difficult to accommodate the desires of both regulators and the consumers. And since we have seen a number of our community banks become expensively ensnared with the Justice Department because of being reported by a consumer compliance examiner, many of us simply do not advertise or do particular loans. It is just much too hard and too risky to try to accommodate our customers or any other local consumers with their consumer credit requests when we will second guessed (almost to death) by some eager examiner who MUST find something wrong somewhere in order to justify their presence.

We very often refer such consumer credit requests to area credit unions. In fact, the second largest institution in our city is a $1.7 Billion credit union (#2 after a major money center bank branch) which tries hard to take over our commercial small business market for accounts and loans. Credit unions can easily beat our loan rates because of their tax free status and we observe that their underwriting of loans is very often less stringent than ours. In frustration over their tax free status one day, I researched the enabling legislation when Congress created credit unions back in 1933 or so. The intent of the Congress then was excellent. Many people, particularly "those of modest means" (today's low-to-moderate income), had no good access to credit or even financial institutions. Therefore, charters for credit unions were to be allowed so that they could serve the people of modest means who enjoy a common bond. In return for such service, credit unions were granted an exemption from income tax – a great benefit! In fact, as I run the numbers, credit unions today make over 60% more net profit on each dollar of (pretax) income than we do as a community bank that, I might mention, is charged under the Community Reinvestment Act with serving the same entirety of our local market, including those of "modest means".

The competition between community banks and credit unions seems to be more than just a tad unfair. The unbridled expansion of community and common bond credit unions is of tremendous concern to us and to every community banker. These are tax-exempt de facto banks competing head on with us, but unburdened by the commensurate regulation or tax costs. Their pressing for further advantage with H.R. 1418 and the companion S. 509 seeking increased commercial lending authority is simply unacceptable to other community based financial providers such as we, given all the other negative regulatory and economic factors presently impacting community banks. At some point, this disparate (perhaps even discriminatory) treatment of community banks merits Congressional action.

In closing, I wish to thank this Committee for holding this hearing and for its attention to my and to the other comments here today. I have attached several articles and documents that may be of interest or assistance in understanding the current frustration (leading to even anger) not only among community bankers, but also among our customers and other fellow citizens. The good intent of the Congress as it works to meet the needs of the Nation and the what must seem like unending calls for action from constituents, is being drowned and swept under by the swollen flood of regulatory exuberance and excess overseen by many Administrations. It is a situation that cannot continue if we are to pass on the promise of America to our grandchildren and to our world.

Over-regulated America

The home of laissez-faire is being suffocated by excessive and badly written regulation

AMERICANS love to laugh at ridiculous regulations. A Florida law requires vending-machine labels to urge the public to file a report if the label is not there. The Federal Railroad Administration insists that all trains must be painted with an "F" at the front, so you can tell which end is which. Bureaucratic busybodies in Bethesda, Maryland, have shut down children's lemonade stands because the enterprising young moppets did not have trading licences. The list goes hilariously on.

But red tape in America is no laughing matter. The problem is not the rules that are self-evidently absurd. It is the ones that sound reasonable on their own but impose a huge burden collectively. America is meant to be the home of laissez-faire. Unlike Europeans, whose lives have long been circumscribed by meddling governments and diktats from Brussels, Americans are supposed to be free to choose, for better or for worse. Yet for some time America has been straying from this ideal.

Consider the Dodd-Frank law of 2010. Its aim was noble: to prevent another financial crisis. Its strategy was sensible, too: improve transparency, stop banks from taking excessive risks, prevent abusive financial practices and end "too big to fail" by authorising regulators to seize any big, tottering financial firm and wind it down. This newspaper supported these goals at the time, and we still do. But Dodd-Frank is far too complex, and becoming more so. At 848 pages, it is 23 times longer than Glass-Steagall, the reform that followed the Wall Street crash of 1929. Worse, every other page demands that regulators fill in further detail. Some of these clarifications are hundreds of pages long. Just one bit, the "Volcker rule", which aims to curb risky proprietary trading by banks, includes 383 questions that break down into 1,420 subquestions.

Hardly anyone has actually read Dodd-Frank, besides the Chinese government and our correspondent in New York (see pages 22-24). Those who have struggle to make sense of it, not least because so much detail has yet to be filled in: of the 400 rules it mandates, only 93 have been finalised. So financial firms in America must prepare to comply with a law that is partly unintelligible and partly unknowable.

Flaming water-skis

Dodd-Frank is part of a wider trend. Governments of both parties keep adding stacks of rules, few of which are ever rescinded. Republicans write rules to thwart terrorists, which make flying in America an ordeal and prompt legions of brainy migrants to move to Canada instead. Democrats write rules to expand the welfare state. Barack Obama's health-care reform of 2010 had many virtues, especially its attempt to make health insurance universal. But it does little to reduce the system's staggering and increasing complexity. Every hour spent treating a patient in America creates at least 30 minutes of paperwork, and often a whole hour. Next year the number of federally mandated categories of illness and injury for which hospitals may claim reimbursement will rise from 18,000 to 140,000. There are nine codes relating to injuries caused by parrots, and three relating to burns from flaming water-skis.

Two forces make American laws too complex. One is hubris. Many lawmakers seem to believe that they can lay down rules to govern every eventuality. Examples range from the merely annoying (eg, a proposed code for nurseries in Colorado that specifies how many crayons each box must contain) to the delusional (eg, the conceit of Dodd-Frank that you can anticipate and ban every nasty trick financiers will dream up in the future). Far from preventing abuses, complexity creates loopholes that the shrewd can abuse with impunity.

The other force that makes American laws complex is lobbying. The government's drive to micromanage so many activities creates a huge incentive for interest groups to push for special favours. When a bill is hundreds of pages long, it is not hard for congressmen to slip in clauses that benefit their chums and campaign donors. The health-care bill included tons of favours for the pushy. Congress's last, failed attempt to regulate greenhouse gases was even worse.

Complexity costs money. Sarbanes-Oxley, a law aimed at preventing Enron-style frauds, has made it so difficult to list shares on an American stockmarket that firms increasingly look elsewhere or stay private. America's share of initial public offerings fell from 67% in 2002 (when Sarbox passed) to 16% last year, despite some benign tweaks to the law. A study for the Small Business Administration, a government body, found that regulations in general add $10,585 in costs per employee. It's a wonder the jobless rate isn't even higher than it is.

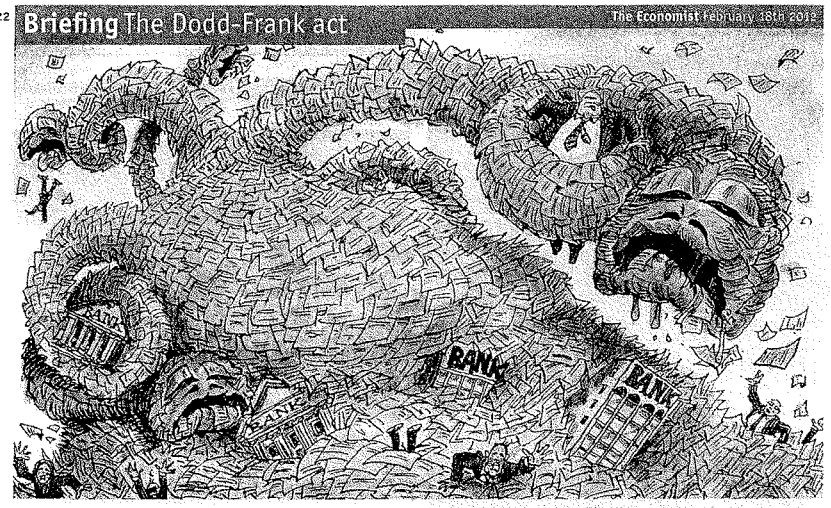
A plea for simplicity

Democrats pay lip service to the need to slim the rulebook—Mr Obama's regulations tsar is supposed to ensure that new rules are cost-effective. But the administration has a bias towards overstating benefits and underestimating costs (see page 77). Republicans bluster that they will repeal Obamacare and Dodd-Frank and abolish whole government agencies, but give only a sketchy idea of what should replace them.

America needs a smarter approach to regulation. First, all important rules should be subjected to cost-benefit analysis by an independent watchdog. The results should be made public before the rule is enacted. All big regulations should also come with sunset clauses, so that they expire after, say, ten years unless Congress explicitly re-authorises them.

More important, rules need to be much simpler. When regulators try to write an all-purpose instruction manual, the truly important dos and don'ts are lost in an ocean of verbiage. Far better to lay down broad goals and prescribe only what is strictly necessary to achieve them. Legislators should pass simple rules, and leave regulators to enforce them.

Would this hand too much power to unelected bureaucrats? Not if they are made more accountable. Unreasonable judgments should be subject to swift appeal. Regulators who make bad decisions should be easily sackable. None of this will resolve the inevitable difficulties of regulating a complex modern society. But it would mitigate a real danger: that regulation may crush the life out of America's economy. ■



Too big not to fail

NEW YORK

Flaws in the confused, bloated law passed in the aftermath of America's financial crisis become ever more apparent

SECTIONS 404 and 406 of the Dodd-Frank law of July 2010 add up to just a couple of pages. On October 31st last year two of the agencies overseeing America's financial system turned those few pages into a form to be filled out by hedge funds and some other firms; that form ran to 192 pages. The cost of filling it out, according to an informal survey of hedge-fund managers, will be $100,000-150,000 for each firm the first time it does it. After having done it once, those costs might drop to $40,000 in every later year.

Hedge funds command little pity these days. But their bureaucratic task is but one example of the demands for fees and paperwork with which Dodd-Frank will blanket a vast segment of America's economy. After the crisis of 2008, finance plainly needed better regulation. Lots of institutions had turned out to enjoy the backing of the taxpayer because they were too big to fail. Huge derivatives exposures had gone unnoticed. Supervisory responsibilities were too fragmented. Dodd-Frank, named after its co-sponsors, Senator Chris Dodd and Congressman Barney Frank, attempted to address these issues (section 404 is one of those aimed at excessive risk exposure). But there is an ever-more-apparent risk that the harm done by the massive cost and complexity of its regulations, and the effects of its internal inconsistencies, will outweigh what good may yet come from it.

The law that set up America's banking system in 1864 ran to 29 pages; the Federal Reserve Act of 1913 went to 32 pages; the Banking Act that transformed American finance after the Wall Street Crash, commonly known as the Glass-Steagall act, spread out to 37 pages. Dodd-Frank is 848 pages long. Voracious Chinese officials, who pay close attention to regulatory developments elsewhere, have remarked that the mammoth law, let alone its appended rules, seems to have been fully read by no one outside Beijing (your correspondent is a tired-eyed exception to this rule). And the size is only the beginning. The scope and structure of Dodd-Frank are different to those of its precursor laws, notes Jonathan Macey of Yale Law School: "Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies." Like the Hydra of Greek myth, Dodd-Frank can grow new heads as needed.

Take the transformation of 11 pages of Dodd-Frank into the so-called "Volcker rule", which is intended to reduce banks' ability to take excessive risks by restricting proprietary trading and investments in hedge funds and private equity (Paul Volcker, a former chairman of the Federal Reserve, has argued that such activity contributed to the crisis). In November four of the five federal agencies charged with enacting this rule jointly put forward a 298-page proposal which is, in the words of a banker publicly supportive of Dodd-Frank, "unintelligible any way you read it". It includes 383 explicit questions for firms which, if read closely, break down into 1,420 subquestions, according to Davis Polk, a law firm. The interactive Volcker "rule map" Davis Polk has produced for its clients has 355 distinct steps.

Boom time for lawyers

"I fear that the recently proposed regulation to implement the Volcker rule is extraordinarily complex and tries too hard," Sheila Bair, a former head of the Federal Deposit Insurance Company (FDIC), told Congress in December. A notable pre-crisis critic of regulatory gaps, she now believes that in this case "regulators should think hard about starting over again with a simple rule." Her comments were made before the Commodity Futures Trading Commission (CFTC), the fifth federal agency involved, issued its own proposal on proprietary trading on January 17th. That one is 489 pages long.

When Dodd-Frank was passed, its supporters suggested that tying up its loose ▸▸

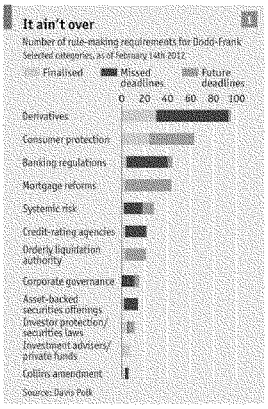
ends would take 12-18 months. Eighteen months on, those predictions look hopelessly naive. Politicians and officials responsible for Dodd-Frank are upbeat about their progress and the system's prospects, at least when speaking publicly. But one banker immersed in the issue speaks for many when he predicts a decade of grind, with constant disputes in courts and legislatures, finally producing a regime riddled with exceptions and nuances that may, because of its complexity, exacerbate systemic risks rather than mitigate them.

For the same reasons that bankers are worried, lawyers are rubbing their hands. For many of America's most prominent law firms helping companies to cope with Dodd-Frank is a vital service to clients, a lubricant for the American economy and a great new business. Daily updates on Dodd-Frank from Davis Polk and Morrison & Foerster have become as important to many on Wall Street as newspapers. Their popularity looks set to endure: according to Davis Polk only 93 of the 400 rule-making requirements mandated by Dodd-Frank have been finalised. Deadlines have been missed for 164 (see chart 1). And litigation is just beginning.

On July 22nd 2011 the United States Court of Appeals for the District of Columbia upheld a challenge by two trade groups to a Dodd-Frank-related rule on shareholder voting put forward by the Securities and Exchange Commission (SEC); the court found that the rule was backed by insufficient or faulty economic analysis of costs and benefits. On December 2nd, another case on similar grounds was filed in a Washington, DC, district court by two securities-industry trade groups, this time against the CFTC, concerning restrictions on derivative holdings. If that court, too, finds for the plaintiffs expect a deluge of further suits.

Along with requiring oodles of contestable rules, Dodd-Frank mandates 87 studies on big and small issues, ranging from the impact of drywall on mortgage defaults to the causes of the financial crisis. Once again, deadlines have been missed and progress is limited: 37 studies have yet to be completed. The ones that have been finished have received little public attention; trying to drink from the rule-making fire hose leaves little time for absorbing the output of the reporting one. Some of the reports seem to reach odd conclusions. A report from the FDIC contends that had Dodd-Frank been in effect four years ago, Lehman Brothers' creditors would have received 97 cents on the dollar; one expert on the case calls this ludicrous. The problem is not that the reports are necessarily wrong, but that no one is scrutinising them.

Another product of Dodd-Frank is a plethora of new government powers and agencies (see chart 2) with authority over areas of the American financial system



and economy affecting veterans, students, the elderly, minorities, investor advocacy and education, whistle-blowers, credit-rating agencies, municipal securities, the entire commodity supply chain of industrial companies, and more. Quite a lot have tasks already done by others—frustrating the act's worthwhile objective of consolidating fragmented pre-crisis supervision. A new office within the Treasury department is intended to forecast and head off disasters—already a goal of research groups at the 12 regional Federal Reserve Banks, the Federal Reserve Board, the president's Council of Economic Advisers and numerous federal agencies, not to mention universities, think-tanks and private firms.

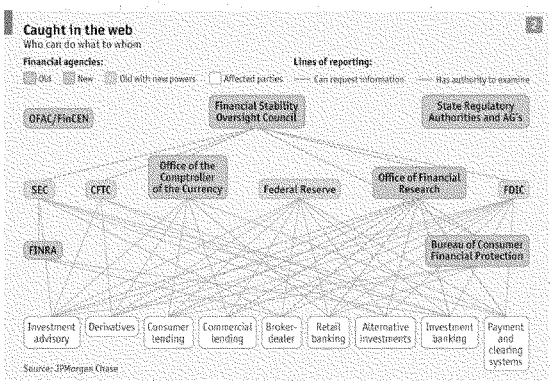
If the roles of many of these Dodd-Frank entities are overly familiar, their funding—which often skirts constitutional requirements for congressional approval—is more exotic. The new research bureau in the Treasury will be entitled to the proceeds of a new tax on banks. The new Consumer Financial Protection Bureau (CFPB) will be funded by the Fed.

But the really big issue that Dodd-Frank raises isn't about the institutions it creates, how they operate, how much they cost or how they are funded. It is the risk that they and other parts of the Dodd-Frank apparatus will smother financial institutions in so much red tape that innovation is stifled and America's economy suffers. Officials are being given the power to regulate more intrusively and to make arbitrary or capricious rulings. The lack of clarity which follows from the sheer complexity of the scheme will sometimes, perhaps often, provide cover for such capriciousness.

For example, the new CFPB will have latitude to determine what type of financial products can be provided to which consumers and at what cost, as well as the right to pursue institutions for acting in an "abusive" fashion (a term with no legal definition). Requirements for "living wills" that encompass hypothetical business plans have to be pored over by regulators; "stress tests" insert government assumptions deep into the decisions banks make about their capital. Such tests are not new to Dodd Frank. But the befuddling form the act gives such ideas unintentionally opens a path to much more state interference.

Dodd-Frankenstein's monsters

Another problem with complexity is that it encourages efforts to game the system by exploiting the loopholes it inevitably creates. Take the simple matter of nomenclature. Anticipating the Volcker rule, bank departments previously using the word "proprietary" have been dropped, re- ▸▸



▸ named or quietly shifted to sheltered corners. The shadow banking system existed before the crisis, but expect it to grow as some financiers decamp to companies that evade Dodd-Frank's definitions.

The fees banks can charge for debit cards are being sharply reduced, but other retailers with similar products have received a waiver, courtesy of the so-called Durbin amendment (named after a Democratic senator, Dick Durbin). Consequently the payment industry may be in the early stages of a rule-driven and otherwise unlooked-for transformation with no rationale in efficiency or safety. The bank-remittance business, which was also selectively hit with new rules, is facing a similar shake-up. The governments of Japan, Canada and the European Union have had their hackles raised by the fact that American federal and municipal bonds will be exempt from the Volcker rule, however it is put into practice, whereas their own bonds will not. Goldman Sachs's chief financial officer, David Viniar, has said that inefficiencies in the market resulting from Volcker could make trading more profitable—which was hardly the point.

Paying up

There could well be unintended consequences at the level of the employee, too. Last August the SEC opened an office mandated by Dodd-Frank that is dedicated to examining whistle-blower complaints. It collected 334 reports in its first seven weeks; no one will say how many have come forth since, but many more are expected the better known the office gets. This may sound welcome. But Dodd-Frank's provisions for massive payments to the whistle-blowers—of up to 30% of any monetary sanctions collected on the basis of their report—will make the SEC route more attractive than using companies' own processes, and may thus make corporate governance less effective.

For their part manufacturers seem largely unaware that a provision in Dodd-Frank concerning the extraction of minerals from in and around the Congo will mean that they will have to begin filing information on their entire supply chain to the SEC. This is officially estimated to affect 1,000-5,000 companies at a cost of $71m. The US Chamber of Commerce thinks it will affect hundreds of thousands. The National Association of Manufacturers estimates it will cost $9 billion-16 billion. Conflict minerals are a disturbing issue. They were not one of the causes of the global financial crisis.

The overall cost of all this—both directly to public and private institutions and indirectly to the markets—is staggering. At the same time as banks are sacking employees in operating roles, they are adding swarms to cope with various requests from government agencies and other new filings, all to avoid violating rules that may never come into existence and temporary measures that may be rescinded. That is without looking at losses in terms of business not done. Loans that might not fit into a category favoured by regulators are being trimmed or withdrawn.

Jamie Dimon, JPMorgan Chase's boss, reckons the direct costs to his bank, America's largest, will be $400 billion-600 billion annually. "Additional regulations resulting from the Dodd-Frank act may materially adversely affect BB&T's business, financial condition or results of operations," said one regional bank in its recent annual filing to the SEC. Other institutions are said to be in the process of drafting similar statements, or, at the least, planning to acknowledge the costs in the conference calls that surround quarterly earnings.

Banks are trading below book value. Low valuations make it hard for banks to raise the capital that would allow them to lend more, as politicians would like. This state of affairs is in part due to the condition of the economy. And the reasonable goal of restricting banks from taking private risks with socialised consequences may in some cases reduce their value. But it is hard to find a banker or analyst who doesn't privately attribute a lot of the low valuation to the unnecessarily harsh impact of current regulations.

Inevitably, banks themselves are adding to the costs with a vast lobbying effort. SIFMA, a financial industry trade association, says it has 5,490 people dealing with various subcommittees, almost all devoted to Dodd-Frankery. And there are quieter attempts to blunt the act's provisions or redirect them to the advantage of one set of financial institutions or another. The Occupy Wall Street crowd, with its emphasis on government-business collusion, would be enraged if it knew.

But most bankers are reluctant to discuss the law in public, and will do anything to avoid commenting on regulators. This is in part due to the risk that, given the industry's low public esteem, complaining would be inflammatory and counterproductive, perhaps also bringing with it regulatory retribution. A few also see the possibility of gaining an edge: some well established banks consider themselves better able to handle the costs than smaller or newer ones, particularly those that don't have cushy relationships with regulators. Others, according to the head of one large bank, are quiet only because they do not understand the scope of the changes.

Back to the drawing board

All of which leads to the question of what Dodd-Frank has actually achieved. More information on America's derivatives markets will be available to regulators than was previously the case, though how much will be useful is debatable. A new (untested) insolvency procedure is now in place for firms like AIG, which lacked an alternative to bankruptcy or bail-out before the crisis. But the heavy lifting on higher capital requirements for banks is being done internationally via the Basel 3 process. And Dodd-Frank has hardly touched Fannie Mae and Freddie Mac, the two big government-sponsored lending entities that received the largest bail-outs in 2008, and which are more important in the housing markets than ever.

The muddle stands in sharp contrast to the aftermath of earlier legislation. The banking-reform act of 1864 consolidated America's fragmented currency system and enabled Abraham Lincoln to finance the civil war. The period of reregulation between 1933 and 1940 reserved a safe harbour for commercial banks, which were backed by federal deposit insurance but didn't attract speculative capital because of caps on the rate of interest that could be paid. Risk was left to investment banks and asset-management firms, tempered by abundant requirements for disclosure and a shift in where the burden of proof lay in litigation, from plaintiffs to defendants.

Even Dodd-Frank's creators can bring no similar clarity to its intentions. In 2009 Mr Frank attempted to frame the new law's goals under four heads: securitisation, compensation, liquidation and systemic risk. But in a single speech his ambitions overflowed to consumer protection and the reform of ratings agencies, too. Ambition is often welcome; but in this case it is leaving the roots of the financial crisis under-addressed—and more or less everything else in finance overwhelmed. ■

Testimony before the Subcommittee on

Financial Institutions and Consumer Credit

Committee on Financial Services

March 14, 2012

San Antonio City Council Chambers

9:30am

Ignacio Urrabazo

President – Commerce Bank

Laredo, Texas

Chairwoman Capito, Congressman Canseco, Congressman Green, and colleagues.

Thank you for letting me participate in this important forum.

My name is Ignacio Urrabazo, Jr and I am President of Commerce Bank in Laredo, Texas: a classic community bank. Commerce Bank is a $550 million bank established in 1982: we are a subsidiary of International Bancshares Corporation. IBC is the largest minority-owned bank in the continental United States with $11.7 billion in assets.

By way of background:

- I currently serve on the FDIC Advisory Committee on Community Banking,
- I am on the Executive Board and Treasurer of the Texas Bankers Association
- I serve on a variety of committees for the American Bankers Association
- I was a former Chairman of the Board for the National Bankers Association the largest minority banking trade association; and
- I have been in banking for over 42 years.

This morning, I would like to focus on three things---fairness, the current regulatory climate, and the impact to banks and consumers from these regulations.

They say a picture is worth a thousand words, so I have enclosed a page in my presentation to provide a visual of what compliance looks like today at IBC.

There is no need to rehash the causes of the unprecedented financial meltdown with near catastrophic results that occurred in 2008-2009. But I do want to say that the regulators were clearly part of the problem but got very little blame.

In my lifetime, the FDIC fund has been broken twice, several decades ago with the S&L crises and just recently with the sub-prime crises. Unfortunately, the industry received virtually all the blame and the regulatory agencies by in large received a pass. As an old banker, I have to tell you, the regulators failed every bit as badly as the industry, but they have never been called to judgment.

As seen in prior economic cycles and prior periods of crises, policymakers and the regulators overreact to these cyclical problems. Congress's holistic approach to fix everything in the financial sector has created unnecessary and inflexible rules. The Dodd-Frank Act in my view is a perfect example of horrible overreach. The Dodd-Frank bill which is 848 pages long, is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies—it can in fact become a multi-headed monster.

This action by Congress is unprecedented. I would like to remind the committee, the laws that set up America's banking System in 1864 ran to 29 pages, the Federal Reserve Act of 1913 went to 32 pages, The Banking Act that transformed American finance after the Wall Street crash, commonly known as the Glass-Steagall Act,

spread out to 37 pages. I ask you how will our community banking system survive under the weight of Dodd Frank?

The community banks across the country will be destroyed as regulators create additional regulations on top of existing regulations. Community bankers are frustrated with the unknown and the additional costs required for compliance review and implementation. This has come when banks are trying to survive the worst economic crisis in the last 50 years and at a time when our interest margins are shrinking. Not to mention the elimination of fee income through the Durbin Amendment and limitations on overdraft fees.

These fees are critical to the survival of community banking: it is key noninterest income that helps provide many of our banking products and services for consumers.

The Dodd-Frank Bill has not been fully implemented, but we are already seeing its effects. While the Dodd-Frank bill has some necessary provisions that are required for systematic risk and certain complex financial products, we again see that good intentions for the short term will have unintended horrible consequences for the long term.

Let me talk about some issues that I see as having major consequences not only for our community banks, but more importantly for the consumer.

First, in the area of compliance and fair lending, we are seeing examiners becoming totally inflexible and rigid in the interpretation of fair lending laws—all in the name of fairness and equality. In order for a bank to avoid a violation of fair lending laws and a referral to DOJ, we have put in place very inflexible and rigid underwriting standards to avoid criticism.

On the surface, this sounds very appropriate, but in the trenches we are now rejecting many long time customers that pay well, but do not qualify under these new standards because of their credit scores, or their debt-to-income ratio. The same concept applies to pricing of these loans. Some of these customers have had a long term relationship with the bank, but now everybody has to fit into a box. If you don't fit and the bank makes the loan, you become an exception. If you make an exception and create an outlier, you must justify the reason for making the loan and then the examiner will ask for similar exceptions to other outliers that are in a protective class.

This applies to mortgage loans and consumer loans. The results, exceptions create enormous fair lending risks, so banks stop making exceptions. Furthermore, the FDIC has stated as a policy: the FDIC does not want loan officer's discretion in consumer lending. You must fit into the box. The bottom line, we are declining loans at record levels and worst of all, alienating our customers and damaging our reputation.

In addition to the above, the costs involved in monitoring and living with such regulatory tests as regression analysis has become burdensome and unclear.

Banks provide data and the regulators will run regression analysis on (1) women vs. men; (2) Hispanic vs. white non Hispanic; (3) unsecure loans for women vs. men, or (4) unsecured loans for Hispanic vs. white non Hispanic; (6) vehicle loans for women vs. men; (7) vehicle loans for Hispanic vs. white non Hispanic; and (8) various other combinations.

If there are no significant variances or a disparate impact in the Underwriting Standards or the Pricing, then the regulator will continue to cut and slice the portfolio into other combinations such as one branch against another or even one loan officer against another loan officer of different branches until the regulators have exhausted every conceivable iteration—as they are clearly practicing "Gotcha" examination tactics. Smaller banks will be forced to outside consultants to gather and analyze the data at greater costs because they do not have the resources to handle these difficult and complicated tasks internally.

All banks are different and all customers are different: it is very difficult to place everybody in the same box. Rules are a poor substitute for good judgment. Policymakers are now attempting, in effect, to force good judgment out of the process by creating rules that embody their view of what is right—they want no discretion.

The second issue is the CFPB's review of Overdraft Programs and their impact on consumers. The CFPB has initiated new inquiries into overdraft practices and their impact on consumers and they are soliciting feedback on a prototype "Penalty fee Box" on the consumer's checking account statement. Last year the Fed, FDIC and the OCC all promulgated their own guidance and rules to supervise overdraft programs.

Many community banks incurred significant costs instituting new forms, new operating systems, new disclosures and training to comply with Reg E and Reg DD to establish full transparency and ensure customer consent to the Opt-in provisions, all based on customer choice. Now the CFPB's wants to review the same programs. What this means for banks is new rules and guidance. The Overdraft programs serve as a safety net to consumers, and it's a service that is widely demanded by our customers. It should be noted that the consumer has complete control and can revoke their Opt-in status at any time.

Overdraft protection satisfies a unique and important need in the consumer credit marketplace. Restricting access will not eliminate the need that consumers have for it—but it could limit their access to it as banks begin to realize it's too burdensome, too expensive to maintain and carries to much regulatory risk. I have included a recent study by Todd Zywicki for the record that thoroughly studies the overdraft product.

My bank has also done extensive research on overdraft programs. The bottom line, consumers want this important product.

The third issue is that consumer complaints will now play a larger role with the CFPB and will have a significant impact on my costs and many possible dangerous consequences. Of major concern to banks is the "Unfair, Deceptive, and Abusive Practices" (UDAAP) section. Banks will clearly need to formalize customer compliant programs, if for no other reason than to prove that the bank takes such concerns seriously. Banks will have to identify patterns of complaints and establish procedures to review such patterns as well as individual complaints. Management systems will have to be established and monitored.

Ridiculous and far-fetched allegations will surface driving the banks' crazy. The definition of "abusive" will be solely at the discretion of the CFPB, DOJ and consumer groups. At IBC, we recently spent several hundred thousand dollars to buy a consumer compliant system to help us manage these complaints. A huge burden on the bank.

Other issues that are of concern to community banks are:

- There will be higher capital requirements under different risk approaches at a time when a fair return on your investment are difficult to obtain. Additional capital for community banks is difficult to obtain

with limited profitability, Stress Testing will require even higher levels of capital -- near impossible.

- There will be new costly record-keeping and reporting requirements. The Bureau will require banks to compile and report additional HMDA data and HMDA-like small business loan data. Banks will be required to provide customers with expanded access to account, transaction and fee information. If the CFPB moves into small business lending, that type of lending will disappear.

- There will be more difficulty for banks to tailor loans or deposit products to their customers, since the Bureau will favor standardized "Plain Vanilla" products as it pursues disclosure simplification. This is creating the large bank mentality and will drive all community banks to merge, consolidate, or abandon the market since all products will be basically the same and no room for flexibility or good judgment.

- Banks will now face changes to Mortgage Disclosures and new provisions to promote the accuracy and independent judgment for appraisals. There is pending new rulemaking to implement requirements for mortgage-related escrow accounts.

- Mortgage Credit will be curtailed as the QRM is implemented by the regulators that will require a minimum of 20 percent down and nearly spotless credit histories. Other new proposals are pending. Borrowers will now be able to raise ability-to-pay challenges when failing to pay their mortgage.

- Many banks in rural areas have decided not to make mortgage loans because of the costs and pitfalls. Their CRA ratings will be at risk as well as possible redlining as a consequence. Bottom line, many consumers will not get a mortgage loan.

- New rules from the SEC on the definition of a "Municipal Advisor" will require bank employees to register as municipal advisors and will have a fiduciary duty to the municipalities.

- New rules on underwriting the bank's investment portfolio will place bigger burden on community banks.

- Safety and soundness examinations are extremely difficult and menacing.

In summary, community banks are facing stiff challenges in the next few years. As interest margins shrink, and fee income becomes more difficult to obtain, the regulatory burden will overrun small community banks causing them to either merge or consolidate with a larger bank, or just go out of business.

Most large banks are not interested in small rural banks and rural banks do not want to become part of a larger holding company, they will be lost. In 1992 there were 1,193 banks in Texas; there are currently 594---a decrease of 50% or 599 banks. I venture to say, that another 50% or 300 banks will disappear from Texas in the next decade. At the national level, the trend is the same. As one who has worked in community banking for over 4 decades, I maintain, despite policymaker's good intentions in implementing regulations, they are ultimately detrimental to banks' ability to grow, to create capital in our communities and to build communities through job creation.

More importantly, consumers and small businesses are impacted in negative ways, such as higher costs for financial products or limited products or limited credit availability at a higher cost. At some banks, certain types of credit will be completely eliminated and access to credit will be denied.

Before I close, I want to personally thank Congresswoman Capito and Congressmen Canseco for being sponsors of HR 3461 – Financial Institutions Examination Fairness

and Reform Act. This bill is a critical piece of legislation for banking. More than ever, the regulators are out of control.

They are the judge, jury and executioner and without the important appeal provision in HR 3461, banking has no chance. As a community banker, I believe we will not survive under the weight of the current regulatory environment. We absolutely need independent appeal. It is the right thing to do.

Thank you for involving us at this important forum where we can share the experience of community banks. I hope our perspectives, which are based on our day to day interactions with consumers, help illuminate the need to lessen the burden on community banks and consumers who are directly and negatively impacted. Without community banking, we will no longer be the America that created the largest economy in the world. We have already lost over 11,000 community banks since 1985. How many more can we afford to lose?

Thank you.

Compliance Review Committee Organizational Chart-MEMBERS

Compliance Review Committee Mission Statement: To test, review, or evaluate the financial institution's conduct, transactions, or potential transactions for the purpose of monitoring and improving or enforcing compliance with:
(1) a statutory or regulatory requirement;
(2) financial reporting to a governmental agency;
(3) the policies and procedures of the financial institution or its affiliates; or
(4) safe, sound, and fair lending practices.

Objectives:
1. Coordinate all bank examinations.
2. Evaluate all regulatory manuals and determine applicability to IBC processes.
3. Redefine business processes as deemed appropriate and based on an enterprise compliance risk assessment.
4. Develop a working knowledge of all banking regulations for all lines of business.

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*Home Owners Protection Act
*Real Estate Settlement Procedures (Reg X)
*Truth in Lending (Reg Z)
*Credit Extended to Svc. Members (Part 232)

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*Fair Credit Reporting & FACT Act
*Fair Debt Collections
*Preservation of Consumer's Claims and Defenses
*Talent Amendment (John Warner National Defense Auth. Act)
*Reg O
*Reg S

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*Controlling the Assault of Non-Solicited Pornography & Marketing Act (CAN-SPAM)
*E-Sign Act.
*Telephone Consumer Protection Act (TCPA) and Junk Fax Prevention Act

*Privacy of Consumer Financial Information (Part 332)

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*Expedited Funds Availability (Reg CC) and Check 21
*Interest on Deposits
*Right to Financial Privacy
*Truth in Savings (Reg DD)
*Unfair & deceptive Acts or Practices
*FDIC Deposit Ins. Coverage
*Dormant Accts
*Certification of Ign Accts
*B&C Notices
*NOW accounts
*Reg D

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*Advertisement of Membership (part 328)
* Reg G

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*ACH Origination
*Disaster Recovery/Business Continuity Plan(s)
*Physical Security
*Vendor Management Policy
*Identity Theft Prevention
*Red Flags
*Remote Deposit Capture
*Reg GG

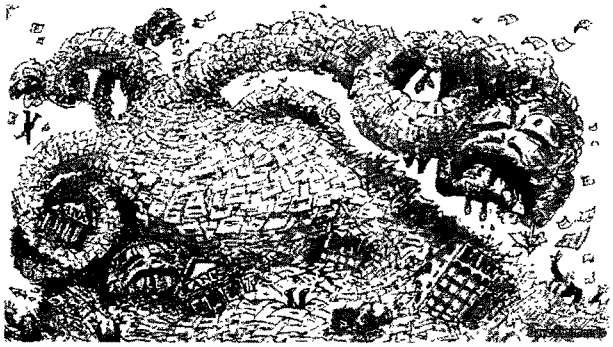
revised 3/13/12

The Dodd-Frank act

Too big not to fail

Flaws in the confused, bloated law passed in the aftermath of America's financial crisis become ever more apparent

Feb 18th 2012 | NEW YORK | The Economist



SECTIONS 404 and 406 of the Dodd-Frank law of July 2010 add up to just a couple of pages. On October 31st last year two of the agencies overseeing America's financial system turned those few pages into a form to be filled out by hedge funds and some other firms; that form ran to 192 pages. The cost of filling it out, according to an informal survey of hedge-fund managers, will be $100,000-150,000 for each firm the first time it does it. After having done it once, those costs might drop to $40,000 in every later year.

Hedge funds command little pity these days. But their bureaucratic task is but one example of the demands for fees and paperwork with which Dodd-Frank will blanket a vast segment of America's economy. After the crisis of 2008, finance plainly needed better regulation. Lots of institutions had turned out to enjoy the backing of the taxpayer because they were too big to fail. Huge derivatives exposures had gone unnoticed. Supervisory responsibilities were too fragmented. Dodd-Frank, named after its co-sponsors, Senator Chris Dodd and Congressman Barney Frank, attempted to address these issues (section 404 is one of those aimed at excessive risk exposure). But there is an ever-more-apparent risk that the harm done by the massive cost and complexity of its regulations, and the effects of its internal inconsistencies, will outweigh what good may yet come from it.

The law that set up America's banking system in 1864 ran to 29 pages; the Federal Reserve Act of 1913 went to 32 pages; the Banking Act that transformed American finance after the

Wall Street Crash, commonly known as the Glass-Steagall act, spread out to 37 pages. Dodd-Frank is 848 pages long. Voracious Chinese officials, who pay close attention to regulatory developments elsewhere, have remarked that the mammoth law, let alone its appended rules, seems to have been fully read by no one outside Beijing (your correspondent is a tired-eyed exception to this rule). And the size is only the beginning. The scope and structure of Dodd-Frank are fundamentally different to those of its precursor laws, notes Jonathan Macey of Yale Law School: "Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies." Like the Hydra of Greek myth, Dodd-Frank can grow new heads as needed.

Take the transformation of 11 pages of Dodd-Frank into the so-called "Volcker rule", which is intended to reduce banks' ability to take excessive risks by restricting proprietary trading and investments in hedge funds and private equity (Paul Volcker, a former chairman of the Federal Reserve, has argued that such activity contributed to the crisis). In November four of the five federal agencies charged with enacting this rule jointly put forward a 298-page proposal which is, in the words of a banker publicly supportive of Dodd-Frank, "unintelligible any way you read it". It includes 383 explicit questions for firms which, if read closely, break down into 1,420 subquestions, according to Davis Polk, a law firm. The interactive Volcker "rule map" Davis Polk has produced has produced for its clients has 355 distinct steps.

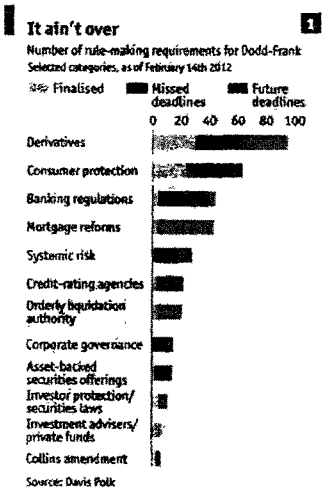
Boom time for lawyers

"I fear that the recently proposed regulation to implement the Volcker rule is extraordinarily complex and tries too hard," Sheila Bair, a former head of the Federal Deposit Insurance Company (FDIC), told Congress in December. A notable pre-crisis critic of regulatory gaps, she now believes that in this case "regulators should think hard about starting over again with a simple rule." Her comments were made before the Commodity Futures Trading Commission (CFTC), the fifth federal agency involved, issued its own proposal on proprietary trading on January 17th. That one is 489 pages long.

When Dodd-Frank was passed, its supporters suggested that tying up its loose ends would take 12-18 months. Eighteen months on, those predictions look hopelessly naive. Politicians and officials responsible for Dodd-Frank are upbeat about their progress and the system's prospects, at least when speaking publicly. But one banker immersed in the issue speaks for many when he predicts a decade of grind, with constant disputes in courts and legislatures, finally producing a regime riddled with exceptions and nuances that may, because of its complexity, exacerbate systemic risks rather than mitigate them.

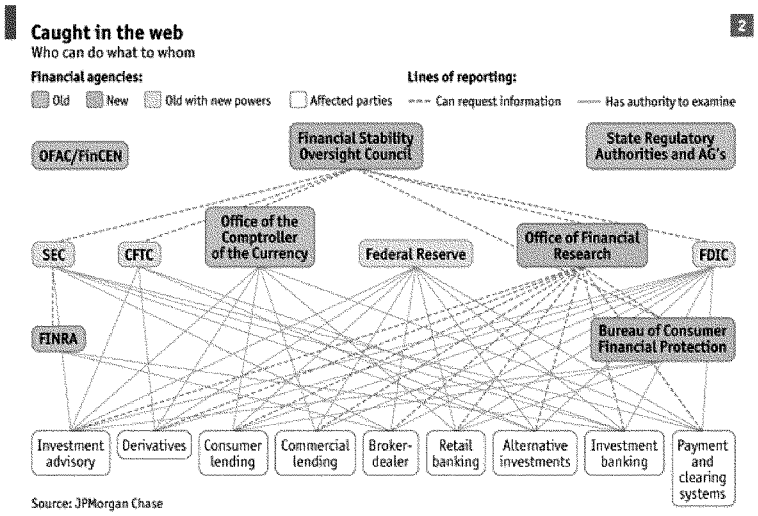
This is always the case - we never understand for a decade and then it is too late - 5000 Banks will be gone.

For the same reasons that bankers are worried, lawyers are rubbing their hands. For many of America's most prominent law firms helping companies to cope with Dodd-Frank is a vital service to clients, a lubricant for the American economy and a great new business. Daily updates on Dodd-Frank from Davis Polk and Morrison & Foerster have become as important to many on Wall Street as newspapers. Their popularity looks set to endure: according to Davis Polk only 93 of the 400 rule-making requirements mandated by Dodd-Frank have been finalised. Deadlines have been missed for 164 (see chart 1). And litigation is just beginning.



On July 22nd 2011 the United States Court of Appeals for the District of Columbia upheld a challenge by two trade groups to a Dodd-Frank-related rule on shareholder voting put forward by the Securities and Exchange Commission (SEC); the court found that the rule was backed by insufficient or faulty economic analysis of costs and benefits. On December 2nd, another case on similar grounds was filed in a Washington, DC, district court by two securities-industry trade groups, this time against the CFTC, concerning restrictions on derivative holdings. If that court, too, finds for the plaintiffs expect a deluge of further suits.

Along with requiring oodles of contestable rules, Dodd-Frank mandates 87 studies on big and small issues, ranging from the impact of drywall on mortgage defaults to the causes of the financial crisis. Once again, deadlines have been missed and progress is limited: 37 studies have yet to be completed. The ones that have been finished have received little public attention; trying to drink from the rule-making fire hose leaves little time for absorbing the output of the reporting one. Some of the reports seem to reach odd conclusions. A report from the FDIC contends that had Dodd-Frank been in effect four years ago, Lehman Brothers' creditors would have received 97 cents on the dollar; one expert on the case calls this ludicrous. The problem is not that the reports are necessarily wrong, but that no one is scrutinising them.



Another product of Dodd-Frank is a plethora of new government powers and agencies (see chart 2) with authority over areas of the American financial system and economy affecting veterans, students, the elderly, minorities, investor advocacy and education, whistle-blowers, credit-rating agencies, municipal securities, the entire commodity supply chain of industrial companies, and more. Quite a lot have tasks already done by others—frustrating the act's worthwhile objective of consolidating fragmented pre-crisis supervision. A new office within the Treasury department is intended to forecast and head off disasters—already a goal of research groups at the 12 regional Federal Reserve Banks, the Federal Reserve Board, the president's Council of Economic Advisers and numerous federal agencies, not to mention universities, think-tanks and private firms.

If the roles of many of these Dodd-Frank entities are overly familiar, their funding—which often skirts constitutional requirements for congressional approval—is more exotic. The new research bureau in the Treasury will be entitled to the proceeds of a new tax on banks. The new Consumer Financial Protection Bureau (CFPB) will be funded by the Fed.

But the really big issue that Dodd-Frank raises isn't about the institutions it creates, how they operate, how much they cost or how they are funded. It is the risk that they and other parts of the Dodd-Frank apparatus will smother financial institutions in so much red tape that innovation is stifled and America's economy suffers. Officials are being given the power to regulate more intrusively and to make arbitrary or capricious rulings. The lack of clarity which follows from the sheer complexity of the scheme will sometimes, perhaps often, provide cover for such capriciousness. Already A Regulatory Method—

For example, the new CFPB will have latitude to determine what type of financial products can be provided to which consumers and at what cost, as well as the right to pursue institutions for acting in an "abusive" fashion (a term with no legal definition). Requirements for "living wills" that encompass hypothetical business plans have to be pored over by regulators; "stress tests" insert government assumptions deep into the decisions banks make about their capital. Such tests are not new to Dodd Frank. But the befuddling form the act gives such ideas unintentionally opens a path to much more state interference.

Allows regulators to run the industry

Dodd-Frankenstein's monsters

Another problem with complexity is that it encourages efforts to game the system by exploiting the loopholes it inevitably creates. Take the simple matter of nomenclature. Anticipating the Volcker rule, bank departments previously using the word "proprietary" have been dropped, renamed or quietly shifted to sheltered corners. The shadow banking system existed before the crisis, but expect it to grow as some financiers decamp to companies that evade Dodd-Frank's definitions.

The fees banks can charge for debit cards are being sharply reduced, but other retailers with similar products have received a waiver, courtesy of the so-called Durbin amendment (named after a Democratic senator, Dick Durbin). Consequently the payment industry may be in the early stages of a rule-driven and otherwise unlooked-for transformation with no rationale in efficiency or safety. The bank-remittance business, which was also selectively hit with new rules, is facing a similar shake-up. The governments of Japan, Canada and the European Union have had their hackles raised by the fact that American federal and municipal bonds will be exempt from the Volcker rule, however it is put into practice, whereas their own bonds will not. Goldman Sachs's chief financial officer, David Viniar, has said that inefficiencies in the market resulting from Volcker could make trading more profitable—which was hardly the point.

very possible

Paying up

There could well be unintended consequences at the level of the employee, too. Last August the SEC opened an office mandated by Dodd-Frank that is dedicated to examining whistle-blower complaints. It collected 334 reports in its first seven weeks; no one will say how many have come forth since, but many more are expected the better known the office gets. This may sound welcome. But Dodd-Frank's provisions for massive payments to the whistle-blowers—of up to 30% of any monetary sanctions collected on the basis of their report—will make the SEC route more attractive than using companies' own processes, and may thus make corporate governance less effective.

For their part manufacturers seem largely unaware that a provision in Dodd-Frank concerning the extraction of minerals from in and around the Congo will mean that they will have to begin filing information on their entire supply chain to the SEC. This is officially estimated to affect 1,000-5,000 companies at a cost of $71m. The US Chamber of Commerce thinks it will affect hundreds of thousands. The National Association of

Manufacturers estimates it will cost $9 billion-16 billion. Conflict minerals are a disturbing issue. They were not one of the causes of the global financial crisis.

The overall cost of all this—both directly to public and private institutions and indirectly to the markets—is staggering. At the same time as banks are sacking employees in operating roles, they are adding swarms to cope with various requests from government agencies and other new filings, all to avoid violating rules that may never come into existence and temporary measures that may be rescinded. That is without looking at losses in terms of business not done. Loans that might not fit into a category favoured by regulators are being trimmed or withdrawn. Very Big Issue

Big Issue

Jamie Dimon, JPMorgan Chase's boss, reckons the direct costs to his bank, America's largest, will be $400m-600m annually. "Additional regulations resulting from the Dodd-Frank act may materially adversely affect BB&T's business, financial condition or results of operations," said one regional bank in its recent annual filing to the SEC. Other institutions are said to be in the process of drafting similar statements, or, at the least, planning to acknowledge the costs in the conference calls that surround quarterly earnings.

Banks are trading below book value. Low valuations make it hard for banks to raise the capital that would allow them to lend more, as politicians would like. This state of affairs is in part due to the condition of the economy. And the reasonable goal of restricting banks from taking private risks with socialised consequences may in some cases reduce their value. But it is hard to find a banker or analyst who doesn't privately attribute a lot of the low valuation to the unnecessarily harsh impact of current regulations.

Inevitably, banks themselves are adding to the costs with a vast lobbying effort. SIFMA, a financial industry trade association, says it has 5,490 people dealing with various subcommittees, almost all devoted to Dodd-Frankery. And there are quieter attempts to blunt the act's provisions or redirect them to the advantage of one set of financial institutions or another. The Occupy Wall Street crowd, with its emphasis on government-business collusion, would be enraged if it knew.

But most bankers are reluctant to discuss the law in public, and will do anything to avoid commenting on regulators. This is in part due to the risk that, given the industry's low public esteem, complaining would be inflammatory and counterproductive, perhaps also bringing with it regulatory retribution. A few also see the possibility of gaining an edge: some well established banks consider themselves better able to handle the costs than smaller or newer ones, particularly those that don't have cushy relationships with regulators. Others, according to the head of one large bank, are quiet only because they do not understand the scope of the changes. Very True for most –

Huge Problem

Back to the drawing board

All of which leads to the question of what Dodd-Frank has actually achieved. More information on America's derivatives markets will be available to regulators than was previously the case, though how much will be useful is debatable. A new (untested)

insolvency procedure is now in place for firms like AIG, which lacked an alternative to bankruptcy or bail-out before the crisis. But the heavy lifting on higher capital requirements for banks is being done internationally via the Basel 3 process. And Dodd-Frank has hardly touched Fannie Mae and Freddie Mac, the two big government-sponsored lending entities that received the largest bail-outs in 2008, and which are more important in the housing markets than ever.

The muddle stands in sharp contrast to the aftermath of earlier legislation. The banking-reform act of 1864 consolidated America's fragmented currency system and enabled Abraham Lincoln to finance the civil war. The period of reregulation between 1933 and 1940 reserved a safe harbour for commercial banks, which were backed by federal deposit insurance but didn't attract speculative capital because of caps on the rate of interest that could be paid. Risk was left to investment banks and asset-management firms, tempered by abundant requirements for disclosure and a shift in where the burden of proof lay in litigation, from plaintiffs to defendants.

Even Dodd-Frank's creators can bring no similar clarity to its intentions. In 2009 Mr Frank attempted to frame the new law's goals under four heads: securitisation, compensation, liquidation and systemic risk. But in a single speech his ambitions overflowed to consumer protection and the reform of ratings agencies, too. Ambition is often welcome; but in this case it is leaving the roots of the financial crisis under-addressed—and more or less everything else in finance overwhelmed.

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THE ECONOMICS AND REGULATION OF BANK OVERDRAFT PROTECTION

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THE ECONOMICS AND REGULATION OF BANK OVERDRAFT PROTECTION

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Abstract:

Consumer use of bank overdraft protection has risen rapidly over the past decade, leading to increased scrutiny and the imposition of new regulations. Public and political debate regarding overdraft protection has highlighted anecdotal stories about irresponsible college students who overdraw their accounts to buy a cup of coffee, thereby triggering substantial overdraft fees. But there has been little systematic examination of the safety and soundness or consumer protection issues implicated by the increased use of overdraft protection.

Available evidence indicates that those who rely on overdraft protection tend to have low credit ratings, use overdraft protection because it is sometimes less expensive, to maintain short-term liquidity needs, and more convenient than available alternatives. These alternatives include other credit options, such as payday lending, or options such as bounced checks or dishonored payments, which may result in eviction or termination of utilities or other services.

There is also no evidence that those who use overdraft protection are unaware of the cost or otherwise use overdraft protection foolishly or unknowingly. In addition, there is no evidence that banks are earning economic rents off the issuance of overdraft protection, as increases in overdraft revenues have been offset by dramatic increases in free checking, improved quality, and free services offered to bank customers. A serious reduction in overdraft revenues would reverse all of these trends and result in many consumers being driven out of the mainstream financial system, especially low-income consumers.

Absent a demonstrable market failure or demonstration of systematic consumer abuse, restriction on consumer choice of overdraft protection would likely impose substantial costs on consumers and banks with minimal gains.

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The Economics and Regulation of Bank Overdraft Protection

Todd J. Zywicki[1]

Consumer use of bank overdraft protection has risen rapidly over the past decade. In 2010, 13 million consumers used overdraft protection and banks generated $35 billion in revenue, an important and growing part of total bank revenue. In turn, this growth has spawned increased media and regulatory attention focused on the product. Standard economic analysis recognizes that the increased demand for a product—including a financial product such as overdraft protection—as evidence of consumer satisfaction and demand for the product. Bank regulators, by contrast, have raised concerns about the increased use of overdraft protection by consumers and have issued regulatory guidance regarding the product under a safety and soundness rationale. In 2009, the Federal Reserve imposed new limits on overdraft protection that made it more difficult for banks to provide the service to consumers.[2] The Federal Deposit Insurance Corporation (FDIC)[3] and the Office of the Comptroller of the Currency have also issued guidance on overdraft protection and pricing.[4] In addition, the newly-created Federal Reserve Consumer Financial Protection Bureau (CFPB) created by the Dodd-Frank Financial

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[1] George Mason University Foundation Professor of Law; Senior Scholar, Mercatus Center at George Mason University School of Law; Editor, *Supreme Court Economic Review*. Funding was provided by the Mercatus Center. Special thanks to International Bancshares Corp. (IBC), a major regional bank operating throughout Texas and the Southwest with approximately $12 billion, which generously agreed to provide data on the use of overdraft protection courtesy loans by its customers. In terms of assets and customer base, IBC appears to be generally representative of major banks.

[2] Federal Reserve System, Amendments to Regulation E, 74 FED. REG. 59,033 (Nov. 17, 2009) (to be codified at 12 C.F.R. pt. 205).

[3] Federal Deposit Insurance Corporation, Overdraft Payment Programs and Consumer Protection Final Overdraft Payment Supervisory Guidance, FIL-81-2010 (Nov. 24, 2010).

[4] Department of the Treasury, Office of the Comptroller of the Currency, "Guidance on Deposit-Related Consumer Credit Products," 76 FED. REG. No. 110, p. 33409 (June 8, 2011).

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Regulatory Reform Legislation,[5] is also expected to consider additional restrictions on overdraft protection through regulation or enforcement actions.

Public and political debate regarding overdraft protection has highlighted anecdotal stories about irresponsible college students who overdraw their accounts to buy a cup of coffee, thereby triggering substantial overdraft fees.[6] Irresponsible college students who can't or won't balance their check books, however, are a small fraction of those who use overdraft protection in any given year. More important, although this subset of overdraft users might view the availability of overdraft as unnecessary or even a nuisance, for millions of others, overdraft can be a valuable tool to deal with short-term liquidity issues. The wisdom of imposing new guidance or regulations that could impair access to overdraft protection should be judged not by unrepresentative anecdotes but by seeking to understand the typical users of overdraft protection, why they use the product, and whether they understand its true cost relative to alternatives.

This paper seeks to take a first step toward answering those questions. To date, regulation has been promulgated despite an almost complete lack of knowledge about consumer demand for overdraft protection and any rigorous analysis of safety and soundness or consumer protection questions. Although the analysis presented here should also be understood as tentative, not comprehensive. But this first look at consumer use of overdraft protection suggests that those who use overdraft protection generally do so because the real-world alternatives that are available are more expensive or less flexible and convenient than overdraft protection, especially when the full cost of

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[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. NO. 111-203 (July 21, 2010).
[6] *See* Ron Lieber & Andrew Martin, *Overspending on Debit Cards is a Boon for Banks*, N.Y. TIMES (Sept. 8, 2009), *available at* http://www.nytimes.com/2009/09/09/your-money/credit-and-debit-cards/09debit.html?em.

alternatives is taken into account, including time, travel, and convenience. Moreover, those who use overdraft protection the most—and thus those about whom regulators appear to be most concerned—generally use the product rationally in light of available alternatives indicating that they are generally aware of the costs and benefits of overdraft protection and choose to use it anyway. In a free society, absent compelling evidence that consumers are ignorant or irremediably foolish—neither of which has been demonstrated with respect to overdraft protection—people are assumed to be the best judge of what is in their interests and should remain free to choose. If this is true, then restricting access to overdraft protection will harm most those supposedly sought to be helped.

To date, while regulators have imposed regulations and proposed still further interventions, they have provided no tangible evidence of safety and soundness risk, consumer harm, or other market failure from overdraft protection. Nor have they provided any evidence that consumers, especially high intensity users, are unaware of the cost of overdraft protection or other key terms of the contract or that they use overdraft protection irrationally in light of available alternatives. Most importantly, regulators have provided no evidence that curtailing access to overdraft protection would make better-off those consumers intended to be helped by the limitations. Those using overdraft protection generally do so because it is preferable to their available alternatives and forcibly reducing access will make many consumers significantly worse off by increasing the frequency of adverse events such as bounced checks, possible criminal prosecution, utility shut-offs, and evictions, or alternatively, forcing greater use of high-cost alternatives such as payday loans, pawn shops, rent-to-own, and even illegal lenders.

This article explores the economics of overdraft usage by consumers and banks to understand the economic logic of the product. It then examines the recent regulatory initiatives by the Federal Reserve, FDIC, and OCC governing overdraft protection issued under the rubric of safety and soundness protection as well as purported consumer protection rationales that might prompt regulatory action by the CFPB. The case for regulation in this area under traditional safety and soundness is exceedingly weak and the evidence of harm that would justify action under a consumer protection rationale, such as evidence of a lack of consumer understanding of the product's terms or prices, is nearly nonexistent. Moreover, although some of the regulations that have been issued to date have been troublesome but not crippling, the unintended consequences that followed in the wake of the Federal Reserve's 2009 rules illustrate the potential for more serious harm that could follow from intrusive regulation that dramatically limits access to or the usefulness of overdraft protection. In particular, although prudential safety and soundness regulators have taken a relatively cautious approach to the issue, it is foreseeable that an activist CFPB could dramatically reduce access to and the usefulness of overdraft protection, with far-reaching consequences for consumers, the banking system, and the national economy.

Sensible regulation of courtesy overdraft-protection services begins with a sound understanding of who uses overdraft protection and why. For most consumers, the primary purpose of overdraft protection is as liquidity insurance for which there are few real substitutes: convenient short-term credit to ensure the payment of current obligations (avoiding bounced checks and the like), paid back in a short period of time, and used as an alternative to maintaining low-interest precautionary balances in savings and checking

accounts that can be accessed at the point of sale without a credit card. And even though some consumers use overdraft protection frequently, there is no evidence that they would be made better if their choices were restricted. Based on currently available evidence, the defining characteristic of frequent overdraft users is a low credit score and poor credit history, resulting in a paucity of attractive alternatives, not low income or other demographic characteristics.

Although overdraft protection is relatively more expensive than many mainstream financial products (such as credit cards), there is no evidence that overdraft protection is systematically more expensive relative to the real-world alternatives available to those who use it regularly.[7] More specifically, although overdraft protection may be more expensive than alternatives for some consumers, it may also be relatively superior for other consumers. This is especially so once the full costs of acquiring credit (including nonfinancial costs such as the time, travel, and convenience) are taken into account.

Overdraft protection also goes hand-in-hand with the availability of low minimum-balance, free checking accounts, which has provided access to the mainstream financial system for many low-income and young families. The rapid rise in the availability of free checking from 2001-2009 was aided by the spread of overdraft protection, and especially automated overdraft protection, as well as the increased use of debit cards.[8] Instead of the monthly-fee based model that dominated consumer banking

[7] It should be stressed at the outset that while the standard measure of lending cost—the "Annual Percentage Rate" or APR—might be a somewhat useful shorthand for describing the cost of loans, it is practically worthless in describing the real cost of a small-dollar short-term loan such as payday lending or overdraft protection, which is a loan for only a few weeks or even days. For example, the faster a consumer repays an overdraft loan the higher the APR, and the slower he repays it the lower the measured APR. This suggests the artificiality of APR as a measure of cost in the context of small-dollar short-term loans.

[8] Increased access to free checking began around 1998 but remained modest in numbers until access rose dramatically beginning in 2001.

for decades, the spread of overdraft protection opened the doors of the banking system to consumers who previously could not afford monthly maintenance fees and who were thus excluded from the banking system. And while substitution from use of fixed monthly fees to overdraft fees has produced a different pattern of cross-subsidization among bank consumers, reducing access to overdraft protection in the name of a subjective definition of fairness would reduce the availability of free checking accounts and impose new limits on bank access, such as higher mandatory minimum balances.

Finally, although overdraft fees and revenues have increased during the past decade, there is no evidence to date that banks are earning economic profits or "rents" from the growing use of overdraft protection. Instead, the market for overdraft protection is competitive both among banks offering overdraft services and with comparable products, such as payday lending. There is no evidence of super-normal returns to the banking industry generally from the growth of overdraft protection or from overdraft protection specifically. In fact, there is clear evidence to the contrary. Although overdraft revenues have risen, the costs of retail banking have increased as well, due to a range of quality improvements, including increased innovation (including on-line and mobile banking), an expansion of free services, and increased banking hours and banking days. These quality improvements and service improvements have made banking more convenient and accessible for consumers and brought many consumers into the mainstream banking system for the first time. These developments were spurred by the need to "keep up" in the highly competitive retail banking marketplace and reflect the high degree of competition in the banking market, a reality that makes it highly implausible that banks could earn sustainable economic profits that are not competed

away. The decline in access to free checking in response to the Federal Reserve's imposition of regulations on overdraft protection in 2009 evidences the market's competitiveness and that where revenues fall and costs rise those costs are passed through to consumers. Absent any evidence of sustainable economic profits in this sector of the banking industry, regulations that limit revenues from overdraft protection or any other service will have to be made up elsewhere through new and increased banking fees or substantial reduction in retail banking services and quality. There is no reason to believe that this regulatory-induced equilibrium outcome would be economically superior to that chosen by voluntary choice in a competitive market, especially once these other offsetting price and quality adjustments occur.

Regulatory proposals offered in the name of consumer protection can be justified in two ways. Under a theory of information failure, it might be argued that consumers simply lack sufficient information about the products that they are using, such as cost or other elements of the contract. In that case, intervention might be justified to improve the flow of information in the market, such as be required standardized disclosure formats, to enable consumers to better match their preferences with the products available in the marketplace. Substantive regulation of terms, however, generally would not be justified under this theory. Alternatively, under a theory of paternalism, it might be argued that *even if* information is freely available to consumers, consumers should simply be prohibited from making certain choices. Regulation grounded in paternalism, however, is much more dangerous in the unintended consequences it can produce precisely because it overrides consumers' assessments of their own best interests in light of the options they have at any given time with the preferences of a bureaucratic agency unfamiliar with the

particular context of consumer decision-making. Using overdraft protection is usually cheaper and more sensible than bouncing payments for utilities, rent, credit card accounts, or other bills. Crude and narrow measures of cost, such as APR, exclude many of the important total costs of obtaining and using credit—time, flexibility, and convenience—as well as these other costs of eviction and termination of utility service. Taking away overdraft protection or making it less useful and flexible for consumers and financial institutions will likely result in consumer harm in terms of more dishonored payments, utility service shut-offs, evictions, and other hardship, as well as more time and travel wasted in order to borrow relatively small sums of money.

I. Overdraft Protection: Background

A. The History of Overdraft Protection

Traditionally, American consumers had three primary forms of payment available to them: cash, checks, and more recently, credit cards. The advent and rapid spread of debit cards has added an additional payment system, one which has highlighted the question of overdraft fees because of the perception that debit cards and ATM machines are unusually prone to triggering "unfair" overdraft charges.

When using cash, a consumer bears no risk of overdrawing his account because he is limited to the cash he has on hand. On the other hand, cash is inconvenient and time-consuming to obtain and the consumer bears the risk associated with its loss or theft. Many consumers are reluctant to carry large amounts of cash with them or to make frequent trips to the bank to obtain cash. This in turn creates a liquidity constraint for consumers who use cash because they lack sufficient cash on hand, thus they may be

unable to take advantage of a retailer's sale or to purchase goods or services in an emergency. Cash generally is not used to make larger purchases and some merchants will not accept large-denomination bills. Moreover, cash can only be used for face-to-face transactions and cannot be used to pay bills by mail. Accessing large amounts of cash may also arouse suspicion with law enforcement authorities. And while ATMs make it easier to obtain and use cash than in prior eras, there is still a substantial cost in terms of time and inconvenience from ATM visits. Consumers can reduce those costs by making more infrequent ATM visits, but that requires withdrawing and carrying a larger amount of cash per transaction, which raises problems of loss or theft. Using out-of-network ATMs reduce the transaction costs of obtaining cash but usually incurs fees. In addition, using ATMs to withdraw cash can create a risk of overdrafting one's account.

Checks are an ancient response to all of these limits on the usefulness of cash. Checks solve many of the problems inherent in cash by enabling parties to transfer funds among themselves through bank drafts, rather than physically. But checks create new problems of their own because the payment order is separated in time from the actual payment. Even if there were sufficient funds in the account at the time the check was written, there might not be at the time the check clears. This gives rise to the well-known danger that a check might "bounce" and be returned for insufficient funds. In fact, because of bounced check risk, delay in settlement, and the slowness of checks in the checkout line, many merchants today no longer accept checks or do so only under

limited, lower-risk circumstances, and instead prefer payment by electronic payment systems such as debit cards.[9]

Bounced checks can be very costly to consumers. Direct fees imposed for checks returned for insufficient funds are substantial. For example, a bounced check may lead to fees imposed by both the payee as well as the financial institution that may exceed $60 total per transaction, an implied APR far higher than for high-cost loans such as payday loans.[10] Moreover, bounced check fees are cumulative—bouncing several checks can result in the imposition of substantial fees each time from both the bank and injured merchants. Dishonored checks also impose indirect costs. If a check is for payment of insurance, the policy will be terminated, and if for utilities (such as telephone or electricity) the bounced check may lead to termination of service, penalties, and a substantial security deposit to reconnect service. Retailers may refuse future service to customers who bounce checks. Bounced checks may also result in termination of a bank account[11] and even a risk of criminal prosecution[12]. In all, these various penalties may exceed hundreds of dollars. Most bounced check occurrences also require physical redemption of the check with payment of cash, which is time-consuming and embarrassing. Bouncing a check is also very damaging to one's credit score, making subsequent access to credit even more difficult.

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[9] According to one recent study 40% of national retail merchants will not accept checks for the purchase of goods and services. *See* Ed Roberts, *Average Account Overdraft Is $40, but Total Cost is $58, Study Finds*, CREDIT CARD MANAGEMENT (Aug. 22, 2011).

[10] Michael W. Lynch, *Legal Loan Sharking or Essential Service? The Great "Payday Loan" Controversy*, REASON (2002); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 155 (2004).

[11] According to one news story, at most banks "if you've bounced too many checks you're banned for five to seven years." Douglas McGray, *Check Cashers, Redeemed*, N.Y. TIMES MAGAZINE (Nov. 9, 2008).

[12] Every state provides for criminal penalties for passing bad checks under some circumstances. *See, e.g.*, National Check Fraud Center, *Bad Check Laws by State*, http://www.ckfraud.org/penalties.html.

B. The Growth of Overdraft Protection Programs

Instead of bouncing checks, many banks have instead offered overdraft protection, in which a bank advances funds to clear the check so that it is not returned. Historically, banks occasionally cleared some checks on an *ad hoc* basis that otherwise would bounce. But this courtesy service was highly limited and discretionary, reserved for high income customers with short-term liquidity problems.[13] That overdraft protection traditionally was a benefit for high-income customer is relevant for understanding the current demographics of overdraft usage: the practice originated as an ad hoc courtesy service for high-income customers, not low income. Thus, although overdraft protection now has been made available to middle-class and lower-income bank customers as well, its origin was as a short-term liquidity source for high-income customers. Most customers were denied this *ad hoc* courtesy and thus were forced to deal with the cost, inconvenience, and potential criminal penalties of bounced checks.

Over time, access to overdraft protection has grown as automated overdraft protection has reduced its cost and risk and increased its scale. Automated overdraft protection removed much of the subjectivity and selectivity of discretionary overdraft protection, mainstreaming access to overdraft protection by using automated underwriting and processing systems to control risk and cost and increasing the scale of the program to mitigate risk. The FDIC found in its 2006 survey of 1,171 FDIC-supervised banks that 86% of banks "operated at least one formal overdraft program" and that 40.5% of all banks offered automated overdraft programs.[14] Among larger banks with over $1 billion in assets, 76.0% offered automated overdraft programs.

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[13] *See* Regulation E, *supra* note 2.
[14] *See* FDIC STUDY OF BANK OVERDRAFT PROGRAMS 2-3 (Nov. 2008), *available at* http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf.

Approximately 70 percent of banks with overdraft programs implemented their automated programs after 2001.[15] As the use of ATMs and point-of-sale debit cards increased, banks have also extended overdraft protection to those products.[16] As of 2007, the average fee for an overdraft was $26 and larger banking institutions charge higher rates on average than smaller institutions.[17]

Bank revenues from overdraft fees rose from $30 billion in 2005 to $37 billion in 2009 before slipping back to $35 billion in 2010 as a result of new Federal Reserve regulations that reduced the number of consumers using overdraft protection.[18] Overdraft fees constitute a substantial portion of bank revenues, and an even larger percentage for credit unions.[19] According to the FDIC's 2006 survey, overdraft fees on average represent 6% of total net operating revenues of FDIC-insured banks.[20] It is estimated that 90% of overdraft revenues are generated by a relatively small percentage of heavy users.[21]

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[15] *See id.* at 8.

[16] According to the FDIC study, 81% of banks that operated automated overdraft programs allow overdrafts to be paid at ATMs and POS debit card terminals. *Id.* at 6.

[17] *See* U.S. Government Accounting Office, *Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts*, GAO REPORT 08-281 at 14 (Jan. 2008). According to Moebs, banks with over $50 billion in assets charge an average of $35 per overdrawn check compared to $26 for all institutions. Press Release, Moebs Services, Consumer Overdraft Fees Increase During Recession: First-Time Phenomenon (Jul. 15, 2009), *available at* http://www.moebs.com/AboutUs/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/65/Default.aspx.

[18] *Overdrafts Pile Up as Opt-In Pays Off, But Were Consumers Misled?*, PAYMENTS JOURNAL (May 5, 2011), *available at* http://www.paymentsjournal.com/Featured_Stories/Overdrafts_Pile_Up_as_Opt-In_Pays_Off,_But_Were_Consumers_Misled_/.

[19] Brian T. Melzer & Donald P. Morgan, *Competition and Adverse Selection in a Consumer Loan Market: The Curious Case of Overdraft vs. Payday Credit* (Working Paper, 2009) *available at* http://www.clevelandfed.org/research/conferences/2010/9-9-2010_household-finance/Melzer_Morgan_2_16_2010.pdf.

[20] FDIC Study, *supra* note 14, at iv.

[21] Press Release, Moebs Services, Overdraft Fee Revenue Drops to 2008 Levels for Banks and Credit Unions (Sept. 15, 2010), *available at* http://www.moebs.com/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/193/Default.aspx.

This growth in the availability and usage of overdraft protection is consistent with consumer preferences. According to a 2009 survey by the American Bankers Association, of those consumers who had paid an overdraft fee in the past 12 months, 96% wanted the payment covered.[22] A 2010 survey found that 69% of those who paid overdraft fees were happy that the payment was covered.[23] Four of six respondents in a small focus group research by ICF Macro conducted in connection with the Federal Reserve's promulgation of its amendments to Regulation E said that they were glad that their debit and ATM transactions were paid even though they triggered overdraft fees.[24] The vast majority of overdraft customers, therefore, self-report that they are happy that overdraft protection was available to cover their payments.

C. Risk of Overdraft Protection to Banks

The risk to banks of offering overdraft protection is nontrivial but reasonable. The historical chargeoff rate for overdraft loans is between 3-5%, comparable to the rate on many other unsecured bank loans such as credit cards.[25] Between 2001-2005 banks closed 30 million bank accounts for recidivist check bouncing.[26] And the average loss per bad account was $310.[27] In the one year period between October 2009 and October 2010, for example, according to data provided, one bank charged-off 53,588 overdraft

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[22] Press Release, American Bankers Association, ABA Survey: More Consumers Avoid Overdraft Fees (Sept. 9, 2009), *available at* http://www.aba.com/Press+Room/090909ConsumerSurveyOverdraftFees.htm.
[23] Press Release, American Bankers Association, ABA Survey: Most Consumers Avoid Overdraft Fees (Sept. 15, 2010), *available at* http://www.aba.com/Press+Room/091510ConsumerOverdraftSurvey.htm.
[24] Macro International Inc., *Review and Testing of Overdraft Notices* at ii, submitted to Board of Governors of the Federal Reserve System (Dec. 8, 2008).
[25] American Bankers Association, Letter to John Walsh, et al., at 4 (Aug. 24, 2011).
[26] Dennis Campbell, Asis Martinez-Jerez, & Peter Tufano, *Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures* (Working Paper, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335873.
[27] FDIC Study, *supra* note 14, at 62.

accounts for a total of $18,733,457.[28] Even if every overdraft or non-sufficient funds charge generated $30 in pure profit with no cost of provision, therefore, it would be necessary to process 10 repaid overdrafts for every account that went bad.

According to data provided by one regional bank, the largest loss risk for financial institutions from overdraft programs is not those customers who overdraft repeatedly although this seems to be a particular concern of the FDIC.[29] Instead, the largest risk arises from low-use or "hit-and-run" customers who open an account with the minimum required balance, conduct several overdrafts in short succession, and then abandon the account. The bank's largest losses on its overdraft program are from new accounts less than three months old. Although frequent overdraft customers may eventually default on an overdraft loan, the fact that they have paid prior overdraft fees typically renders them profitable on average. For this bank, for example, the average chargeoff for free checking customers who default on one overdraft in a year is $188.78. But the aggregate loss on all customers who default on one overdraft is $838,733.80. Moreover, the bank reports that despite its best efforts to ascertain risk of new customers, accurate risk assessment on overdraft accounts remains elusive. Precisely because free checking makes banking available to nontraditional customers, it is difficult to predict who among those customers eventually will default on overdraft loans. Although the bank uses ChexSystem reports (a central reporting service for bounced checks and closed bank accounts) to try to predict risk, it provides little predictive weight for subsequent default on overdraft loans. The size of the first deposit made by a new customer also has no predictive value. Nor is account seniority very predictive: As noted, accounts of 1-3

[28] Data on file with author.
[29] Data on file with author.

months old are the riskiest ones for overdraft default losses but older accounts over 24 months old also present substantial risk of loss. It is actually those who overdraft infrequently who present the safety and soundness risk, not those who use the product regularly.

II. The Regulatory Framework

A. Federal Reserve Regulation

In 2009, the Federal Reserve promulgated amendments to Regulation E, governing electronic transfers, to place new regulations on overdraft fees.[30] Under those rules, consumers must affirmatively choose to opt-in to overdraft protection for ATM and point-of-sale debit transactions. The Federal Reserve's justification for its action was its conclusion that based on the responses of participants in a survey of just six people, "participants generally indicated that they would want their checks paid into overdraft" but that the "majority of participants [4 of 6] also indicated that they would prefer an opt-in over an opt-out even if they would choose to have ATM and one-time debit card transactions paid."[31] Even if the responses of this six-person study are generalizable, however, the Fed made no determination of the relative cost of opt-in versus opt-out options on the system as a whole. Thus, if opt-in is substantially more expensive to obtain than opt-out would be, it might still be more efficient to have an opt-out regime even if many consumers would actually choose to opt-out.[32] In the context of securing

[30] 12 C.F.R. §205.17 (Nov. 17, 2009).
[31] Regulation E, *supra* note 2, at 59,036.
[32] For example, even though a majority of consumers arguably would choose to opt-out of telemarketing calls through the National- Do-Not-Call Registry created by the Federal Trade Commission, it might nonetheless be efficient for the rule to be set as an opt-out rather than opt-in rule in light of the relative ease by which consumers could opt out (by adding their phone numbers to the list) versus the high cost and difficulty that telemarketers would have to incur to contact and persuade consumers to opt-in. *See* Posting

consent for banking services such as overdraft protection, it is much easier for consumers to contact the bank than for the bank to track down consumers, especially those who have to be contacted at home. For example, when one large regional bank sought to contact its customers to give them the option to opt-in to overdraft protection for debit cards and ATM transactions, it was unable to contact almost 10% of its customers even after repeated efforts.[33] I have located no authoritative estimate of the impact of adopting an opt-in regime on participation rates in overdraft protection programs, but news reports indicated that participation has declined. About 20% of banks increased the fee that they charged on overdrafts to offset lost revenues from those who opt-out.[34] Because of the cost and difficulty of contacting consumers, many banks chose to not even try to contact customers to solicit their opt in, which included both community banks for whom it was too expensive relative to their somewhat smaller customer base as well as very large banks with such a large and transient customer base that it was financially infeasible to contact them.

On the other hand, for those who have made the effort to contact consumers, a high percentage of consumers chose to opt in and the heaviest users were those most likely to choose to opt in. For example, one regional bank solicited opt-in for overdraft protection for debit card transactions from its largest overdraft users.[35] The bank sought permission from 499 customers that had 25 or more overdraft transactions in 2010. Of the 499 customers, 466 (93%) opted in for debit card transactions and 33 (7%) opted

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of Todd J. Zywicki to the Volokh Conspiracy, Two New FTC Commissioners and the National Do-Not-Call Registry, *available at* http://www.volokh.com/posts/1092515307.shtml.

[33] Comment of International Bancshares Corporation to the Federal Deposit Insurance Corporation at 6 (Sept. 24, 2010), *available at* http://www.fdic.gov/regulations/laws/publiccomments/overdraft_comments/2010-09-24-ibc.pdf.

[34] In addition, opt-in may create an adverse selection problem as low-risk users who use the product rarely may be more likely not to opt-in.

[35] Data on file with author.

out.[36] This willingness of the heaviest users to opt-in to overdraft protection suggests that they value access to overdraft protection notwithstanding its seemingly high cumulative cost. Overall, 73% of the bank's customers chose to opt-in to debit card overdraft protection. A subsequent survey of the bank's customers by the Raddon Financial Group in June 2011 found that when asked to rank the value of overdraft courtesy protection from "Extremely valuable" to "Not at all valuable," 86% of elevated users stated that the availability of overdraft protection was extremely valuable (only 2% said it was "Not at all valuable").[37] Moreover, the percentage of those stating that overdraft protection is "extremely valuable" rose consistently with the intensity of use, from 57% for non-users of overdraft protection to 86% for elevated users. Overall, of 2,009 respondents to the online survey, 71% said that access to overdraft protection is "Extremely valuable" and another 21% said it was "Somewhat valuable." Only 4% said it was "Not at all valuable."

Market surveys have suggested similar results. According to a survey by Moebs, at various large banks 60%-80% of customers opted-in to debit card overdraft protection, with a median opt-in rate of 75%.[38] According to analysis by the American Bankers Association, 46% of consumers opted-in to one-time debit card and ATM transactions.[39] A study by the Center for Responsible Lending, by contrast, concluded that 33% opted-in.[40]

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[36] Information provided by International Bancshares Corporation to author.
[37] Raddon Financial Group, Inc., *Custom Survey Research Findings* (June 2011), on file with author.
[38] Overdrafts Pile Up, *supra* note 18.
[39] Press Release, American Bankers Associations, Half of Bank Customers Choose Overdraft Protection (Aug. 31, 2010), *available at* http://www.aba.com/Press+Room/083110OverdraftProtection.htm .
[40] Center for Responsible Lending, Banks Collect Overdraft Opt-Ins Through Misleading Marketing (Apr. 26, 2011), *available at* http://www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/banks-misleading-marketing.html.

Perhaps more significant, Moebs found that almost all of those who use overdraft protection regularly—more than 10 times per year—opted-in to coverage[41] and JP Morgan reported that 53% of those who regularly use overdraft protection opted-in[42]. Similarly, a survey by *Consumer Reports* found that a majority of those who had overdrawn their account in the past six months opted-in to overdraft protection.[43] Although these surveys and studies are not rigorously scientific, they suggest that the most-frequent (and thus presumably the most knowledgeable) users of the product also are those who are most likely to opt-in to overdraft protection when given the choice. As the analysts at Moebs Services put it, "The consumer no longer views overdrafts as a penalty like a parking ticket, but as a safety net."[44]

The recent experience of one bank is also illustrative with respect to overdraft fees at ATMs.[45] Between April 7 and April 30 this year, the bank had 41,273 customers who were alerted when they sought to make an ATM withdrawal that doing so would overdraw their account and asked whether to cancel the transaction or continue with an overdraft charge. Of that group, only 3,380 (8%) initially declined to have the transaction processed with an overdraft fee. Of that group of 3,380 who initially declined to have the transaction go forward, however, 1,470 (44%) came back within 24 hours and opted-in to overdraft protection for ATM transactions. Within 24 hours, therefore, 95%

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[41] Moebs Services Inc., Press Release, Banks Lower Overdraft Fees as Consumers Choose to Opt-In (Dec. 8, 2010), *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/197/Default.aspx.
[42] David Benoit, *Customers Opt for Overdraft Protection*, WALL ST. J. (Nov. 26, 2010), *available in* http://online.wsj.com/article/SB10001424052748703678404575636884207120508.html.
[43] Consumer Reports Poll (Nov. 16, 2010), *available at* http://www.consumersunion.org/pub/core_financial_services/017109.html.
[44] Moebs, Banks Lower Overdraft Fees, *supra* note 41.
[45] Data provided by IBC bank and on file with author.

of those who were originally given the opportunity to accept overdraft protection for an ATM withdrawal chose to do so.

This real-world experience rebuts one of the proffered rationales offered by Federal Reserve—but one for which it offers no evidence or even serious theoretical support—that opt-in would paternalistically protect frequent users of overdraft protection from overusing the product.[46] According to Federal Reserve, requiring opt-in would make it more difficult for these consumers to access overdraft protection, which "could therefore best prevent these consumers from entering into a harmful cycle of repeated overdrafts."[47] But experience shows that heavier users of overdraft protection are those who are most likely to opt in to overdraft protection. Standard economic analysis provides a straightforward explanation for this observation: regular users of overdraft protection are those who are most likely to be aware of its costs and to choose to use overdraft protection because they believe it to be superior to their available alternatives. Consistent with standard economic analysis, and contrary to the Federal Reserve's paternalistic approach, making overdraft protection more expensive and less available to the heaviest users is almost certainly likely to reduce their welfare and to impose unnecessary costs on the financial institution in order to reach the desired end by consumers and banks. Restriction has proven to just add cost to those that are supposedly being protected with no obvious benefits.

B. FDIC Guidance

[46] Regulation E, *supra* note 2, at 59,038.
[47] *Id.* On March 1, 2010, the Federal Reserve promulgated additional amendments to Regulation E clarifying some questions raised by the prior rulemaking. 75 Fed. Reg. 9120 (March 1, 2010).

On November 24, 2010, the FDIC issued guidance regarding overdraft fees.[48] Under the FDIC Guidance, financial institutions must take several steps regarding their overdraft accounts. Among its requirements, banks must "monitor [customer] accounts" and "take meaningful and effective action to limit use by customers" of overdraft protection. For example, the guidance provides that with respect to "excessive or chronic" users of overdraft protection—defined as those who overdraw their accounts on more than six occasions in a rolling twelve-month period—the bank must take affirmative steps to provide the customer with reasonable opportunity to choose a less costly alternative, such as linked savings account overdraft protection or a line of credit.[49] Banks are required to institute "appropriate daily limits" on overdraft fees and consider eliminating overdraft fees for transactions that overdraw an account by a "de minimis" amount. Finally, banks are required to "not process transactions in a manner designed to maximize the cost to consumers," which has been interpreted to prohibit posting larger items first.

C. OCC Guidance

In June 2011, the Office of the Comptroller of the Currency also issued proposed "Guidance on Deposit-Related Credit Products."[50] The OCC guidance describes several principles that the OCC expects national banks to follow in connection with any deposit-

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[48] Overdraft Payment Programs, *supra* note 3.

[49] Since the initial announcement of the Guidance the FDIC has clarified that this requirement can be satisfied by a statement on a customer's monthly statement. *See* FDIC Overdraft Payment Program Supervisory Guidance Frequently Asked Questions, *available at* http://www.fdic.gov/news/conferences/overdraft/FAQ.html. Research suggests that this simple statement may be sufficient to persuade consumers to avoid use of overdraft fees by raising the salience of the issue even if it does not directly lead to a shift to substitute products. *See* Victor Stango & Jonathan Zinman, *Limited and Varying Consumer Attention: Evidence from Shocks to the Salience of Bank Overdraft Fees* (Nat'l Bureau of Econ. Research, Working Paper No. w17028, 2011).

[50] Office of the Comptroller, Guidance, *supra* note 4.

related consumer credit product, and specifically automated overdraft protection programs and deposit advance products. The OCC contends that the purpose of its program is to provide "a high degree of flexibility" for banks to "structure and operate their programs in a prudent and safe and sound manner" that also "provides for fair treatment of customers without dictating specific product terms." Although the rules purport to be only guidance and not to impose specific prescriptive requirements, it is likely to be interpreted as dictating specific requirements.

The OCC's guidance imposes several different requirements. First, it requires disclosure not only of the terms of the overdraft protection program offered but also of any alternative deposit-related credit products offered by the bank (such as tied savings protection). The OCC guidance also requires banks to provide customers with clear disclosure about the order of processing transactions as well as to inform consumers that the order in which they are processed can affect the total amount of fees incurred. Second, the OCC rules urge banks to adopt an opt-in approach for all overdraft protection products, including checks, ACH, and recurring debit card transactions.[51] Unlike overdraft protection for one-time debit transactions and ATM transactions (for which consumer testing by the Federal Reserve suggested about half of consumers preferred to be opt-in), available evidence clearly indicates that an overwhelming majority of consumers want overdraft protection for these larger and more important transactions, so requiring opt-in seems like an unnecessary logistical hurdle. Third, pursuant to safety and soundness requirements, the OCC guidance requires the bank to conduct sufficient analysis to ensure that the customer will be able to manage and repay the credit obligations arising from the product. Fourth, the OCC requires banks to adopt "prudent

[51] For check, ACH and recurring debit transactions the opt-in requirement is prospective only.

programmatic limitations" on the usage of overdraft protection in terms of the number of overdrafts and the total amount of fees that may be imposed per day and per month and any *de minimis* levels.

D. Rationales for Regulation

To date, regulation of overdraft protection has been grounded in purported safety and soundness concerns. But safety and soundness concerns are obviously misplaced. The provision of overdraft protection is a net financial asset to banks that provide it—there is no evidence that banks lose money from it. Individual overdraft loans are quite small, just a few hundred dollars or up to $1,000. In addition, regulators have claimed that there is an undefined "reputation risk" from overdraft protection, a completely unsubstantiated assertion and hard to square with the market trend toward greater availability of overdraft protection for customers. Those who use overdraft protection most regularly—who regularly borrow and repay overdraft loans—provide the *smallest* safety and soundness risk, as they are the customers most likely to generate revenues from overdraft loans that exceed the costs or risk of loss to the bank. Thus, although safety and soundness regulation has focused on heavier users of overdraft protection as presenting particular risk, this focus is obviously nonsensical from a traditional safety and soundness perspective. Overdraft programs are highly effective from a risk-mitigation perspective because of their large scale and small dollar exposure per account, i.e., a large number of accounts with small average balance. On the other hand, safety and soundness can become a real concern if regulators continue to carve away at the revenues generated from overdraft programs, thereby subjecting banks to greater and greater exposure from

declining revenues, a reduction in the scale of the program that would spread the risk across a smaller number of customers, and heightened risk of adverse selection. When combined with the negative impact of the Durbin Amendment on interchange fee revenue, excessive interference with overdraft protection could imperil the solvency of the retail banking system as it exists today, producing its own safety and soundness concerns and eventually leading to a major restructuring and retrenchment in retail banking.

On the other hand, purported safety and soundness concerns actually appear to be poorly disguised consumer protection concerns. One suspects that the concern of bank regulators is not that banks will *lose* too much money from the issuance of overdraft protection thereby imperiling safety and soundness, but rather that banks will *make* too much money on the product which many activists believe to be an undesirable product for consumers, notwithstanding their decision to use it. It is precisely because overdraft protection is profitable that it is criticized.

Unlike purported safety and soundness rationales which are completely backward, consumer protection at least provides a coherent (although questionable) rationale for heightened regulation of overdraft protection. But without understanding who uses overdraft protection and why, regulation runs a serious threat of imposing greater cost in the form of unintended consequences than benefits.

III. Consumer Protection and Overdraft Regulation

A. Who Uses Overdraft Protection?

The overwhelming majority of bank customers in the United States never use overdraft protection. According to the FDIC, in 2006, 75% of bank customers never overdrew their bank accounts and 12% overdrew only one to four times. A 2009 survey by the American Bankers Association found that 83% of consumers did not overdraft their account during the past year and that of the 17% who did overdraw, 64% used overdraft protection four or fewer times.[52] A 2010 survey by the American Bankers Association found that 77% of consumers paid no overdraft fees and of those who did, 64% paid four or fewer.[53] Melzer and Morgan found that 86% of bank customers take out fewer than 4 overdrafts per year.[54] On the other hand, some bank customers use overdraft protection dozens of times over the span of a year or two and incur hundreds of dollars in overdraft fees as a result.

Overdraft protection traditionally was used by high-income consumers to address short term liquidity problems. Even though the customer base eligible for overdraft protection has broadened most still use overdraft protection to meet short-tem liquidity needs—even if sometimes recurrent liquidity issues—rather than as a source of long term borrowing. According to data provided by a major regional bank, approximately one-third of all overdraft loans are repaid within 10 days and approximately 90 percent are paid off within a month of the initial credit extension.

It is often asserted without evidence that overdraft protection is used predominantly by low-income consumers. A study by Moebs research firm, however, concludes that the only accurate predictor of the propensity to overdraft is credit score—

[52] Sept. 9, 2009 ABA Survey, *supra* note 22.
[53] Sept. 15, 2009 ABA Survey, *supra* note 23.
[54] Melzer & Morgan, *supra* note 19.

those with lower credit scores are more likely to use overdraft protection.[55] All other demographic information—including income—is non-predictive of the likelihood of using overdraft protection and building a reliable risk model has proven elusive.[56]

Economist Marc Fusaro also finds that among frequent users of overdraft protection there is little correlation between income and overdraft usage: high-income individuals are just as likely as lower income individuals to overdraft, but that higher-income customers' overdrafts typically are larger.[57] Frequent users of overdraft protection also tend to be younger than less-frequent users.[58]

The FDIC study found that accounts held by customers in low-income geographic areas are more likely to incur overdraft charges and that use of overdraft protection is more common among younger bank customers than others. For example, according to the FDIC, 46.4% of those in the 18-25 age range overdrew their account in the 2006 study, while only 12.2% of seniors did. But the FDIC study did not control for credit score, which tends to be correlated with income and age, thus it cannot be determined whether the driving factor was creditworthiness or demographic variables.

There are other reasons to think that overdraft customers are not particularly poor. By definition, overdraft borrowers have a bank account, which distinguishes them from many unbanked consumers and suggests that they have higher and more stable income than users of alternative financial products such as payday lending and pawnshops. Moreover, access to overdraft protection is commonly linked to direct deposit of payroll

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[55] Press Release, Moebs Services, Who Uses Overdrafts? (Sept. 29, 2009), *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/194/Default.aspx.
[56] *See supra* note 29 and accompanying text.
[57] Marc Anthony Fusaro, *Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks*, 29 J. FAM. ECON. ISS. 251, 257, 260 (2008); Marc Anthony Fusaro, *Are "Bounced Check Loans" Really Loans? Theory, Evidence and Policy*, 50 Q. REV. OF ECON. & FIN 492, 499 (2010).
[58] Fusaro, *Are Bounced Checks*, *supra* note 57, at 499.

checks, suggesting that many overdraft customers are also steadily employed. Finally, recall that overdraft protection was originally a benefit offered to high-income customers, thus there is no reason to presume that it is a product exclusively or even primarily for low-income customers.

Thus, according to available research, the significant distinguishing feature of heavy overdraft users appears to be their credit score, not their income or other demographic status. After all, overdraft fees can be entirely avoided through responsible financial management: one regional bank found, for example, that 71% of its free checking accounts with average balances of less than $250 incurred no overdraft fees in the one year period between October 2009 and October 2010 (a total of 105,000 accounts).[59] Moreover, the percentage of low-balance accounts that incurred zero overdraft fees during that period (71% of all accounts) was actually *higher* than the overall percentage of *all* accounts at the bank that incurred no overdraft fees (62%).[60] Those who are financially responsible can and do manage even low balance accounts without triggering overdraft fees. Because of their paternalistic focus on protecting irresponsible consumers from overdraft fees, however, regulators have implicitly assumed that overdraft fees are a function of income and have overlooked the important role of consumer responsibility in avoiding overdraft fees.

Infrequent users of overdraft protection exhibit distinct patterns of behavior. Fusaro finds those who overdraft only occasionally (1-10 times in his study) generally make overdrafts that are much larger in size than those who overdraft frequently. He

[59] Data on file with author.
[60] This figure may not be entirely representative as some of those with low-balance free checking accounts may not be actively using those accounts and thus may not be incurring overdraft fees. But it does illustrate the point that whether overdraft fees are incurred is within the control of the consumer and cannot be simply assumed to be a low-income product.

finds that the average overdraft size for those who overdraft occasionally is $306, as compared with $90 for those who overdraft chronically (over 100 overdrafts).[61] This might be explained in several ways. It is consistent with the hypothesis that infrequent overdraft users use overdraft protection to ensure payment of large and important checks, such as for utilities, mortgage payments, rent, or the like. If this is so, it seems unlikely that these occasional users are simply being tripped up by inadvertent use of their debit cards, rather than choosing to use overdraft to clear large and important payment obligations.[62] Alternatively, it might reflect usage by "hit and run" scammers who open a bank account and exploit overdraft protection in several short-term transactions that they never intend to repay.

B. Why Consumers Use Overdraft Protection

Overdraft protection usually serves as a short-term source of small-dollar credit in order to meet a pressing need for funds and to prevent important payments such as utilities, rent, or other bills from being denied for insufficient funds. Moreover, those who use overdraft protection do so because it is better than available alternatives. For many, the closest real-world alternative to overdraft protection is payday lending. Other sources of credit are either unavailable (such as credit cards), clearly inferior (such as pawnbrokers), or unwanted because they are longer term or require borrowing larger amounts of money than desired (such as personal finance company installment loans). According to research by Moebs Services, about 19 million Americans use payday

[61] Fusaro, *Hidden Consumer Loans*, *supra* note 57, at 259.
[62] Note that this feature also makes the requirement of opt-in for checks, ACH transactions, and recurrent debit card payments extremely cumbersome and counterproductive for infrequent users, as those most likely to use it for that purpose may be the least likely to anticipate their subsequent need for it and thus to op-in.

lenders and 13 million use overdraft protection every year.[63] Thus, both are popular products with significant market demand. How then do consumers choose between payday loans and overdraft protection—and do they do so rationally?[64]

For most consumers, both payday lending and overdraft protection are fairly expensive compared to mainstream credit offerings such as credit cards.[65] This is to be expected: fundamentally it is and always has been the case that the cost of making small loans to consumers is high relative to the size of the loan. And these costs are reflected in a variety of forms—fees, interest rate, time, search costs, convenience and many others. For example, even if a consumer could shop around and find a slightly lower rate for a payday loan than an overdraft loan, doing so would incur time and shoe leather costs of searching around, the risk of being rejected for the loan, or having to process paperwork and wait for the money. Many of these costs (such as the time spent traveling from store to store, paperwork time, and approval delays) are incurred regardless of the size of the loan and thus are especially costly in relation to the small size of these loans. Similarly, many of the costs of making small loans such as store rent, employee time, paperwork, and credit checks are expensive to amortize over small, risky loans of a few hundred dollars. In light of these basic economics, there simply is no foundation for thinking that the total cost of overdraft loans is exorbitant when compared to alternatives. High price relative to the size of the loan is simply inherent in small loans. But even then, many of the real costs of a small loan are not directly financial at all but include a variety of

[63] Press Release, Moebs Services, Payday Loans are a Better Deal for Consumers than Overdraft Fees (Jul. 7, 2010), *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/169/Default.aspx.

[64] Available evidence indicates that consumers generally use payday loans rationally. *See* Todd J. Zywicki, The Case Against New Restrictions on Payday Lending (George Mason University Mercatus Ctr., Working Paper No. 09-28, 2009).

[65] Credit cards are not always a less-expensive alternative than payday lending and overdraft protection for those whose usage tends to trigger substantial behavior-based fees.

transaction costs in terms of time, effort, and convenience, none of which is captured in a crude and limited measure of cost such as APR and which generally are invariant of loan size.

Payday and overdraft loans share these fundamental economic characteristics that explain why their prices seem high. But payday loans and overdraft protection also differ in several significant ways. First, payday loans are less convenient and flexible than traditional overdraft loans, including the time and "shoe leather" costs of going to a payday lender, waiting in line, and then delivering the cash to a bank or to pay a bill. In fact, payday loans might not even be realistically available in some situations, such as when traveling or in an emergency. Overdraft protection, by contrast, is processed automatically and immediately, 24 hours a day from anywhere in the world, and can be directly triggered by retail or online transactions rather than having to make a special trip to acquire the funds from a payday lender. Consumers who place a higher value on their time or convenience might therefore prefer using overdraft protection rather than going to a payday lender even if payday lending is less expensive. Second, there is a possible psychological cost of payday loans for some consumers in that they might feel embarrassed to be seen patronizing a payday lending storefront or otherwise uncomfortable with going to a payday lending store. By contrast, overdraft protection is done privately, instantaneously, and electronically so there is no concern about outsiders becoming aware of their borrowing.[66] Third, although the fees may be high relative to the amount borrowed, overdraft protection in fact permits the consumer to borrow exactly the amount needed (plus the fee), no more and no less. Moreover, overdraft loans must

[66] For example, the upper-income professionals for whom overdraft protection originally was created might be unwilling to patronize payday lenders or other storefront small-loan lenders.

be paid back within 45 days or the account will be terminated. For payday loans, by contrast, consumers may be tempted to borrow more than they need for immediate purposes and while the overwhelming majority of payday loan customers benefit from and value the option to revolve their payday loan at the end of the loan period, this can lead some borrowers to fall into a "debt trap" of rolling over payday loans or credit card balances. Thus, if consumers fear their inability to precommit to timely repayment, then they might prefer overdraft protection. Finally, consumers who have defaulted on a payday loan simply may find themselves unable to acquire payday loan credit in the future—so payday loans may no longer be an available option. For those consumers, overdraft protection may be the best alternative available in a group of options limited to pawnshops, auto title loans, rent-to-own and other options.

Overdraft protection also benefits consumers by reducing their need to maintain precautionary bank account balances, and in fact those who have bounce protection generally hold smaller precautionary balances. This is valuable for many consumers because checking accounts, especially free checking accounts, often pay no interest. Thus, the ability to reduce precautionary balances enables consumers to keep more of their funds in less-liquid but higher earning accounts.

Overdraft loans also provide a degree of flexibility that many other products lack. For example, when overdraft protection is combined with a debit card it can be used functionally like a credit card, allowing purchases to be made immediately with payment to come later (albeit an expensive credit card). Because overdraft can be used to pay bills, it can also be used to protect access to other types of credit, such as utilities, medical treatment, credit cards, or even payday lending, as overdraft can be used to make

sure those payments are honored and thus to avoid costly penalties and termination of service. For example, the effective APR on a bounced check is many times higher than for overdraft or payday loans once all fees are assessed and this doesn't even include the threat of criminal prosecution and bank account termination. A simple financial measure of cost such as APR does not include the value of maintaining access to other types of credit or avoiding the costs associated with not performing on them.

In addition, although payday loans often are less expensive than overdraft fees, this is not always the case. Leaving aside the benefits of overdraft protection in terms of convenience, privacy, and time and shoe-leather costs, there are important differences in the pricing scheme that are relevant to understanding consumer behavior. Payday loans typically charge $15 for every $100 borrowed. Overdraft loans, by contrast, typically charge a fee of $26-$35 *regardless* of the amount advanced. For loans to cover a single small expense of $100 or less, therefore, payday loans are typically less expensive than overdraft loans.[67] For loans of about $200, the price is about equal, and for loans of $300 or above, a single overdraft loan typically will be less expensive. This calculation will vary, of course, depending on whether the consumer is making one overdraft or more. But that is precisely the point—freedom of contract is most likely to more efficient than regulation when consumer preferences are heterogeneous and knowledge of one's needs is highly personal.

In fact, evidence indicates that consumers generally act rationally when choosing between payday and overdraft credit. Federal Reserve economists Brian T. Melzer and Donald P. Morgan have studied consumer decision-making with respect to the choice

[67] Moebs Services, Payday Loans, *supra* note 63.

between payday lending and overdraft protection.[68] They note that the key difference in the way the two products are priced generates predictions about rational consumer behavior. Because the primary price component of overdraft protection is a flat fee (irrespective of the size of the overdraft) rather than a periodic interest rate, rational consumers would tend to use overdraft protection to cover *larger* transactions that otherwise would be declined for insufficient funds. The price of payday loans, by contrast, is tied to the size of the loan (e.g., $15 per $100 borrowed), thus consumers would be predicted to use them to cover *smaller* transactions. This pricing difference also creates a potential adverse selection problem as consumers select the option that gives them the lowest price for any given-sized transaction.

Melzer and Morgan's analysis confirms that consumers generally use overdraft and payday lending in the manner predicted by economic theory. Moreover, they find that in markets where payday loans are available, the number of overdraft attempts and bounced checks *fall* in number (as consumers use payday loans to cover some transactions that otherwise might bounce) but *rise* in average dollar amounts as payday loans continue to be used to cover larger transactions. They find further that in markets where payday credit is available banks reduce the availability of "free" checking for those accounts *without* direct deposit, but not those *with* direct deposit. This is because the presence of direct deposit is a sort of insurance for the bank against "hit and run" customers who open an account without direct deposit anticipating large overdrafts that will never be repaid and then switch to using payday loans to meet short-term credit needs.

[68] Melzer & Morgan, *supra* note 19.

Economist Jonathan Zinman also found evidence of substitution between payday lending and overdraft protection. He found that when Oregon imposed a cap on the finance charge that could be assessed on payday loans, there was a dramatic drop in the number of licensed payday lenders, a short-run deterioration in the overall financial condition of Oregon households, and some evidence that the ban led to an increase in late bill payments and a substitution to greater use of overdraft protection by consumers.[69]

Research by Policis analysts also found a significant substitution effect between payday lending and overdraft protection. In a survey of Australian payday loan customers, they found that if payday loans were not available, approximately 20% of payday loan customers would make greater use of overdraft protection. Those who were most likely to shift to use of overdraft protection tended to be higher-income and have a greater number of alternative credit sources than payday loan customers on average.

A survey conducted by the Raddon Financial Group of customers of a large regional bank asked customers who used overdraft services where they would turn for emergency funds if they no longer had access to overdraft protection.[70] Fifty-three percent of "Elevated users" of overdraft protection reported that if overdraft protection was not available they would "Not be able to get money," as opposed to only 16% of non-users.[71] And while 26% of non-users of overdraft protection said that they would "Use a credit card" if overdraft protection were unavailable, only 10% of elevated users said they would use a credit card (presumably reflecting their lack of access to credit cards or that using a credit card would cause them to exceed their credit lines and lead to

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[69] Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap* (Fed. Res. Bank of Philadelphia, Working Paper No. 08-32, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335438.
[70] Raddon survey, *supra* note 37.
[71] 30% of low users and 39% of moderate users said that they would be unable to get money.

penalties). Similarly, while only 6% of non-users said that they would seek a payday loan if overdraft protection was unavailable, 24% of elevated users reported that would be their option (the second-highest response after "Not able to get money" for elevated users). Moreover, while 56% of non-users said in such situations they would simply transfer the needed money from another account (presumably a savings account), only 13% of elevated users said that they would do so, presumably reflecting the simple truth that they have no other accounts available. Regular users of overdraft protection have low credit quality and limited credit alternatives.[72] According to the Raddon survey, for example, only 7% of elevated users of overdraft protection describe their personal assessment of their credit rating as "excellent," while 70% describe their credit rating as "fair" (38%) or "poor" (32%). By contrast, 74% of non-users of overdraft protection describe their credit rating as "excellent" or "good" and only 9% consider their credit rating to be "poor." Thus, reducing access to overdraft protection would simply exacerbate the plight of those who rely upon it because of a lack of better alternatives.

Another survey conducted by Baselice & Associates, Inc., of one bank's customers found similar results.[73] According to that study, 54% of those who self-identified as having "poor credit" thought that overdraft protection was "extremely important," compared to only 18% of those who said that they had "excellent credit." When asked how upset they would be if overdraft protection was eliminated, 62% of those with poor credit said they'd be "extremely upset" compared to only 20% of those with excellent credit. In addition, while 41% of lower-income customers reported that

[72] Raddon Survey, *supra* note 37.
[73] Baselice & Associates, Inc., Banking Survey (Aug. 29-31, 2011), on file with author.

they'd be "extremely upset," 29% of customers with annual incomes over $60,000 also said that they would be extremely upset if overdraft protection were eliminated.

Overdraft protection may be used either to cover unintentional errors (an unknowing lack of funds in one's bank account) or intentionally as a short-term line of credit. Fusaro concludes that approximately 79% of overdraft use is of the first type: clearing payments that otherwise would result in bounced checks. The remaining 21%, he concludes, is conscious use by consumers of overdraft protection as a short-term line of credit.[74] Intentional overdrafters tend to borrow the money for longer durations, a rational strategy in light of the flat-fee pricing scheme in which the fees are front-end loaded. This suggests that many chronic overdrafters use overdraft protection intentionally as a short-term line of credit and becoming more sophisticated and knowledgeable about the most efficient ways to use overdraft protection as they become more experienced.[75]

Overall, Fusaro concludes that on average consumers gain a consumer surplus of approximately $50 per year from the availability of overdraft protection and the accompanying benefits of avoiding NSF fees and maintaining lower precautionary balances, or $2 billion economy wide.[76] Fusaro and Ericson conclude that overdraft protection is generally welfare improving for middle-class bank consumers and neutral for low-income consumers.[77] They conclude that eliminating overdraft protection

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[74] Fusaro, *Are "Bounced Check Loans" Really Loans?*, *supra* note 57, at 499.
[75] Marc Anthony Fusaro, *Consumers' Bank Choice and Overdraft Volume. An Empirical Study of Bounce Protection Programs* (Working Paper , 2003).
[76] *Id.*
[77] Marc Anthony Fusaro & Richard E. Ericson, *The Welfare Economics of "Bounce Protection" Programs*, 33 J. CONSUM. POL'Y 55, 71 (2010).

"through excess regulation would hurt the most vulnerable population most, as they have the fewest alternatives to maintain necessary liquidity."[78]

C. Do Consumers Understand the Cost of Overdraft Protection?

Evidence that consumers generally tradeoff usage of overdraft protection and payday loans in a manner consistent with the predictions of economic theory also suggests that consumers are generally aware of the costs of overdraft protection compared to various alternative forms of credit and tend to use those which are most efficient in light of the limited options that they have available to them.

The pricing of overdraft protection is simple and seemingly transparent. Attached as Appendix A is the form "Overdraft Courtesy Customer Disclosure" for one bank's free checking account. As can be readily seen, the costs of overdraft protection are clearly disclosed, easily understood, and the criteria for available line of credit are plain (such as whether one has an overdraft account linked to a direct deposit account or not). The fees are clear: $29 per overdraft, up to a maximum of six charged overdrafts per day (after which additional overdrafts within the credit limit are free), and an 18% APR for any overdraft loan. The bank will not charge any overdraft fees for *de minimis* balances of less than $3. The bank also clearly discloses its clearing order from highest to lowest for various types of charges. Finally, it states that if the overdraft is not repaid within 45 days the account will be closed.

In short, the disclosure is clear, concise, and easy to understand. Moreover, although overdraft protection has been the source of criticism and regulatory scrutiny, it has not been claimed that consumers fail to understand the costs of or criteria for

[78] *Id.*

overdraft protection. Instead, criticism has focused on paternalistic rationales that even if consumers fully understand the costs of overdraft protection, they nonetheless should not be permitted to use it "chronically" or "excessively"—as those terms are defined by bank regulators.

In connection with the Federal Reserve's amendments to Regulation E, Macro International Inc. conducted consumer surveys to see if consumers understood standard disclosure forms regarding overdraft protection. They found that consumers understand the concept of overdraft protection—that the institution will cover its customers' overdrafts for a fee—and that they would be enrolled in the service automatically unless they opted-out.[79] They also understood what would happen when they overdrew their account through an ATM, debit card, recurring debit, or check transaction. Subsequent research confirmed these findings that consumers are able to understand overdraft programs.[80]

Research on payday loans also confirms that payday-loan customers are generally aware of the cost of payday loans. According to Elliehausen, only two percent of payday-loan customers reported that they did not know the finance charge for their most recent new payday loan; 94.5 percent reported finance charges consistent with prevailing market prices.[81] Those who used payday loans most often were also most likely to know the reported APR on their loan.[82] Whatever concerns have been expressed about payday loans, lack of transparency is not one: Payday-loan pricing is simple and easily

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[79] *See* Macro International Inc., *supra* note 24.
[80] ICF Macro, *Design and Testing of Overdraft Disclosures: Phase Two*, submitted to Board of Governors of the Federal Reserve System (Oct. 12, 2009).
[81] Gregory Elliehausen, An Analysis of Consumers' Use of Payday Loans 35, 36-37 (Fin. Servs. Res. Program, Monograph No. 41, Jan. 2009).
[82] *Id.* at 38.

understood.[83] Given the predominantly flat-fee nature of overdraft protection, it seems probable that those who use overdraft protection (especially those who use the product regularly) are aware of its cost as well as available alternatives. Moreover, to the extent that consumers are unclear about some terms of overdraft protection, their uncertainty relates to specific details, such as the fact that the bank is not required to pay an overdraft in some situations, not the price charged for an overdraft.[84]

IV. Overdraft Protection and Free Checking

A. Overdraft Protection and the Economics of Retail Banking

The expansion in the availability of overdraft protection has also helped to transform the consumer banking system over the past decade, especially by spurring rapid growth in the availability of free checking and other bank services, increased innovation, and expanding access to bank services for previously-excluded consumers. The link between overdraft fees and free checking is a tight one: overdraft protection is essential for free checking to exist for low-balance consumers. Low-balance customers have little margin for error in managing their affairs—absent overdraft protection, these consumers might bounce checks and other payments with great regularity. For low-income consumers, overdraft protection essentially serves as a substitute for higher required minimum balances or other fees that would be necessary to cover the cost and risk of serving these customers. Overdraft protection, which provides a line of credit to insure payment of obligations after the fact, is a substitute for requiring higher precautionary balances as insurance ahead of time that payments will be honored.

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[83] As one news story characterized payday lending terms, "[N]o surprises, no hidden fees." McGray, *supra* note 11.
[84] ICF Macro, *supra* note 80.

Indeed, the shorthand term "free checking" hardly captures the full value of a standard demand deposit account to consumers today. In fact, the typical "free checking" account today includes a bundle of valuable services: free debit card usage, free ATM access, free on-line bill payment, free mobile banking, and a host of other services. One bank estimates that the value of the products bundled in its "free checking" account is $751 per year.[85] The bank makes up the cost of providing that bundled service in a variety of ways, one of which is through revenue generated by overdraft protection.

The past decade saw a revolutionary transformation in the pricing of bank services, away from the traditional pricing model of flat-fee monthly service fees to a combination of free checking and other bundled banking services, offset by growing debit card interchange and overdraft revenues.[86] There is a very close link between the spread of overdraft protection and free checking. Although banks began mainstreaming free checking in the late-1990s, between 2001 and 2009 the percentage of accounts at large banks that qualified for free checking rose dramatically from 7.5% to 76% and the average minimum balance required for free checking fell from $440 in 2001 to $186 in 2009.[87] This growth in access to free checking appears to have arisen from two sources: the simultaneous growth in the availability of overdraft protection and the rapid increase in the use of debit cards and the interchange fee revenues that they generate. Bringing

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[85] Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 4. Obviously this is an interested estimate, but "free checking" today includes multiple valuable services for which consumers otherwise would have to pay.

[86] *See* Stango & Zinman, *supra* note 49.

[87] David S. Evans, Robert E. Litan, & Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Deb it Card Interchange Fee Regulations on Consumers and Small Businesses* (Feb. 22, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/March/20110308/R-1404/R-1404_030811_69120_621655419027_1.pdf. With the onset of the Durbin Amendment's price controls on interchange fees for large bank customers, by 2011 free checking had plummeted to only 45% of bank accounts. *See* Claes Bell, *Abracadabra: Free Checking Disappears*, BANKRATE.COM (Sept. 26, 2011), *available in* http://www.bankrate.com/finance/checking/abracadabra-free-checking-disappears.aspx.

lower-income consumers with lower average balances into the banking system also has brought with it greater risk that those consumers will bounce checks or otherwise miss payments. Absent universal access to overdraft protection, it is likely that average minimum balances would be raised and monthly fees reimposed. To reduce risk exposure many financial institutions also link the availability of free checking or the size of the available overdraft line of credit to a commitment to paycheck direct deposit.

The reduction in the availability of free checking in the immediate period after the Federal Reserve's amendments to Regulation E took effect, illustrates the competitive nature of the market. According to Evans, Litan, and Schmalensee, "within days" of the Fed's announcement of its new rules banks starting scaling back access to free checking, imposing new fees, and eliminating services for consumers. The number of accounts eligible for free checking fell 11 percentage points—from 76% in 2009 to 65% in 2010—a figure that translates to approximately 20 million accounts.[88] Although some of these adjustments may be attributable to other factors, such as the ongoing banking crisis, much of this change is attributable to the new restrictions on overdraft protection.

Market experience also suggests that overdraft protection is popular with consumers and that bank consumers prefer the combination of zero up-front maintenance fees and lower required balances with overdraft protection to the traditional model of monthly maintenance fees and higher minimum required balances. Consumers have tended to migrate to banks that offer overdraft protection (and thus lower required monthly fees), which has increased the market share of those banks and put competitive pressure on competitors to respond.[89] Access to overdraft protection allows consumers to

[88] *See* Evans, Litans, & Schmalensee, *supra* note 87.
[89] Fusaro, *Consumers' Bank Choice*, *supra* note 75.

hold smaller precautionary balances in low-interest demand deposit accounts, which also leads them to overdraft their accounts more often.[90] Moreover, an obvious but often-ignored point is that consumers can easily avoid paying overdraft fees simply by not spending more money than they have in their account, and can avoid overdraft charges by better financial management or by holding larger precautionary balances. Overdraft loans are created by the customer, not the bank—the customer decides whether to draw on his overdraft line of credit.[91]

For example, a Federal Reserve study published in 1999, when free checking was still somewhat uncommon, illuminates the tradeoff between various types of banking fees. The study found that checking accounts that did not require customers to consistently maintain a certain minimum balance through the month also imposed higher fees for various services.[92] According to the study, for non-interest bearing accounts (the closest analog to free checking today) the average required minimum balance was $348, and the average monthly fee was $5.50 if the minimum balance was not maintained. Moreover, these accounts had additional fees for many other services and reduced services generally. Although the monthly maintenance fee was slightly higher for interest-bearing accounts, once the additional fees were considered, bank customers with a no minimum-balance account paid $12.30 each month in higher monthly fees (approximately $250 per year) than those who maintained a certain minimum balance. Thus, as would be expected in a competitive market, there has always been a tradeoff between different bank fees and other requirements. The market response to Regulation

[90] Fusaro, *Are "Bounced Check Loans" Really Loans?*, *supra* note 57.
[91] Recall, for example, that 71% of low-balance free checking accounts at one bank never incurred overdraft fees. *See supra* note 60.
[92] Joanna Stavins, *Checking Accounts: What Do Banks Offer and What Do Consumers Value?*, NEW ENGLAND ECON. REV. 3, 6 (March/April 1999).

E and the subsequent market responses to the imposition of the Durbin amendment are consistent with the predictions of the banking industry as a competitive market where sustainable economic rents are absent.

B. The "Fairness" of Overdraft Fees

Critics of overdraft might protection might argue that even though there are no demonstrable economic rents generated by overdraft fees, overdraft fees should nonetheless be regulated because they are "unfair." "Fairness," of course, is an entirely subjective and arbitrary concept. To the extent that the term has any meaning in this context, it appears to express a concern that the actual operation of overdraft fees results in a cross-subsidization by some consumers by others, as the minority of bank customers who pay overdraft fees sustain the system and provision of free services, innovation, and expanded service for the larger number of those who do not.

The vast majority of bank consumers pay zero or few overdraft fees, meaning that they gain access to bank accounts at very low cost. Moreover, the FDIC estimates that for those customers who conducted 1 to 4 NSF transactions during the prior year on average were charged $64 in NSF fees—or approximately $5 per month—less than that person would have been expected to pay in monthly bank fees prior to the spread of overdraft protection. Even a consumer with 5 to 9 NSF transactions paid on average $215 year, or about $15 per month. In addition, of course, the consumer avoided ancillary costs of bounced checks, late fees on other bills, etc. On the other hand, the bulk of overdraft fees are accumulated by heavy users of the product, but presumably

they are most aware of the cost and the alternatives available to them and find it most necessary to use overdraft protection in light of available alternatives.

Is it "unfair" that most bank customers benefit from this system by receiving valuable bank services at low or zero costs, while bank customers who pay substantial overdraft fees appear to pay fees in excess of what they receive in exchange? As an initial matter, economics establishes that because those who use overdraft protection do so voluntarily their behavior establishes that in fact they do receive value in excess of what they pay, albeit value not entirely in direct banking services but in convenience and avoidance of higher alternative costs.

The claim of unfairness founders on another conceptual problem: consumer cross-subsidies are ubiquitous in the modern economy, yet few people consider most of these cross-subsidies to be "unfair" in some way. For example, customers who purchase items on sale or with a coupon pay less than those who do not. Some consumers pay more to buy a book in hardback when it is first released while others are more patient and buy it at much-cheaper paperback prices. Those pay full price for movies subsidize those who attend matinee showings. Indeed, those who buy on sale or with coupons are typically commended for being thrifty and responsible shoppers although this means that they are being effectively subsidized by those who pay full price. That some bank consumers subsidize free checking for others through overdraft fees seems no more unfair than consumers who pay full price or attend full-priced movies, thereby subsidizing others who are patient and buy on sale. It cannot be contended that the simple existence of consumer cross-subsidies in the retail economy is inherently unfair, yet it is difficult to understand what the "fairness" critique of overdraft fees could mean.

Banking services are no exception to this rule. Today, banks offer a wide variety of services (many of them provided for free), but all of those are funded by a relatively small number of revenue streams. Different customers use different services supported by these streams and few consumers would prefer that every service be priced on an a la carte manner.[93] For example, some consumers physically go into branches to conduct transactions, thereby using the rent, heat, and employee time that others do not. Yet no banks of which I am aware charge a fee for those who use a teller window, even though those who do not use tellers are forced to subsidize those who do. Nor have bank regulators sought to prohibit this "unfair" cross-subsidization of those who use tellers. Similarly, banks that offer free parking or drive-through banking subsidize those who drive rather that walk or take public transportation. Similarly, some customers use online bill pay or other services that are offered for free as part of a bundle of products and others do not. Banks offer all of these "free" services as a bundle—debit cards, tellers, heat, free parking, drive-through windows, online banking, and a myriad of other services—even though they result in cross-subsidies because of competition and customer demand. There is simply no sound policy justification for the arbitrary assertion that the only appropriate pricing scheme for banking services is one that is *a la carte* and that bundling services or cross-subsidizing consumers as competitive circumstances demand is a fundamentally flawed pricing scheme. Even more unsustainable is the notion that every one of these other cross-subsidies is "fair" and permissible and that overdraft protection alone is arbitrarily condemned on this ground.

[93] Similarly, few consumers seem to prefer paying separate baggage fees for checked bags on every flight rather than having those fees bundled into the price of their ticket.

In fact, like all of these other market-driven cross-subsidies, the expansion of overdraft and the accompanying increase in access to free checking and other innovations is the product of competition among banks that has benefited consumers overall. For example, as free checking has expanded over the past decade so has the number of bank branches nationwide, the number of services offered, and banking hours generally have been extended.[94] The number of bank branches nationwide grew from 64,900 in 2000 to over 83,000 by the end of the decade.[95] Local banks have opened branches inside supermarkets and other retailers, thereby expanding the number of branches and the hours during which a teller is available to assist with banking services.[96] Rarely are consumers charged on a piecemeal basis for this increased choice and customer service, but rather all of these efforts are funded out of a handful of revenue streams.

Once the trade-off between free checking and overdraft protection is recognized, however, the concern about whether the current allocation of banking fees is consistent with some arbitrary definition of "fairness" is overwhelmed by a more significant point: the development of the current pricing model has promoted competition, innovation, and expanded access to the mainstream banking system to many consumers who traditionally were excluded and the return to older fee structures. Replacing the outcomes of market competition and consumer free choice with those preferred by bureaucratic design of prices and products will reverse all of these beneficial trends. Regulatory policies that result in the elimination of free checking and the imposition of higher fees will drive

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[94] The number of branches of commercial banks rose 39% between 1988-2006. *See* Timothy H. Hannan & Gerald A. Nanweck, *Recent Trends in the Number and Size of Bank Branches: An Examination of Likely Determinants*, 23 J. OF FIN. TRANSFORMATION 155 (2008) (Capco Institute).
[95] FDIC, Table CB01, *available in* www.fidc.gov/hsob/hsobRpt.asp.
[96] Between 2003 and 2008 the number of retail-based bank branches increased from 5,581 to 6,162. *See* Kevein Dobbs, *In-Store Branches Could Boost Growth for Some Banks in the West* (Sept. 1, 2009), *available in* http://branchlocation.com/showArticle.php?id=68.

many consumers out of mainstream financial services and force them to rely on alternative financial products, such as check cashers, prepaid card issuers, and rent-to-own companies. While those credit providers play a crucial and valuable role in serving certain members of the economy, especially unbanked consumers, it is difficult to conceive of a justification for government policies that promotes reduced access to mainstream banks and greater reliance on those products. Yet this is the predictable unintended consequence of the cascade of government regulation since the financial crisis. In fact, as restrictions on overdraft fees and the Durbin Amendment's price controls on debit card interchange fees have bitten deeper, these trends have been reversing. Fewer customers are now eligible for free checking, new fees have been imposed on existing services, quality and convenience have declined, and banks have begun closing branches. It is hard to see how these trends will benefit consumers.

V. Competition and Overdraft Protection

If overdraft fees were simply a novel tool for banks to rip-off consumers then the growth of revenue from overdraft protection would be correlated with an increase in bank's bottom line profitability overall. Or, in economics jargon, the growth in interchange fee revenues would evidence "economic rents" or "economic profits" for those banks that have adopted overdraft protection. But, in fact, there is no evidence that risk-adjusted bank profitability has increased substantially during the period that overdraft protection has spread and overdraft revenues have risen. Instead, profitability of depository institutions has remained relatively constant over time, even though overdraft revenues have risen substantially. Indeed, the crisis in bank solvency that

began in 2008 developed just as revenues from overdraft fees reached their peak. Nor is there any obvious difference in the overall profitability of those institutions that offer overdraft protection versus those that do not. This absence of any systematic evidence of major economic profits linked to the provision of overdraft protection suggests that the increased use of overdraft fees has been driven by the competitive need to meet growing consumer demand not oppressive or unfair behavior by banks.

The apparent absence of risk-adjusted economic profits can be explained by several different, overlapping explanations. First, although overdraft revenues have increased, bank risk and loss has increased as well by bringing into the banking system lower-income consumers with lower average balances, narrower profit margins for banks and lower credit ratings. Moreover, as noted, the average loss on a non-paid overdraft loan is approximately $300, roughly ten times the amount of the standard overdraft fee ($30)—suggesting that approximately 10 or more successfully repaid overdraft loans are necessary to offset the losses from one defaulting overdraft customer.

Further evidence that overdraft protection does not generate economic rents is the rapid spread of the product and general satisfaction with those who use overdraft protection regularly. The banking industry is highly competitive.[97] This high degree of competition in the banking industry suggests that if any economic profits are earned from overdraft protection they are dissipated in the competitive process of extending banking services to more consumers or reducing other banking fees, such as monthly account maintenance fees. Banks offering overdraft protection also compete with non-bank products such as payday lending and evidence suggests that if the cost of overdraft protection became unduly high relative to those alternatives, then consumers could and

[97] Evans, Litan, & Schmalensee, *supra* note 87.

would shift to those alternatives. Circumstantial evidence is provided by the absence of economic rents in the payday lending industry once risk and cost are considered [98] and the beneficial effect of competition on payday loan prices.[99]

Finally, the cost of retail banking has risen during the past decade as banks have increased the quality of bank services through innovation and expanded services, thereby competing away increased revenues from overdraft protection and debit card fees. Of course, the opposite is true as well: if revenues from these are forcibly reduced, then banks will be forced to cut costs and services, closing branches and charging for services that were formerly free. This economic reality is already appearing in the market place as regulations are causing many banks to abandon free checking and to adopt "a la carte" charges on products and services previously offered without charge. Rather than imposing new fees, other banks have chosen to trim costs by closing branches or otherwise reducing services.[100] Again, there appears to be no coherent regulatory principle that would support the principle that the combination of lower revenues and a lower level of consumer services is preferable to the alternative from a safety and soundness perspective and thus should be encouraged by law.

VI. Unintended Effects of Regulation of Overdraft Protection

Regulation of the terms of overdraft loans may also have negative unintended consequences. As noted, the Federal Reserve's amendments to Regulation E, which

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[98] *See* Paige Skiba & Jeremy Tobacman, *The Profitability of Payday Loans* (Working Paper, 2006).
[99] Donald P. Morgan, *Defining and Detecting Predatory Lending* (Fed. Res. Bank of New York, Staff Report No. 273, 2007); Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* (Fed. Res. Bank of Kansas City, Working Paper No. 09-07, 2009); *see also* Philip Bond, David K. Musto, & Bilge Yilmaz, *Predatory Lending in a Rational World* (Fed. Res. Bank of Philadelphia, Working Paper No. 06-2, 2006).
[100] *See* Nelson D. Schwartz, *Branch Closings Tilt Toward Poor Areas*, N.Y. TIMES (Feb. 22, 2011), *available in* http://www.nytimes.com/2011/02/23/business/23banks.html?pagewanted=all.

adopted an opt-in regime for debit card overdraft protection, had the severe effect of reversing a decade-long increase in the percentage of free checking accounts at banks and subsequent regulation has accelerated this trend.[101] Moreover, most of the regulations are patently absurd from a safety and soundness perspective: banking regulators have singled out for special concern the most profitable customers and terms of overdraft protection products without any empirical evidence or even plausible economic theory about how reducing revenues could improve safety and soundness.[102] Moreover, overdraft programs have grown over the past decade, increasing their scope and volume, without any tangible evidence of heightened safety and soundness risk. In fact, most of these purported safety and soundness concerns are actually consumer protection concerns in disguise. An awareness of the incoherent nature of the safety and soundness concerns expressed by bank regulators may explain the tentative nature of many of these regulations.

Leaving aside these incongruities in safety and soundness issues, regulations could have unintended consequences for consumers and the banking system if interpreted in an unduly prescriptive manner. In addition, even if the FDIC's approach is characterized by some degree of restraint, there remains a looming threat that the newly-formed Bureau of Consumer Financial Protection which might seize the authority to regulate overdraft protection in a less-measured and less-informed manner, thereby potentially harming consumers and the economy.

A. Regulating the Posting Order of Transactions

[101] *See* discussion at *supra* note 88, and accompanying text.

[102] Note the obvious point which actually must be stated in this context: simply because a customer or term is highly profitable (and thus beneficial from a safety and soundness perspective) does not mean that it is adverse to the interests of consumers. Profits in a free market economy generally are earned by providing a service that consumers desire and value.

The FDIC Guidance requires that banks not process transactions in a manner designed to maximize overdraft fees. As an example, the FDIC has suggested clearing items in the order received or by check number. Although the formal guidance does not speak further to the issue, the FDIC has stated that the practice of many banks of re-ordering transactions to clear payments from the largest to smallest value items as many banks is impermissible under the FDIC's guidance because this will "tend to increase the number of overdraft fees."[103] The FDIC's justification for the rule is belief that it will improve consumer welfare by reducing the number of payments that bounce—by clearing multiple small payments first, the absolute number of payments that bounce will be reduced. The traditional convention of clearing larger payments first, by contrast, results in a more rapid depletion of funds which then leads to a larger number of smaller payments being rejected later thereby incurring a larger number of overdraft or bounced check fees.

Although it is plausible that requiring smaller payments to be posted first will reduce the total amount of overdraft fees, the FDIC's narrow focus on minimizing the total *cost* of overdraft protection ignores the potential *benefit* of overdraft protection to consumer. Requiring clearance from lowest to highest dollar value is contrary to the practice of many institutions which has been to clear larger items first—usually checks and ACH payments—under the assumption that larger items tend to be more important items such as payments for mortgage, rent, utilities, or other high-priority payments that consumers would want to be sure would be paid. Although a requirement that smaller

[103] *See* FDIC Overdraft Payment Program Supervisory Guidance Frequently Asked Questions, No. III.4. According to a 2009 survey, approximately 20 percent of financial institutions reportedly used the practice of clearing transactions from larger to smaller obligations. Moebs Services, Consumer Overdraft Fees, *supra* note 17.

payments to be cleared first would likely reduce the cost of overdraft fees, it ignores that the *benefit* of paying larger items is usually greater because the consequences of dishonoring larger payments are more severe. Overdraft protection programs limit the amount of overdraft credit that can be extended, from $300 for low-balance free checking accounts up to $500 or $800 for more stable accounts. As a result, one large check added on top of several previously-paid small debit card payments might exceed the available credit balance available for overdraft protection, leading large and more important payments to be rejected because honoring them would exceed the available credit line.

In fact, a report by the Raddon Financial Group of one bank's overdraft program found that 58% of its customers preferred that larger items be posted *first*, even though that might result in more overdraft charges in total.[104] Among "elevated users" of overdraft protection the percentage that preferred larger items to be posted first rose to 60%. Thus, the FDIC guidance contradicts the expressed preferences of a majority of the bank's customers, especially those who use overdraft protection most frequently, making consumers worse off. Put more mildly, government interference in contract terms typically is justified only if there is manifest evidence of a failure of market terms to reflect consumer preferences. The findings of the Raddon Report, while subject to qualification about its methodology, strongly suggests that more hard data is necessary before concluding that the contracted-for clearing order reflects a market failure rather than a term best left to be established by competition and free choice, especially with respect to more frequent users.

The problems that the FDIC's guidance can cause in practice is illustrated by the experience of one bank after it changed its policy in October 2010 to comply with

[104] Raddon survey, *supra* note 37.

regulatory guidance to clear debit card payments before checks on the assumption that in general debit transactions are smaller in value than checks.[105] As a result, the bank has returned unpaid many more large payments than in the past. Comparing the two-month period before the rules went into effect with the two months following, the bank reports that the total number of checks and ACH items returned increased 4%, but the dollar value of the rejected payments returned increased 16%. Moreover, many of those returned payments were for important items like payments of mortgages, utilities, medical bills, student loans, rent, taxes, and even payday loans. Thus, while the rule might reduce the amount of overdraft fees paid, it comes at a heightened risk of rejecting larger, more important payments. It is far from obvious that this tradeoff improves consumer welfare. It is even less obvious that this is an appropriate issue to be resolved by a one-size-fits-all FDIC mandate that overrides consumer choice rather than voluntary agreement between banks and their customers.

B. Special Rules for "Excessive or Chronic" Overdraft Customers

The FDIC Guidance also requires banks to make special efforts to educate consumers who engage in "excessive or chronic use" of overdrafts, defined as making use of overdraft protection more than six times in a twelve month period. Defining "excessive or chronic" use as six instances in a twelve month period, of course, is entirely arbitrary. The rationale for this regulation appears to be that there is some arbitrary number of overdraft transactions that regulators consider to be simply "too many" transactions and for which consumers would be better served by choosing some other means to meet those goals. The basis for this belief or this arbitrary number, however, is

[105] The information discussed in this paragraph was provided to the Mercatus Center by IBC.

unclear. Indeed, actual consumer behavior and revealed consumer preferences suggest that the basis for this opinion is paternalism by FDIC officials and is based on little or no investigation of the habits of those who use overdraft protection regularly. There is no reason to believe that the most regular users of overdraft protection are unaware of its cost or available alternatives. Therefore, it seems unlikely that these admonitions will cause many consumers to change their behavior. To be sure, some minority of bank customers may misuse overdraft protection and incur substantial fees. But if the events of recent years have taught anything, it is that virtually every type of consumer credit product can be misused or overused, including even traditional mortgages.

As with virtually every other aspect of overdraft protection, this paternalistic regulation is least popular with the most-frequent users of overdraft protection. According to the Raddon survey, although 89% of non-users of overdraft protection would want to be contacted after six overdrafts occur within a year, only 60% of elevated users would like to be contacted. Elevated users were also those most likely to opt-out of these notices if they could (33%). Thus, according to the survey, a majority of elevated users (those who are most likely to actually incur six overdrafts in a 12 month period) would want to be alerted when they reached six occurrences. On the other hand, providing such notice would incur some cost—had the survey asked whether customers would be willing to *pay* in order to receive such notice (even a nominal fee such as processing and mailing costs), one suspects that the percentage of those who responded affirmatively would drop substantially, especially among elevated users.

Moreover, very few customers are likely to even be able to establish an alternative payment source for overdrafts. For example, in a filing with the FDIC on the proposed

rules, one bank stated that of its 327,865 free checking accounts only 49,616—approximately 15%—have savings accounts at the bank.[106] Moreover, that figure includes *all* free checking customers: The number of customers with free checking who have a savings account and have used overdraft protection is probably even smaller in light of the fact that those with sufficient funds to have a savings account are probably also less likely to overdraft.[107] This small percentage of free checking customers is consistent with the findings of the Raddon survey, which found that only 13% of elevated users of overdraft would "transfer funds from another account" if overdraft protection was unavailable. The reason why repeat users of overdraft protection do not use linked savings accounts or other similar options is not because the do not realize that those options would be less expensive, they do so because those options simply are not available to frequent users and to do without overdraft would force them to either do without the money (and suffer the resulting consequences) or use a payday lender.[108]

The FDIC Guidance also suggests that some customers may find it less expensive to open a bank line of credit. This is true—but almost certainly irrelevant for most overdraft users because acquiring a discretionary line of credit requires a standard loan application and approval, which requires a credit score far in excess of that of most of the bank's overdraft users. As noted, regular users of overdraft have low credit quality and

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[106] Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 12 n.8. Overall, the bank has 446,288 checking accounts with overdraft protection. Of those customers, only 62,310 have a related savings account but only 19,105 have chosen to sign up for its overdraft transfer protection that automatically transfers funds from the customer's savings account to his checking account to cover payments when necessary.

[107] According to the Raddon survey, almost half of elevated users of overdraft protection at one bank reported that they did not have sufficient funds to maintain a separate account from which overdrafts could be drawn. Raddon Survey, *supra* note 37.

[108] These findings on the reasons for using overdraft protection in light of available alternatives are consistent with the usage of other alternative credit products, such as payday lending. Zywicki, Payday Lending, *supra* note 64.

limited credit alternatives. In addition, a line of credit typically requires a minimum line of credit of approximately $2,500, far exceeding the $300-$800 available for overdraft protection. In fact, the spread of overdraft protection was hastened by the regulatory and economic difficulties of offering a line of credit to consumers.[109] Few of those who use overdraft protection are likely to be approved for such a large line of credit. But if the bank were to offer a smaller line of credit then the cost would rise substantially. In the end, therefore, the FDIC Guidance is almost completely irrelevant to the typical elevated user of overdraft protection, although the need to comply with the guidance will impose unnecessary administrative costs on banks and will have negative consequences for consumers.

VII. Conclusion

Regulation by anecdote is always dangerous and regulation of overdraft protection based on unrepresentative anecdote presents the risk of injuring consumers and the safety and soundness of the banking system. Safety and soundness regulators are targeting those borrowers who provide no safety and soundness risk (regular users who generate a net profit for banks). Moreover, it is these very same heavy users who report that they are the least likely to have easy, low-cost alternatives to overdraft protection and thus are the most likely to be diligent in maintaining their access to overdraft loans in good standing. Lacking any identifiable safety and soundness threat or identifiable market failure or evidence of consumer ignorance, regulation can be supported by only bald paternalism. And as the lessons of history indicate, paternalistic regulation of consumer credit products tends to injure precisely those it is intended to help, by driving

[109] Comment of International Bancshares Corporation to the FDIC, *supra* note 33, at 4.

them to use less-preferred credit or reducing their access to credit generally, with all of the ancillary consequences.

The Federal Reserve's amendments to Regulation E implemented last year dealt a major blow to the availability and usefulness of overdraft protection for many consumers. The FDIC's regulatory guidance threatens overdraft protection further. The OCC has raised concerns in its guidance as well. Undoubtedly, some consumers misuse overdraft protection. But as recent years have amply demonstrated, every type of consumer credit is potentially subject to misuse—even traditional mortgages. For millions of consumers, overdraft protection provides a short-term lifeline that enables them to avoid more expensive problems, such as bounced checks, eviction, late fees on credit cards, or utility shutoffs. Lacking overdraft protection, many of these consumers could turn to less-preferred alternatives such as payday lending. Regulators should be careful to ensure that in trying to prevent abuse or misuse of overdraft protection, they do not go too far in the direction of making it too difficult to use or obtain.

Regulators cannot wish away consumers' need for credit. Eliminating access to overdraft protection will not eliminate the need that consumers have for it. History teaches the hard but undeniable lesson that well-intentioned paternalistic regulations that make it more difficult for consumers to obtain certain products cannot magically make them more financially responsible or make other less-expensive products magically appear. Everyone makes errors when it comes to many things, including personal finances. Yet it remains the case that most of us most of the time know better than central planners what is right for ourselves and our families. Access to overdraft protection is no exception. According to the Raddon survey, 94% of one bank's

customers reported that use of overdraft protection should be their personal choice (including 92% of non-users and 96% of elevated users) and 89% reported their view that government should have *no* voice in how many overdrafts are allowed on your account.[110] Government intervention into a competitive market is typically justified only by demonstrable evidence of a market failure and confidence that interventions will ameliorate, not exacerbate, market failures. To date, such evidence is lacking for overdraft protection. All that regulation typically does is reduce access to one type of credit and thereby force consumers to make greater use of other, less-preferred products. Overdraft protection fills a unique need in the consumer credit marketplace—for a convenient, flexible, line of credit accessible 24 hours a day on demand, anywhere in the world, at an ATM, point-of-sale purchase, or for a check to clear. If access to overdraft protection is taken away, where will consumers who count on it turn?

[110] Raddon Survey, *supra* note 37.

APPENDIX A

FORM OVERDRAFT COURTESY CUSTOMER DISCLOSURE

The Deposit Account Agreement controls the duties, obligations and rights of the Depositor, the Authorized Signatories and Bank with regard to your checking account. The Deposit Account Agreement (and all amendments thereto) is incorporated herein for all purposes as if it were set forth verbatim, and its terms shall control any possible conflict, if any, between any provision of this Overdraft Courtesy Policy and the Deposit Account Agreement. This discretionary service is offered to our customers who are United States residents or Resident Aliens.

Discretionary service. Bank is not obligated to pay any item presented for payment if your account does not contain sufficient available funds, and any discretionary courtesy payment (or other negotiation or processing) by Bank of any non-sufficient fund check or other item as identified below does not obligate Bank to pay any additional non-sufficient fund check or item or to provide prior notice of its decision to refuse to pay any additional non-sufficient fund check or item. Approval of payment of reasonable overdrafts by Bank on consumer accounts in good standing (as described below) is only a courtesy, and not a right or an obligation, is within Bank's sole and absolute discretion, and can cease at any time without prior notice or reason or cause.

"Good standing" requirement. Pursuant to Banks commitment to always "Do More," now and in the future, if your consumer account (primarily used for personal and household purposes) or your sole proprietor account has been opened for at least 30 days and is maintained in good standing, which includes at least: A) Making regular deposits consistent with your past practices; B) Depositing $300.00 or more in your account within each thirty (30) day period and bringing your account balance to a positive balance within every thirty-five (35) day period; C) You are not in default on any loan or other obligation to Bank; and D) You are not subject to any legal or administrative order or levy, Bank will consider, as a discretionary courtesy and not a right or obligation, approving your reasonable overdrafts.

Limits. This courtesy will generally be limited to a maximum of (i) a $300.00 overdraft (negative) balance for "Free Checking Accounts," (ii) a $500.00 overdraft (negative) balance for "Free Checking Accounts" that have been open and in good standing for at least one year, OR which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period, (iii) a $700.00 overdraft (negative) balance for "Free Checking Accounts" that have been open and in good standing for at least one year, AND which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period, (iv) a $500.00 overdraft (negative) balance for "Other Personal Checking Accounts / Free Biz Rite Accounts," (v) a $700.00 overdraft (negative) balance for "Other Personal Checking Accounts / Free Biz Rite Accounts" that have been open and in good standing for at least one year, OR which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period, and (vi) a $900.00 overdraft (negative) balance for "Other Personal Checking

Accounts / Free Biz Rite Accounts" that have been open and in good standing for at least one year, AND which have direct deposit, where there have been two or more direct deposits totaling at least $600.00 within the past sixty (60) day period. Customers are highly encouraged to balance their checkbook and use their overdraft courtesy in a responsible manner that avoids excessive fees.

Covered Transactions. Overdraft Courtesy Program covers checks, in person withdrawals, ATM withdrawals, and electronic transactions. "Electronic transactions" includes automatic payments, online bill pay, and debit cards used at point of sale. Authorization and payment of overdrafts for ATM and everyday debit card transactions by Bank are subject to your "opt-in" decision to such coverage.

Order of payment. It is the bank's policy to clear items in the following order: (1) First any wire transfers from highest to lowest dollar amount; (2) items we have already paid out or committed to pay from lowest to highest dollar amount such as ATM withdrawals, teller cash withdrawals, transfers, and debit card or point of sale withdrawals (3) checks and ACH withdrawals from highest to lowest dollar amount. Transactions may not be processed in the order in which they occur. The order in which transactions are processed can affect the total amount of overdraft/non-sufficient funds fees incurred. Bank reserves the right to clear in any order, as permitted by state law.

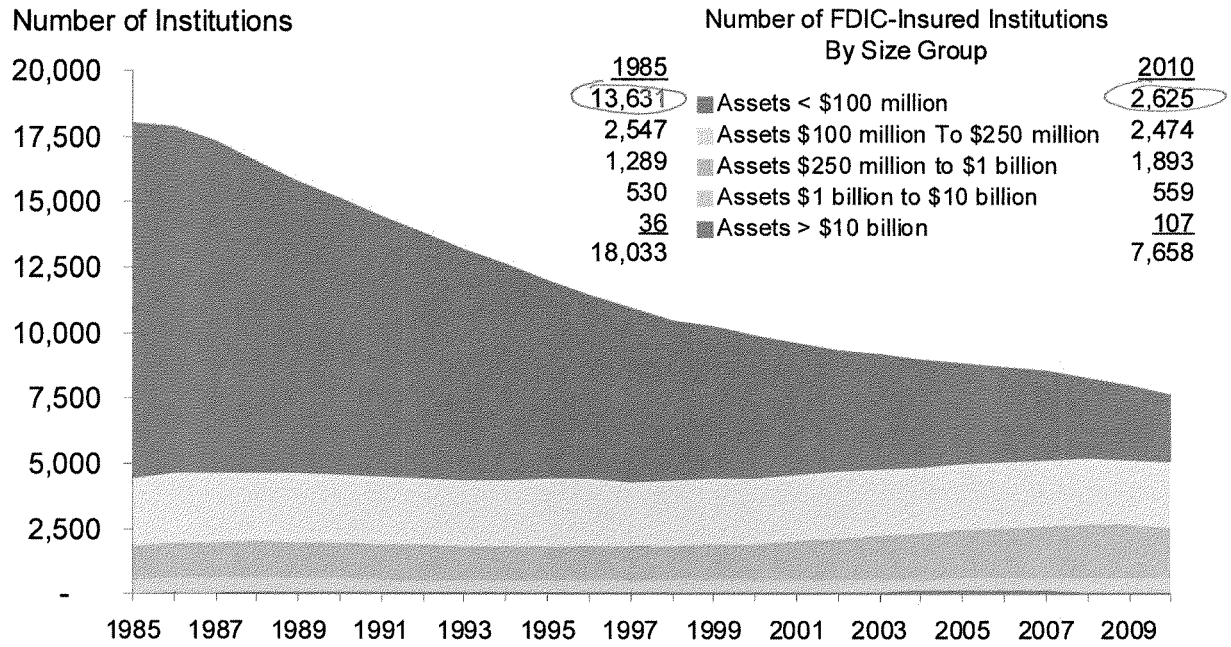
One account per household. Generally, Bank will limit this discretionary courtesy to only one account per household.

Repayment of overdrafts. The total of the courtesy overdraft (negative) balance, including any and all bank fees and charges, including all non-sufficient funds/overdraft fees and OD interest charges is due and payable upon demand, and Depositor and each Authorized Signatory will continue to be liable, jointly and severally, for all such amounts, as described in the Deposit Account Agreement.

Closing of account. If your account is not returned to a positive balance within 45 days of the date it first become overdrawn, your account will be closed.

Fees. The Bank will charge an overdraft fee of $29.00 for each item that is paid as an overdraft. Multiple overdraft fee charges up to 6 may be incurred on the same day. You will not be charged an overdraft fee if your ending account balance is overdrawn by $3.00 or less. Fees are subject to change. You will receive advance notice of any fee increase in accordance with state and federal law. In addition, overdraft amounts will accrue an OD interest charge at the rate of 18% per annum. OD interest accrues from the date of the overdraft until the date of receipt by Bank of repayment of such overdraft. The amount of your overdraft courtesy will be reduced by the imposition of the fee(s).

All of the net decline in FDIC-insured institutions since 1985 has come from banks under $100 million.



Source: FDIC