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THE STATE OF COMMUNITY BANKING: OPPORTUNITIES AND CHALLENGES

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE CURRENT ECONOMIC AND REGULATORY ENVIRONMENT FACING COMMUNITY BANKS

APRIL 6, 2011

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THE STATE OF COMMUNITY BANKING: OPPORTUNITIES AND CHALLENGES

WEDNESDAY, APRIL 6, 2011

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 3 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Subcommittee on Financial Institutions and Consumer Protection will come to order.

This is our first hearing under my chairmanship of the Subcommittee. I look forward to working with Ranking Member Corker, whom I have enjoyed working with. We came to the Senate at the same time, got on the Banking Committee at the same time, and he has been a valuable Member on all kinds of bipartisan efforts in a Committee that has had over the years pretty good bipartisan cooperation. I appreciate Senator Tester being here, who also joined us at the same time.

This hearing will be a bit truncated in this sense, that at 4, we have seven votes and we are going to have to adjourn then, so we probably will not ask the Government witnesses our questions. It probably will not be as extensive for them orally, but some of us, I assume, will have written questions for them. So we will begin the hearing.

This hearing is important for a lot of reasons today. It is an especially timely hearing since April is Community Banking Month. A lot has changed in the banking industry in the last 2 years, putting it mildly, including new consumer protections, including credit card reforms and a Consumer Financial Protection Bureau, enhanced regulatory scrutiny and supervision, challenges relating to capital reserves and funding sources, and, of course, new proposed reforms for the interchange fee structure, something we have all heard a lot about, mostly thanks to Senator Corker and Senator Tester, so thank you for that. There has been a lot of disagreement about these proposals, both among Members of the Committee and among bankers.

One thing that bankers and regulators and consumer advocates could all agree on is the importance of community banks. Community banks have what Ohio Bankers League President Mike Van

Buskirk, who has joined us today, has called high-touch responsiveness to the local area. Fed Chairman Bernanke has said that community bankers live and work where they do business. Their institutions have deep roots, sometimes established over several generations. Elizabeth Warren has said that community banks work hard to be trusted long-term partners with the families they serve. Banks with close relationships with their customers are better able to safely make loans to startups or expanding small businesses.

I have done some 150 roundtables around Ohio in virtually every community in the State, and often, a community banker is part of these roundtables of 15 to 20 people, and their involvement and reach into the community is always exceptional. Banks with close relationships with their customers are better able, as we all know, to safely make loans to startups or expanding small businesses. Mr. Van Buskirk, as he pointed out, while Wall Street banks' computer algorithm might tell a banker to reject a loan, a local banker's personal expertise might tell the same banker to approve that loan.

Community banks do not trade in complex and opaque financial products. They do not speculate in markets that have been created to simply turn money into more money. Yet despite the importance of our Nation's community banks, because of a slumping housing market and declining economy, we lost 157 community banks last year, the most since 1992, when our economy was in a recession following the savings and loan crisis. In my State, community bankers have weathered the financial storm better than most. We lost only two, but two, nonetheless, community banks in Ohio in 2010.

So we are here today to discuss what we need to do for community banks so they can invest more in small businesses and consumers.

As Cam Fine, the President of the Independent Community Bankers, has acknowledged, Dodd-Frank does create an important precedent that recognizes two distinct sectors within the financial services spectrum, Main Street community banks and Wall Street megabanks. Dodd-Frank was crafted to address those institutions that are too big and interconnected to fail. The Volcker Rule provision bans federally insured banks from trading for their own profit. The new Financial Stability Oversight Council will oversee large banks and systematically important financial companies. Enhanced capital requirements will apply to financial companies that are systematically important, and there will be greater oversight in transparency of the derivatives market.

Recognizing the importance of our community institutions, there are a number of targeted benefits for community banks in Dodd-Frank. Those under $10 billion of assets will not be examined by the Consumer Financial Protection Bureau. They have been exempted from parts of Sarbanes-Oxley. Certain small banks are exempt from new regulatory capital and leverage rules.

Despite these efforts to help community banks maintain their competitiveness, challenges remain. One of the greatest threats to community banking is unfair competition and industry consolidation, with banking now more concentrated, excessively more concentrated than it was before the crisis. In 2006, the top ten banks

made up 68 percent of total assets. At the end of 2010, they held 77 percent of total banking assets, and there still may be more consolidation ahead. A recent survey of corporate merger and acquisitions advisors ranked financial services in a tie for second among industries most likely for consolidation.

Megabanks have greater options for raising capital in the debt and equity markets and they enjoy a lower cost of funds. In the fourth quarter of last year, a $100 billion bank enjoyed an 81 basis point advantage over its $10 billion competitor. The ICBA has argued for imposing severe restrictions on any further growth and consolidation within the industry. I agree that we need to working to ensure that banks are more regional and more responsive to local communities.

Community banking is especially very important in the Midwest. Our community banks are our small business lenders. They must play a central role in strengthening the business community in America's recovery. Congress and community banks are both here to support the job creator who just needs a little help from the corner bank to turn his dream or her dream into a profitable venture. We should work together to achieve that goal.

Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Mr. Chairman, thank you. I know we have this panel and another one where folks have traveled from around the country, so I thank you for having this hearing.

I think all of us have seen historically, when there is massive regulation, the big get bigger and the smaller institutions with lesser staff to deal with these regulations end up bearing the brunt of that. So I thank you for having this hearing and I am not going to say anything else. I would rather hear our witnesses and move on, especially to the second panel. I know many of you all are here in Washington and we have great access to you, but we thank you all for being here and look forward to your testimony.

Chairman BROWN. Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Yes, thank you, Mr. Chairman.

I just want to say, as we come out of the worst economic mess since the 1930s and what was a potential total financial meltdown, I think the regulatory environment as it applies to community banks is critically important. We are hearing—I am hearing issues that revolve around consistency and predictability as it applies to our regulators that regulate our community banks and it is very concerning to me because there has to be predictability in the regulation as it goes forward. Otherwise, the community banks are continually bounced around on that. Why is this important? Because community banks loan to small businesses. Small businesses create the majority of jobs in this country.

And so I want to thank all the panelists for being here today and look forward to your testimony and the questions we will have for you, and maybe your questions for us, too, as we go on with this hearing. So thank you very much.

Chairman BROWN. Senator Vitter, you wanted to introduce Mr. Ducrest, I understand.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Yes, thank you, Mr. Chairman.

I just wanted to make two quick points. First of all, I want to welcome and introduce one of our panelists, John Ducrest. He is a Louisiana native of Broussard, Louisiana, and is our Commissioner of the Office of Financial Institutions, and he has served in that very important post, which is basically the top bank regulator in the State, since June 8, 2004. He has a solid record and list of experience leading up to that job. He basically had been in that very important office for nearly 26 years, filling multiple roles in that office in the State, and particularly distinguished himself during Hurricane Katrina for his tireless leadership in working with other State officials and the Federal Government to ensure a smoothly functioning system. So, John, thank you for your work. Thank you for your upcoming testimony.

I also just want to express disappointment that we do not have as a witness at this hearing anyone from CFPB, Elizabeth Warren, or anyone else. I think, clearly, that new super-bureaucracy is going to have a huge impact, and in my view is going to be a huge threat to the continued viability of community banks.

The Chairman correctly noticed the exemption in terms of outright monitoring of community banks, but still CFPB will have enormous power over products that community banks have to deal with and compete with, and so it is going to be an enormous influence on the new environment that community banks have to try to survive in, and I am very, very concerned about that new threat to community banks created by Dodd-Frank.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Vitter.

The agency/bureau is still an inchoate organization in some sense and they do not have enforcement authority, is the reason they are not here today. But we will certainly have hearings where they will be included and you will be brought in on those discussions.

Senator Hagan.

STATEMENT OF SENATOR KAY HAGAN

Senator HAGAN. Thank you, Mr. Chairman, and as a new Member of the Subcommittee, I am very pleased to be on it.

I do think that community banks are crucial to the success of this economic recovery. I know that in North Carolina, we have community banks and independent banks all over our State and they are definitely in contact with me on many occasions, talking about the impact of this recession and how the regulatory aspects and, in many cases, the inability to make loans that they have in the past has been an impact to them. But the community banks play a significant role in my State and other States around the Nation and we know how important you are. Thank you.

Chairman BROWN. Thank you, Senator Hagan.

Let me just introduce the four witnesses. Maryann Hunter is Deputy Director of the Division of Banking Supervision and Regu-

lation, Board of Governors of the Federal Reserve. Welcome, Ms. Hunter.

Sandra Thompson is Director of the Division of Risk Management Supervision at the FDIC. Welcome, Ms. Thompson. Thank you for joining us.

Jennifer Kelly is Senior Deputy Comptroller for Midsize and Community Bank Supervision, Office of the Comptroller of the Currency. Thank you for joining us, Ms. Kelly.

And Mr. Ducrest, who was introduced by Senator Vitter, is Louisiana Commissioner of Financial Institutions and Chairman of the Conference of State Bank Supervisors.

Begin your comments, if you would, Ms. Hunter.

STATEMENT OF MARYANN F. HUNTER, DEPUTY DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. HUNTER. Thank you. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to testify today on the challenges and opportunities facing community banks. The vast majority of the roughly 830 banks and 4,700 of the bank holding companies under Federal Reserve supervision are community institutions and we understand their importance to the broader economy.

I began my career as an examiner in the Kansas City District of the Federal Reserve and have seen firsthand the important connection between community banks and their communities. The economic downturn has had a significant impact on community banks, and unfortunately, many continue to struggle. Significant improvement in financial condition will likely take considerable time, as well as continued improvement in real estate markets for many smaller institutions. There are some positive signs, however, as nonperforming assets continue to fall and many healthy community banks have continued to lend to creditworthy borrowers.

The Federal Reserve has recently undertaken two initiatives to formalize and expand our ability to understand the perspectives of community banks and the challenges they face. The Board recently established a special supervision subcommittee of Board members to provide a special focus on community bank issues. And it also has formed a Community Depository Institutions Advisory Council, or CDIAC, as we call it, with representatives from councils in all 12 districts. The CDIAC and related councils provide the Board and system with direct insight and information from community bankers about the economy, lending conditions, supervisory matters, and other concerns.

Through our contacts with community bankers, we consistently hear that the changing regulatory environment, including the Dodd-Frank Act, present challenges and concerns for community banks. Recent reforms are directed principally at the largest and most complex U.S. financial firms and explicitly exempt small banks from the most stringent requirements. However, community bankers remain concerned that the expectations being set for the largest institutions will ultimately be imposed in a burdensome manner on smaller institutions and that compliance costs may fall disproportionately on smaller banks that lack economies of scale,

which then could lead to further consolidation in the banking sector.

As we at the Federal Reserve develop rules and policies to implement new statutory requirements, we will use the feedback from the CDIAC, public comments on proposed rules, and information from ongoing interactions with community banks and our State Bank Commissioners to address specific issues of concern to them.

In closing, I would like to emphasize that the Federal Reserve will continue to listen to the concerns of community banks and carefully weigh the impact of regulatory and policy changes on them while at the same time we work with them to address these future challenges.

I thank you for inviting me to appear before you today on this important subject and I would be pleased to answer any questions that you may have.

Chairman BROWN. Thank you, Ms. Hunter.

Ms. Thompson.

STATEMENT OF SANDRA L. THOMPSON, DIRECTOR OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. THOMPSON. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, I appreciate the opportunity to testify on behalf of the FDIC regarding the state of community banking.

Community banks provide vital services around the country. These banks make loans to customers they know in markets they know. They play a critical role in providing credit to local businesses. In fact, during the recent crisis, community banks continued to lend, whereas lending declined in larger institutions.

As the supervisor of approximately 4,400 community banks, the FDIC has a keen appreciation for the important role these banks play in the national economy. Our bank examiners work out of duty stations in 85 locations around the country. They know the banks in their areas and are familiar with local economic conditions. Many of our examiners have seen banks work their way out of more than one economic downcycle. Therefore, they understand firsthand the critical role that community banks play in credit availability.

We experienced a high number of bank failures in 2009 and 2010, and a number of community banks still face headwinds in the form of legacy loan problems in their real estate portfolios. But we believe that last year marked the peak for bank failures and 2010 shows signs of a turnaround starting for community banks. Earnings at many community banks improved last year, in direct contrast to the widespread net losses that were reported in 2009. Asset quality deterioration appears to have leveled off, but volumes of troubled assets and charge-offs remained high. Community banks continue to have high concentrations of commercial real estate loans, a market segment that remains weak in many areas of the country. Bankers are continuing to work through these problems.

Through the economic downturn, the FDIC has advocated for policies that help community banks. We have been a part of all

interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers.

One of the concerns that community banks frequently raise is the implementation of the Dodd-Frank Act and how it will affect their operations. We understand this. I would point out that much of the Act does not affect the operations of community banks and certain of the law's changes provide real benefits for them.

For example, the deposit insurance coverage limit was permanently increased to $250,000. All balances in non- interest-bearing transaction accounts above $250,000 will be insured until the end of 2012. In addition, premium assessments were shifted so that more of the costs will be borne by large institutions. As a result, community banks will see their assessments decline by 30 percent. These changes should help community banks by giving them access to federally insured funding in larger amounts. Further, many provisions of the Dodd-Frank Act should restore market discipline by ending too-big-to-fail and ensuring appropriate regulatory oversight of the largest financial companies and nonbank competitors.

Nevertheless, we understand that community banks are wary about new regulatory requirements and regulatory burden and we are taking steps to address their concerns. As described in my written statement, the FDIC has undertaken several initiatives to eliminate unnecessary regulatory burden on community banks.

In summary, we believe that community banks are an essential part of the financial system. We are committed to a regulatory structure that will support a vibrant, competitive community banking sector and a level playing field between large and small banks.

Thank you for the opportunity to testify and I will be happy to answer questions.

Chairman BROWN. Thank you, Ms. Thompson.

Ms. Kelly.

STATEMENT OF JENNIFER KELLY, SENIOR DEPUTY COMPTROLLER FOR MIDSIZE AND COMMUNITY BANK SUPERVISION, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. KELLY. Thank you. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for this opportunity to talk about the condition of community banking in the United States and the potential impact of the Dodd-Frank Act on those banks.

As the Senior Deputy Comptroller for Midsize and Community Bank Supervision, I am the senior OCC official responsible for the supervision of nationally chartered community banks. The OCC supervises 1,200 banks with less than $1 billion in assets. The majority of our resources, including 75 percent of our examination staff, are devoted to community bank supervision.

In July, when the supervision of Federal Savings Associations is transferred to the OCC, over 650 more institutions will come under OCC supervision. Almost all of those are community institutions.

Community banks play a crucial role in providing consumers and small businesses in communities across the Nation with essential financial services and credit that is critical to economic growth and job creation. While the recent economic cycle has been difficult and extremely challenging for institutions of all sizes, I am pleased to

report that conditions are beginning to stabilize for community banks and we are seeing these institutions return to profitability.

And despite the financial crisis and the deep recession, three-quarters of the community banks we supervise have satisfactory supervisory ratings, reflecting their sound management and strong financial condition. These banks have successfully weathered the recent economic turmoil by focusing on strong underwriting practices, prudent limits on loan concentrations, and stable funding bases.

However, the operating environment for community banks remains challenging. Lending activity, which is the primary revenue source for community banks, has been hampered by the overall economic downturn and net interest margins are at historic lows. At the same time, community bank financial performance continues to be pressured by the elevated levels of problem loans, particularly in the area of commercial real estate.

Against this backdrop, it is easy to understand why community banks are apprehensive about how the Dodd-Frank Act will affect their business. Although much of the Act was intended to apply exclusively to large banks, smaller institutions will feel the impact in a number of ways. As discussed at greater length in my written statement, they will be subject to new regulations that impose additional restrictions and compliance costs as well as limits on revenues for certain products.

We at the OCC are mindful of the economic challenges and regulatory burdens facing community banks, and we recognize that a new law as comprehensive and complex as the Dodd-Frank Act may magnify these challenges. Our goal is to implement the Dodd-Frank Act in a balanced way that accomplishes the law's intent without unduly hampering the ability of community banks to support their local economies and provide the services their customers need. It will be extremely important that we hear from community banks during the comment process of our rulemaking efforts to help determine whether we achieve this goal and whether additional changes or alternatives could be considered to lessen the burden on community banks. I can assure you, we will be listening.

Again, I appreciate the opportunity to appear before the Subcommittee today and look forward to your questions.

Chairman BROWN. Thank you, Ms. Kelly.

Mr. Ducrest.

STATEMENT OF JOHN P. DUCREST, COMMISSIONER, LOUISIANA OFFICE OF FINANCIAL INSTITUTIONS, AND CHAIRMAN, CONFERENCE OF STATE BANK SUPERVISORS

Mr. DUCREST. Thank you, Mr. Chairman. Thank you, Senator Vitter, for the kind introduction. I think I probably could skip my whole opening remarks just echoing your comments and Senator Corker's comments in your opening statement, but I think my staff's heart would skip a beat if I did that, so I will follow my prepared statement.

Good afternoon, Chairman Brown, Ranking Member Corker, and distinguished Members of the Committee. My name is John Ducrest. I am Commission of Financial Institutions for the State of Louisiana and currently serve as our Chairman of CSBS. Our

members regulate approximately 5,600 of the Nation's banks, the vast majority of which are community banks. Thank you for holding the hearing today on the area that is a passion for me and all the commissioners around the country.

As Senator Vitter said, I started my career about 26 years ago as a field examiner. I saw firsthand the impact that locally owned small banks have on small-town America. I also saw, following the many bank closures we had in Louisiana in the 1980s and 1990s, the changes that happened when locally owned, locally run banks become branches of large institutions, when lending decisions, particularly those involving small businesses, once made locally started being made by out-of-town institutions or out-of-State institutions.

Community banks are uniquely qualified to be small business lending experts. The lack of consistent financial data can make it difficult to quantify or standardize loan decisions. Community banks engage in relationship banking involving the use of local knowledge which is not always readily available or quantifiable. It makes a difference to a small town that these loans, in addition to the loans that are easier to make, get made. The impact of local institutions can be particularly powerful during times of crisis.

Louisiana experienced firsthand the role of community banks, that they play in providing economic stability during times of crisis. I witnessed firsthand the need for and the benefits of local ownership in the aftermath of Hurricanes Katrina and Rita. In the days immediately following the storms, I saw the passion that the community bank leadership had to assist their customers and employees in coping with and adapting to the new realities. These bankers quickly understood the displacement of their customers, the customers' need to access funds, and for people to just see their bankers, the peace of mind that comes with seeing a familiar face in a crisis. We approved emergency requests to open branches in areas where the populations had been relocated so that customers could go to their bank. Equally important was the reopening of branches in the impacted areas. Opening at these locations was critical. Citizens were coming home, checking on their property, and operating in a cash society. It is important to realize, as did our community banks, that following any type of disaster like this, that you are operating in a cash society.

Over the past several months, we have heard very loudly the concerns of the community bankers regarding their future. The level of concern and anxiety that I see today is equal to if not greater than what I saw in the 1980s when we were closing banks in Louisiana every Friday. These concerns relate to the feared effect of Dodd-Frank and other regulatory actions. The unknown impact of the Durbin Amendment on community banks is one specific example that has become a lightning rod for concerns by regulators and industry alike. All of this comes at a time when community banks continue to see earnings struggle, face challenges raising capital, and all the while looking to an uncertain future as the structure and future of larger institutions in the economy is evolving.

The viability of the community bank model has systemic consequences which, if left unaddressed, threaten local economies and

erode critical underpinnings of the broader economy. A diverse financial system characterized by strong community banks ensures local economic development and job creation, provides necessary capital for small businesses, and provides stability and continued access to credit during times of crisis.

It is critical that policy makers in Washington fully understand the impact their policies and rules have on smaller banks in the communities they serve. Put simply, how community banks are impacted by Dodd-Frank and other regulatory measures is too important not to understand.

To that end, I offer the following suggestions. First, there must be continued coordination and consultation between the Federal and State regulators.

Second, more analysis is needed to fully understand and appreciate the valuable relationship between community banks and small businesses. The lack of data analysis in this area has made it difficult to understand the true importance of a viable and competitive community banking system. The Fed's recent formation of the committee that Maryann referred to and the FDIC's efforts by Sheila Bair are a step in the right direction.

Finally, Congress and the regulators should investigate ways to tailor regulatory requirements to institutions based upon their size, complexity, geographical location, management structure, and lines of business. The current one-size-fits-all approach to regulation both in terms of safety and soundness in compliance and supervision has fallen harder on community banks.

Thank you again for inviting me to testify. I look forward to your questions.

Chairman BROWN. Thank you, Mr. Ducrest.

I have one question only. I would encourage—well, certainly any Senator can take up to 5 minutes because we have seven votes at 4 and we want to get to the three community bankers. I urge my colleagues to do what they can to help us reach that.

My question is for Ms. Thompson, if you could, and I think we will have questions submitted in writing to probably all of you. Dodd-Frank recognizes—to Mr. Ducrest's comment about one-size-fits-all, the Dodd-Frank recognizes that megabanks should be regulated in a different way from community banks. One key provision requires enhanced standards for capital and leverage for the largest banks and financial companies.

Ms. Thompson, what is FDIC's view of requiring the largest banks to hold more capital, and what benefits will that have or should that have for community banks, in your view?

Ms. THOMPSON. We believe that required the larger institutions to have more capital certainly would be commensurate with the activities that they undertake. Capital should be commensurate with the risk. And to the extent that the Dodd-Frank Act, specifically the Collins amendment, requires that larger institutions at the holding company level hold as much capital as is required at the insured depository institution. We think that is important for consistency, that the holding company and the insured depository institutions hold capital that is based on the riskiness of the activities that those institutions undertake.

Chairman BROWN. Thank you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I have one question also.

I think all of us are concerned about regulations creating unnecessary consolidation, and there are a lot of things we could talk about, but I will be very specific because of the time.

Ms. Hunter, the Chairman of the Fed, Ms. Thompson, the Chairman of the FDIC, Ms. Kelly, the Acting Comptroller, and even Mr. Ducrest in his comments—all have expressed strong concerns about the Durbin amendment. And, you know, typically we here try to rail against regulatory overreach. In this case, the regulators are even concerned about what they have been tasked to do. Certainly the Fed has expressed concerns about the criteria, the FDIC and the OCC strong concerns about what it is going to do to the community banks. And I am glad Mr. Ducrest mentioned that.

Could you be specific here? Because we have numbers of people that, you know, I think wish they had not voted for it. I did not. But could you explain what your concerns are as it relates to community banks and the Durbin amendment?

Ms. HUNTER. The issues around this are very complex, and as you pointed out, we at the Federal Reserve have been studying a wide range of issues. I will tell you this is not my area of expertise in terms of the rule that has been drafted related to this, but there are a range of issues that need to be understood. We have a proposal that is out for comment. We have received 11,000 comments, many of which have substantive concerns in them, and the intent is to fully consider those comments.

The Chairman has recently sent a letter outlining some of the concerns underlying the interchange fee issue, and it is our intent to consider those. He has already been notified that we will need more time to fully consider those concerns and consider the impacts on community banks.

Senator CORKER. It is one of the first times the Fed has missed a deadline, and it is because it is so complex, but go ahead.

Ms. THOMPSON. Yes, our Chairman, Sheila Bair, sent a letter to Chairman Bernanke outlining some of the concerns that the FDIC has about the interchange fee.

First, we want to make sure that the small issuers—there are large issuers and small issuers, and we want to make sure that the small issuer exemption is protected, and we are advocating a two-tier system so that small issuers can take advantage of not having to adhere to the fee cap that will be imposed or that has been recommended.

We also have asked that there be more data on smaller issuers. I think there was a data survey that was done for some of the larger issuers, but I am not sure what data exists for some of the smaller issuers of these cards.

And we also asked for some consideration on the fraud adjustment. When you have a debit card and it is signature based, there is a lot more fraud that is contained—that takes place with the signature-based cards as opposed to the PIN-based cards. And we think that there ought to be provisions made for the fraud adjustment.

Also, the network exclusivity option—right now most banks operate with at least two networks, and one of the alternatives was four networks. And if you have the four, then almost every single debit card would have to be reissued, and that would really increase the costs for many of the banks, which would be very burdensome for the smaller institutions.

But we would be happy to submit the letter that Chairman Bair sent for the record.

Senator CORKER. Thank you.

Ms. KELLY. Speaking on behalf of the Comptroller of the Currency, we also submitted a fairly detailed comment letter to the Federal Reserve. It is a very complex issue, and in the interest of time, I will not go through all the details, but, again, as Sandra said, we would offer our letter as an outline of what we see as some of the complicated issues that we are standing ready to work with the Federal Reserve to try to work through this.

Mr. DUCREST. Senator Corker, the same thing. Sandra's comments are exactly what—you know, we sent a letter also to the Fed commenting on the State Commissioners' perspectives.

Senator CORKER. Mr. Chairman, I will stop. I would just say the two sponsors of the bill oppose the Durbin amendment. All the regulators have concerns. Community banks have concerns. And it seems to me that at a minimum to at least look at this for a period of time—it is very complex; it is going to be very damaging to community banks—would be a reasonable approach, even for people who may have supported the legislation, because of all the concerns that all the regulators themselves, which is very rare, are bringing forth to us. And I thank you so much for having the hearing so we could talk about that.

Chairman BROWN. Thank you.

Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman, and I want to thank Senator Corker for his questions. I am not going to repeat them. I think they are spot on. It is too bad everybody in the Senate cannot hear the concerns that you put forth, because your bosses put forth the same concerns.

To get to the point that I want to talk about, I want to talk about regulation. The smaller institutions, as the gentleman from Louisiana pointed out, are fundamentally different than larger banks and should be regulated and should have regulation applied to them in a way that is consistent and appropriate with that size and risk. And I am very concerned that many of the regulations included in the Dodd-Frank bill, particularly those intended to create a level playing field for community banks, will not be effective until and unless we have more clarity and consistency with respect to how those regulations are enforced.

I am going to try to take as little time as possible, so if you guys would be very concise with your answers, that would be very good.

Mr. Ducrest, you talked about one size fits all from a regulatory standpoint. Is that what you see is happening in Louisiana from the Fed and FDIC standpoint, that there is not a differentiation being made?

Mr. DUCREST. Well, it is a combination of the safety and soundness part of the exam and also the compliance part. We are all for

a sound compliance approach, but, you know, some compliance exams take as long as safety and soundness exams.

Senator TESTER. OK. And when the regulations are applied, are they different for bigger banks than littler banks, or are they the same?

Mr. DUCREST. The same.

Senator TESTER. OK. Ms. Hunter and Ms. Thompson, is that the intent? Is the intent to regulate very small institutions, community banks per se, and large institutions the same way? Or is there a difference based on size and risk when you apply registration?

Ms. THOMPSON. There is a difference based on size and risk. We apply the rules based on the riskiness of the institution and in particular their activities.

One thing of concern is we want to make sure that when we implement the Dodd-Frank Act—that when we issue guidance to the industry describing what the new rules are, there is a description of how these rules will impact community banks because, again, many of the new rules do not apply to community banks.

Senator TESTER. How do you ensure that those regulations are in effect different based on size and risk when the regulators hit the ground?

Ms. THOMPSON. We have examination procedures that we give our examiners, and we work together, all regulators, including CSBS. We meet once a month on the FFIEC and Task Force on Supervision, and we talk about different policies and examination procedures.

Senator TESTER. OK. Is there any sort of transparency so that the banks know that there is some difference? That is OK. I mean, Ms. Hunter is——

Ms. HUNTER. I would echo those comments, and add that it is really in the application of the procedures. If the bank is not a complex institution and there are not a lot of activities, then a lot of the procedures do not apply, and examiners do calibrate in those situations. I guess the transparency might be in published manuals, but you really could not detect it from that.

Senator TESTER. And I have talked to Ben Bernanke about this, too, and you are here, you are a little closer to the ground—at least I hope you are—than he is. And the real question is: How do you know the regulators are doing what you think they are doing on the ground? How do you make that assessment? Do you have people—I mean, how do you make the assessment?

Ms. HUNTER. That is an excellent question and one we wrestle with often. I will tell you how we go about it.

First of all, we have a lot of communications with the offices where the field work is actually conducted. They are responsible for making sure that the examiners are following the guidelines, using balanced judgments and calibrating their judgment about what to do with the risk that is there.

That said, we have a lot of training. We have national phone calls that give guidance to examiners where they all dial in to hear from the person who crafted a given rule and learn what the rule intended to accomplish. And we spend a lot of time communicating with the field about guidelines and rules.

The committees that I referenced in my oral and written statements, provide us input; and we follow up immediately. So when we hear that there is an issue where examiners might be doing one thing or another, we will go back out to the field and ask—Is this happening? It is really an ongoing dialog.

Senator TESTER. And I understand that, you know, especially what we have come through, it is kind of not on my watch is this kind of stuff going to happen. But I can tell you that unequivocally across the board, every time I meet with the community bankers, they talk about the inconsistency in application of regulation. And I believe them. And so the question is: How can we make this process more transparent so that we can ensure that, in fact, those regulations are applied in an evenhanded and fair way? Any ideas?

Ms. HUNTER. Yes, well, one of the things we have been doing is working closely with the CSBS because I think the State Commissioners are a great source of information if they are seeing inconsistency and we are hearing from bankers there is inconsistency, we do follow up.

Trying to get consistency across 50 States and all those jurisdictions is a constant effort. But it is one that we are committed to doing.

Senator TESTER. I do not want to have the members of the panel get in a scrap, but I just asked Mr. Ducrest if there was a difference in the way big banks and small banks were being regulated—at least that is what I thought the question was—and he said not really. So the question becomes—and I point this out because it is a problem, and you guys do not need to wear it. Everybody needs to wear it. And I think there is more work that needs to be done to make sure that the regulation fits the risk, and I do not see community banks as causing the financial crisis that almost took us under. But by the same token, I see them supporting small businesses that create jobs, and I think everybody up here has already said that, and you have said it, too. And so there needs to be—and it is not easy, but there needs to be some regulatory consistency.

Chairman BROWN. Senator Moran.

Senator MORAN. Mr. Chairman, thank you. I am sorry we have structured the afternoon in the way that we have so little time. I appreciate the topic of the hearing and believe it to be a very important one.

I have had the opportunity here in the Banking Committee and on the Appropriations Committee, including the Financial Services Subcommittee, to talk to Chairman Bernanke and Chairman Bair and Secretary Geithner, and there seems to be a theme among regulators, which is: We take into account, we understand the importance of community banks. We work hard to create an environment in which they succeed. And yet every time I talk to a community banker, there is no evidence that that is the case. And so I can never figure out what the disconnect is when the regulators tell me we account for a community bank and the community bankers have no sense of that being the case.

Yesterday, I think, if I understood Secretary Geithner, he suggested that it is not the new regulations. It is the examiners who are applying different standards. And it goes to perhaps what Sen-

ator Tester was talking about, and one of the answers that someone gave was—I think it was you, Ms. Hunter—that we try to have uniformity from State line to State line across the borders. But it is the lack of uniformity from one examination to the next. No banker can make an intelligent decision today about whether or not to loan to whom he or she believes is a creditworthy customer because they were fine in the last exam but now there is a different standard; and yet we are told there are no additional regulations.

I understand the value of our time here this afternoon. I guess my only question would be: Can you tell me the regulations that are placed upon community banks are no more or less onerous today than they were 2 years ago, 3 years ago? When you tell me that you account for community banks, can you back that up by saying no community banker that is operating a solid, sound institution would have any more trouble today complying with regulations today than they did—pick a number—last year, the year before, 2 years before, 3 years before? And I just cannot believe that is true based upon the conversations I have with bankers. And the example I always use is I have had five or six bankers tell me they no longer—hometown bankers no longer make a real estate loan, a mortgage on a house in their hometown, because of the burden of the regulations. Now we have to fingerprint the officer who takes the application, and they are just worried that if they make that loan and they make a mistake, the regulators are going to find it to be a loan that is written up and it is going to call for more capital.

So my question is: Is it true, based upon what you are telling me about how you account for community banks, that they are no more regulated or there is no higher standard of regulations or regulatory burden today than there was just in the past?

Ms. HUNTER. There are more regulations, and it is more complex, so they are not imagining that. When we are talking about taking those factors into account, it is really through looking at what the examiners do and what they do with the information that they find.

So, for example, banks have a hard time sometimes figuring out how to apply a new requirement in their operation. Well, if an examiner sees a new activity and maybe finds that some mistakes have been made, they should be helping work with the bank to point out where it can strengthen its risk management.

One of the things we are seeing with bankers who are struggling more and more in recent years, is that it is partly a reflection of the fact that the economic environment is so much more difficult. And so matters—that were not issues a few years ago now really are because the risk profile has changed. That is much of what examiners do, they look to see what the risk is in the context of the environment that they are working with.

So from that standpoint, I can see why you are hearing those comments because there are more regulations and it is a much tougher environment right now, and examiners are pointing out risks and highlighting things that need to be addressed in order to strengthen risk management.

Senator MORAN. I would only conclude my comments by saying that it seems to me that—I can see it by the number of mergers,

the cost of being in business for a community bank has increased dramatically, and you have to have a larger asset base, customer base to spread those costs among. And it would be one thing to me if a bank closed or went out of business because of market forces or because of bad lending practices. But to lose so many community bankers because of the increasing cost of being in the banking business is a mistake for the communities that they serve.

One of our regional bankers told me in January that for the first time in their bank's history, community bankers are calling to see, "Would you acquire our bank?" Always in the past it was they were out looking for a bank to acquire. But our community bankers are facing this financial burden of trying to stay in business.

One of my bankers tells me that the regulator said, "Well, just hire a couple more people to meet these new guidelines." It is, like, I only have eight employees now; to have ten is a question of whether or not my bank is in business or not. And so I would love to see something different than what I see. I see the demise of community banking in rural America.

Mr. DUCREST. Could I just add one quick point?

Chairman BROWN. Very briefly.

Mr. DUCREST. To clarify my answer to Senator Tester and tying it to that, mine was more a comment regarding the compliance with the regulations and laws of one size fits all. I agree with what Sandra and Maryann said about the way we customize regulation to the risk profile, but it is exactly what you are saying. What I was trying to answer Senator Tester is about the burden of a very small bank trying to do compliance on a rule that applies to the largest banks.

Chairman BROWN. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman.

My questions and concerns echo what you have been hearing. We all come from States, many of us, with large urban centers, but obviously small rural centers, too, and our community banks play a huge role in both of those areas. But in particular, I mean, I hear over and over and over again that the community banks have an incredible regulatory burden, and they are very concerned about the examinations and the different aspects of the bank examiners.

One issue that I think you mentioned, Ms. Hunter, is about the balanced judgment, and, you know, we talk about a balanced approach from an examination standpoint. And what we are concerned about is how this impacts small business lending to smaller companies. I think, Ms. Kelly, you mentioned the fact that so many of these institutions have so much commercial real estate lending that is in their portfolios, and we know that we have come through a severe economic recession, and a lot of the valuations have gone down. But in many cases—not in all but in many cases you have still got, you know, high occupancies and still cash-flow coming in, but the valuation of the asset has gone down.

So many of these small businesses cannot get further extensions on some of their lines, and this is such a burden to many of these smaller communities. I mean, it is really affecting the whole economy in those areas.

How do you monitor banks to ensure the appropriate extensions of new credits and appropriate restructuring of existing loans

under reasonable terms? Any of you, feel free to jump in and look at that question.

Ms. THOMPSON. Sure. As you mentioned, we just came through the worst economic cycle ever, and all of the regulators worked together to issue guidance specifically to address the issue that you raised regarding restructuring. We are very adamant about ensuring that our examiners work with institutions so that the institutions can work with borrowers to restructure loans so that they can have a good loan that can be repaid.

We are very concerned about ability to repay. We issued guidance on commercial real estate loan restructuring, and we have been really watching to make sure that the examiners are following up with the banks to make sure that they are restructuring troubled debt.

Senator HAGAN. When you say you make sure and you try to monitor this, what happens if you find something that is not consistent?

Ms. THOMPSON. Well, we go in and conduct the examination, and to the extent that the banker has an issue, if they bring it to our attention, we will subject that to review either at our local field office—again, if they are not happy with the outcome, it goes to our regional office; and if they are not happy there, it goes to Washington.

I have also established a——

Senator HAGAN. If they are or they are not?

Ms. THOMPSON. Are not.

Senator HAGAN. Are not.

Ms. THOMPSON. I have also established a dedicated mailbox to allow bankers to have direct contact with me to the extent that they have issues with their examination because we are very interested in how these examinations are taking place.

Senator HAGAN. And how many times do you alter?

Ms. THOMPSON. Excuse me?

Senator HAGAN. Do you have a percentage where, if they do not like the outcome and they take it on appeal, that it actually is, in fact, changed?

Ms. THOMPSON. Sometimes it does not even get to appeal. Sometimes it is a discussion with the examiners, and they come to a good conclusion.

Senator HAGAN. Thank you.

Chairman BROWN. Thank you, Senator Hagan. Thanks to all of you, all four of you.

Let us call the next panel up. Unfortunately, it is going to be a shorter discussion than we hoped. We very much appreciate the four witnesses. Let me do the introductions as they move forward.

Bill Loving is president and CEO of Pendleton Community Bank. Mr. Loving is vice chair of the Independent Community Bankers of America and the president and CEO of Pendleton Community Bank in Franklin, West Virginia, past president of the Community Bankers of West Virginia.

Paul Reed is president of Farmers Bank and Savings Company, chief executive officer of Farmers Bank and Savings Company, a community-owned bank with five branches located in separate markets, a graduate of Ohio University, the Stonier School of

Banking, the Graduate School of Banking at Louisiana State University. He is from Pomeroy, Ohio.

Tommy Whittaker, chief executive officer, First Farmers Bancshares—what is that?

Senator CORKER. You want me to——

Chairman BROWN. Yes, I am sorry. We will let Senator Corker introduce Mr. Whittaker. I apologize.

Senator CORKER. And I will be equally brief. I will say that Tommy Whittaker is the epitome of a community banker. He has been with Farmers Bank for 35 years. He is the CEO. He is involved in every civic activity you could possibly be involved in in his hometown. And, again, if you had an encyclopedia and there was a photo of a community banker, it would be Tommy Whittaker, the kind of person that all of us want to see flourish all across this country. And so I am thrilled that he is here. He is a great friend. He is a great citizen in our State. And, Mr. Chairman, I thank you for allowing him to testify, and we welcome him here to Washington.

Chairman BROWN. At least in the Tennessee version of the encyclopedia. In the Ohio version, it might be different.

Mr. Loving, thank you for joining us.

STATEMENT OF WILLIAM A. LOVING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PENDLETON COMMUNITY BANK, FRANKLIN, WEST VIRGINIA, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. LOVING. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, my name is William A. Loving, Jr., and I am president and CEO of Pendleton Community Bank, a $250 million asset bank in Franklin, West Virginia. I am pleased to be here today to represent the nearly 5,000 members of the Independent Community Bankers of America. ICBA appreciates the opportunity to testify on this important topic as we are the only trade association dedicated solely to the community banking industry.

Community banks will play a very significant role in the economic recovery. We collectively finance the growth of small businesses where many citizens work in rural, small-town, and suburban areas. These are customers and markets not comprehensively served by large banks. Our business model is based on long-standing relationships in the communities in which we live. We make loans often passed over by the large banks because a community banker's personal knowledge of the community and the borrower gives him firsthand insight into the true credit quality of a loan. Localized credit decisions made one by one by the thousands of community bankers across the country will restore our economic strength.

When community banks thrive, they create a diverse, competitive financial services sector with real choice, including customized products to consumers and small businesses alike. One of the most harmful consequences of the financial crisis for community banks is the overreaction among bank examiners. As we have stated many times to Members of this Committee, there continues to be a disconnect between the examiners in the field and the directives from Washington.

Many of my community bank colleagues relay experiences with examiners who demand unreasonably aggressive writedowns and reclassifications of viable commercial real estate loans and other assets. The overreaching zeal of these examiners is having a chilling effect on lending and an adverse impact on the recovery. The Dodd-Frank Act, another result of the crisis, is landmark legislation and will permanently alter the landscape for financial services. The entire financial services industry, including each community bank, will feel the effects of this new law to some extent, some more than others.

The most troubling aspect of Dodd-Frank is the debit interchange amendment. The law and the Federal Reserve's proposed rule will fundamentally alter the economics of consumer banking. Despite the statutory exemption for institutions with less than $10 billion in assets, a provision many Senators thought would help community banks, we believe small financial institutions cannot be effectively carved out. Small issuers will feel the full impact of the Federal Reserve proposal over time.

To use my bank as an example, last year we had about 6,250 debit cards outstanding. If the Federal Reserve proposal goes into effect, I estimate as much as $237,000 in reduced revenue—lost income we would have to make up through higher fees or product elimination.

ICBA strongly supports S. 575, the Debit Interchange Fee Study Act of 2011, introduced by Senators Tester and Corker to delay the implementation of the rule and give the Federal Reserve 2 years to study the impact on small issuers and consumers.

Community bankers are also concerned with the new Financial Protection Bureau. While we are pleased that Dodd-Frank allows community banks with less than $10 billion in assets to continue to be examined by their primary regulators, we remain concerned about CFPB regulations. Particularly, the CFPB should not draft any rules to hamstring the ability of community banks to customize products to meet customer needs. ICBA supports amending the law to give prudential regulators a more meaningful role in CFPB rule writing.

Finally, well before the financial crisis, ICBA has long expressed concerns about too-big-to-fail banks and the moral hazard they pose. Every community banker knows how difficult it is to compete against megabanks whose too-big-to-fail status gives them unique funding advantages. For this reason, we are pleased the Dodd-Frank Act takes steps to diminish too big to fail. Powerful interest groups are lobbying doggedly to undermine the too-big-to-fail provisions of Dodd-Frank. This part of the law is essential to creating a robust and competitive financial services sector to the benefit of consumers, businesses, and the economy.

Chairman Brown and Ranking Member Corker, many thanks for convening this important hearing today. Community banks face significant challenges in the months ahead. Community banks are ready to navigate these choppy waters to better serve our communities and promote the economic recovery—a goal we share with this Committee.

Thank you for hearing our concerns. We look forward to working with you.

Chairman BROWN. Thank you, Mr. Loving.

Mr. Whittaker.

STATEMENT OF TOMMY G. WHITTAKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE FARMERS BANK, PORTLAND, TENNESSEE, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. WHITTAKER. Thank you, Senator Corker, for your introduction. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, my name is Tommy Whittaker. I am President and CEO of The Farmers Bank in Portland, Tennessee. Thank you for the opportunity to testify today. These are very important issues for the thousands of community banks that work hard every day to serve our communities.

The health of banks and the economic strength of our communities are closely interwoven. A bank's presence is a symbol of hope, a vote of confidence in a town's future. This connection is not new. Most banks have been in their communities for decades. Next year, The Farmers Bank will be celebrating a century of service to our community. In fact, two of every three banks have served their communities for more than 50 years, and one of every three has been in business for more than a century. These numbers tell a dramatic story about banks' commitment to the communities they serve.

Banks are working hard every day to make credit available in their communities, efforts that are made more difficult by the hundreds of new regulations expected from the Dodd-Frank Act and the constant second-guessing by bank examiners. Managing all the new regulation will be a challenge for a bank of any size, but for the medium-sized bank with only 37 employees, it is overwhelming. Let me give you a few examples of how Dodd-Frank will negatively impact small banks.

First, the Government has inserted itself in the day-to-day business of banking, which will mean less access to credit and banking services. The most egregious example is the price controls on interchange fees, which will devastate retail bank profitability, stifle innovation, and force some people out of the protection of the banking system. Some will say that the so-called carve out for community banks from the Fed's interchange rule will protect community banks. Nothing could be further from the truth. Having two different prices for the exact same product is not sustainable. The result for small banks is a loss of market share and a loss of revenue that supports services like free checking. ABA is grateful for the willingness of Senators Tester and Corker and the many other cosponsors of S. 575, to reconsider the harmful consequences of the Fed's interchange proposal. More time to study the impact of this provision is definitely warranted and ABA strongly supports this bill.

Second, the cumulative burden of hundreds of new regulations will lead to a massive consolidation of the banking industry. Of particular concern is the additional compliance burden expected from the Bureau of Consumer Financial Protection. This new bureaucracy will impose new obligations on community banks that have a long history of serving consumers fairly in a competitive en-

vironment. One claim is that small banks are exempt from the new Bureau, but small banks are not exempt. All banks, large and small, will be required to comply with all rules and regulations set by the Bureau. Bank regulators will enforce these rules as aggressively as the Bureau. The Bureau should focus its energies on supervision and examination of nonbank financial providers. This lack of supervision of nonbanks contributed mightily to the financial crisis. We urge Congress to ensure that this focus on nonbanks is a priority of the Bureau.

Third, some rules under Dodd-Frank will drive banks out of some business loans. For example, the mortgage risk retention rules proposed last week will shut many borrowers out of the mortgage market and will drive some community banks out of mortgage lending completely. ABA urges Congress to use its oversight authority to ensure that the rules adopted will not have adverse consequences for mortgage credit availability.

Ultimately, it is consumers that bear the consequences of Government restrictions. More time spent on Government regulations means less time devoted to our communities. The consequences for the economy are severe. These impediments raise the cost and reduce the availability of credit. Fewer loans mean fewer jobs, and fewer jobs mean slower economic growth. Since banks and communities grow together, limits on one means limits on the other.

The regulatory burden from Dodd-Frank must be addressed in order to give all banks a fighting chance to maintain long-term viability. Each bank that disappears from the community makes that community poorer. It is imperative that Congress take action to help community banks do what they do best, namely, meet the credit needs of their communities.

Thank you for the opportunity to present the views of ABA, and I would be happy to answer any questions you may have.

Chairman BROWN. Thank you, Mr. Whittaker.

Mr. Reed.

STATEMENT OF PAUL REED, PRESIDENT, THE FARMERS BANK AND SAVINGS COMPANY, POMEROY, OHIO, ON BEHALF OF THE OHIO BANKERS LEAGUE

Mr. REED. Mr. Chairman, Ranking Member Corker, Members of the Financial Institutions Subcommittee, my name is Paul Reed. I am President and CEO of The Farmers Bank in Pomeroy, Ohio, a $250 million bank located along the Ohio River, and I am testifying this afternoon on behalf of the Ohio Bankers League, an association representing most of Ohio's banks and thrifts.

I wish I had more time to tell you about the great people I work with in community banks. Community bankers are invested financially and otherwise in the areas they live. Our customers are our friends, and we gladly help them buy their first home, start small businesses, and lay the groundwork for future prosperity. We are proud of the role of trusted advisor we play in so many households.

That pride is one reason the recent turmoil and Wall Street bailouts have been so hard for us to stomach. As many of you are aware, community banks largely did not participate in the shoddy business practices that have been exposed in dramatic fashion. Our business model is different from the largest institutions, whose goal

is often the deal rather than the success of the business being financed, and we believe that taking unfair advantage of our customers to pad our bonuses makes no sense. It does not help our community prosper, and the fate of a community bank is tied to the health of its community.

Recent debate has caused me to wonder if community banking matters to Congress. For the reasons I have already mentioned and for more I could discuss in the time allotted, it should. Robert Frost famously said, a bank is a place where they loan you an umbrella in fair weather and ask for it back when it begins to rain. I do not believe Mr. Frost was talking about a community bank.

We are small business lenders who know our customers and are willing to work with them to help them to survive downturns, to grow and prosper when things improve. There was no pull-back from us in offering credit when the economy turned. We were eager to help, modifying loan terms and working in partnership with our customers to limit the damage to them and to us.

If I could speak frankly to the Committee, many, if not all, of us have been frustrated by recent actions that have relegated us to the sidelines in the credit market, unable to help our local economies grow. It is no secret that small businesses create a majority of job growth, and diminishing the contribution community banks make to small business would be a serious error.

I have concerns about Dodd-Frank and its effect on community banking. Many features of the legislation create obstacles to smaller banks. While the change in the calculation of deposit insurance was a step in the right direction and we welcome the effort to level the playing field, the FDIC has since increased its target reserve ratio by 60 percent, meaning deposit insurance premiums will be historically high for a very long time. Please consider that every dollar I pay in deposit insurance translates into roughly $10 that I cannot lend to businesses in my community.

Dodd-Frank also includes an amendment which jeopardizes trust preferred securities as a means of funding for community banks. Some failed banks invested in poorly underwritten trust preferred securities which caused losses to the FDIC. The amendment was a reaction to these losses, but I believe a better answer would have been to improve the instrument rather than remove it from our tool kit.

And while Dodd-Frank exempted community banks from price controls on debit card interchange fees, it left the choice of processor to the retailer. In practice, I fear the exemption will prove to be fiction. I would point out that interchange income is used for free checking accounts, convenient branches, and more ATMs. I estimate my interchange revenue will be roughly one-fourth of my expense. Home Depot's Chief Financial Officer recently told financial analysts the changes will translate into $35 million in windfall profits annually to her shareholders. Her comments seem to cast doubt on benefit to consumers.

I welcome Dodd-Frank's intention to end "too big to fail." It was long overdue. However, the *Wall Street Journal* reports that the funding costs of the biggest institutions are still well below that of community institutions like mine, causing me to wonder if the market believes "too-big-to-fail" is no longer true. Instead of ending "too

big to fail," the sheer mass of new regulations required by Dodd-Frank may forge an environment where many good community banks are "too small to survive."

Congress created the Consumer Financial Protection Bureau with the right goal, but a substantial percentage of financial service providers were exempted, many of whom offer direct and functional substitutes for what I offer. While my institution has an exemption from direct supervision, understand that whenever a rule changes, community banks face a huge burden. No compliance examiners visited my nonbank competitor's office in the past. The exemptions included mean there is little reason to believe they will now.

Finally, I would submit that the consumer and country might be better served by more logically dividing jurisdiction over FDIC-insured institutions. The creation of a community bank regulator with jurisdiction over both small commercials and thrifts would be helpful, as protecting the public interest in a multinational institution is a very different mission than in my bank. It would eliminate the differences inherent with multiple regulators. Today, the OTS, the OCC, the FDIC, and Fed all oversee some category of community banking. Our public and industry would be better served with a regulator that is experienced and familiar with the unique aspects of our industry.

And finally, Mr. Chairman and Ranking Member Corker, I realize that hearing testimony is a routine part of your job, but please allow me to express my gratitude for being able to speak to the Committee on such important matters. I hope you will find my comments useful as you continue your work, and I would be happy to answer any questions.

Chairman BROWN. Thank you, Mr. Reed.

The vote is about to be called, so I think Senator Corker and I will be brief and hope that Senator Toomey and Senator Moran get to questions, too.

First of all, thank you, Mr. Reed, for your service in Southeast Ohio, a particularly economically troubled part of the State for a long time, as you know, and thanks for what you do to get credit to businesses as this economy slowly begins to grow and the challenges you face.

You had said, I thought, something pretty interesting, Mr. Loving. You talked about the difficulty of competing with megabanks and then you mentioned that megabanks—your discussion of megabanks lobbying the regulators on the issue of "too big to fail." What do you most fear that the megabanks will convince the regulators to go in a certain direction? Give me two or three of your starkest fears, perhaps, about what might result from that as it affects community banks and as it affects the economy and as it affects "too big to fail," in any direction you want to go.

Mr. LOVING. We, I think—as indicated, there is a concern there, because, obviously, as the megabanks grow, that creates more competition for the community banks, and with the competitive advantage that they have from a pricing perspective already. It takes away the ability of the community bank to compete. And then as we have heard, the community bank is the lifeblood of the community itself, particularly a small rural community. And so if the op-

portunity to compete for price is not there, I would have some concerns on the ability to meet the needs of the consumer and the customer.

Along those same lines, I think in its continued growth of the marketplace. You mentioned earlier in the hearing the growth that has taken place since the financial crisis. I think we need to look at that particular area and make sure it does not continue to grow to decrease competition.

Chairman BROWN. Thank you.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and our apologies to all of you. We thank you for your testimony, much of which, I will say, will be very quotable on the Senate floor, and I thank you for doing that.

I do want to make note that we have seven witnesses, four regulators, three bankers. All have castigated the Durbin Amendment. All have asked us to look at it with more study, and I hope we will be able to cause that to happen in this body.

I will give you a quick yes–no question. Is it fact or myth that the regulators that you deal with, whoever they are, are continuing to regulate in such as manner that is keeping you from making loans to otherwise very creditworthy deals and/or clients? Yes or no?

Mr. REED. Yes.

Mr. WHITTAKER. Senator, I have not had an examination in about 18 months. We are about to have one when I get back to Portland, Tennessee, by the way. But our bank has done well and we really, in all honesty, have not had a lot of trouble with the regulators. But hopefully, that says a little bit more about my bank than anything else, but we are due to have an examination when I get back in.

Senator CORKER. Thank you.

Mr. LOVING. I would agree. Our last examination was a good examination, but what we are hearing across the country from colleagues is that there is some concern about the oversight.

Mr. REED. If I could add, we just finished—recently finished an FDIC exam. They complimented our earnings. They are not seeing similar banks with an ROA above 1 percent. But I could not get over the intense focus on what seemed to be very small issues. I was left wondering about the exam's priorities.

One examiner held a lengthy conversation with our CFO to talk about the rate of depreciation of wallpaper in a branch. The amount of money was $250. At the time the wallpaper had already fully depreciated. And we had relatively little conversation during that same exam about our largest commercial loans.

Two other examples, of whether the exam has the right focus, I do not mean to be critical of the examiners. I think they were doing what they were supposed to do. However, one examiner had a 20-minute conversation with our Chief Lending Officer on a $323 loan.

I think perhaps more relevant to your question on the impact on small business lending was a loan to a 30-year customer. Over the years they have run a great business. It has been said that tough times do not last, tough people do. These people have lasted. More recently though, they have suffered 2 years of negative financials

for earnings. However, they are current on their loan payments. Our examiners classified that customer the same way as a bankrupt customer. We had to add $150,000 to our provision by the way that the rules are set with our methodology for loan loss. That $150,000 that we had to beef up our loan reserve for what we believe to be a very solid customer translates into $1.5 million of loans to other businesses cannot now make. And more important, our loan committee and our board members will now ask the question, what will the regulators think of this loan? rather than: is this a good loan? Regulators now have dominate our decisions on what is best for our community.

Senator CORKER. Thank you so much. I appreciate your testimony.

Chairman BROWN. We have about 3 minutes, if Senator Moran can ask a question. I apologize, Senator Toomey, and——

Senator MORAN. Mr. Chairman, thank you. I would ask for them to respond to my question in writing, but I would say that it is interesting to me, Mr. Reed. That is very compelling commentary. I smile because the two bankers who are expecting examinations had a lot less to say than the banker who has already experienced the exam——

[Laughter.]

Senator MORAN. ——once again proving the prudence of a community banker.

But I just would ask you, we often hear, or I often hear from bankers about the regulators, the exams. What we need are the specifics. It is hard to fight bureaucracy, but I think we can do a better job if we have the specific rule or regulation or example which we can take to the regulators, because as you heard them express today, they are working hard to accommodate community banks. We need the examples in which we can take to them and say, this makes no sense. So if you or your associations would be interested in providing me with an example of something you would like for us to try to tackle, I am certainly willing to work with my colleagues to do that.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Moran. Senator Corker, thank you, and Senator Toomey, if you can do 30 seconds of something. I apologize.

Senator TOOMEY. That is quite all right. Thank you, Mr. Chairman.

As until recently cochairman of the board of a community bank of about $700 million in assets, I really worry about how banks less than a billion dollars are going to be able to afford the compliance costs, and I was wondering if, especially Mr. Reed, if you could just comment on your concerns about the survival of your bank, which last I saw was about $234 million. Can a bank that size continue to afford if Dodd-Frank leads to another set of rules that you have to comply with, even though they do not inspect?

Mr. REED. We kind of feel that a $250 million bank is probably a threshold that will be safe. But I find it interesting that we are in the process of renovating our main office and we are now in designing a compliance department. We have one full-time compliance examiner and a second one that deals with suspicious activi-

ties and CTRs. We know that we need to expand our staff to comply.

But I will say I want to speak on behalf of the little guys. The State of Ohio has two banks with less than ten employees. I do not know how it is going to be possible for them to survive.

Chairman BROWN. Thank you. We will have to adjourn. Again, I apologize for truncating this hearing. The three of you coming from West Virginia and Tennessee and Ohio and not living near an airport. Mr. Reed, I appreciate you coming here and cutting up—you are taking a whole day like this, and I apologize for the shortness of the hearing, but thank you very much.

Mr. LOVING. Thank you.

Mr. REED. Thank you.

Mr. WHITTAKER. Thank you.

Chairman BROWN. We are adjourned. Thank you.

[Whereupon, at 4:15 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF MARYANN F. HUNTER

DEPUTY DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APRIL 6, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to testify today on the challenges and opportunities facing community banks. As a former examiner and former head of banking supervision at the Federal Reserve Bank of Kansas City, which has one of the highest numbers of community banks in the Federal Reserve System, I am keenly aware of the critical role that community banks play in their local communities. Community banks also provide valuable insights into the health of their local economies, which the Federal Reserve finds invaluable in determining the appropriate path of monetary policy and in taking actions to preserve the Nation's financial stability. Accordingly, I and my colleagues at the Federal Reserve value our connection with community banks and take very seriously our responsibility for the supervision of these banks.

The Federal Reserve, in conjunction with our colleagues at the State banking supervisory agencies, is responsible for supervising approximately 830 State member banks. The vast majority of these banks are community banks[1] that provide traditional banking services and loans to small businesses and consumers. In addition, the Federal Reserve supervises more than 4,700 community bank holding companies, which together control more than $2 trillion in assets and a significant majority of the number of commercial banks operating in the United States. Beginning in July 2011, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) will transfer responsibility from the Office of Thrift Supervision to the Federal Reserve for the supervision of more than 425 savings and loan holding companies, most of which operate community thrifts. Given these supervisory responsibilities—as well as the Federal Reserve's need to fully understand regional economic conditions—we closely monitor the condition and performance of community banks and appreciate the opportunity to discuss with you today some of the factors affecting their operations.

We gain considerable insight into community banking through our supervisory, research, and outreach activities both at the Reserve Banks and at the Board of Governors. Moreover, the Federal Reserve has undertaken several recent initiatives to better understand the perspectives of community banks and the challenges they face. The Board recently established a special supervision subcommittee of Board members that provides leadership and oversight on a variety of matters related specifically to our supervision of community and smaller regional banks.[2] This subcommittee is chaired by Governor Elizabeth Duke, a former longtime community banker, and also includes Governor Sarah Bloom Raskin, previously the Maryland State banking commissioner. A key role of this subcommittee is to review policy proposals to better understand the effect that these policies and their implementation could have on smaller institutions, both in terms of safety and soundness and potential regulatory burden.

The Federal Reserve also has undertaken an initiative to formalize and expand its dialogue with community banks. In October 2010, the Board announced the formation of the Community Depository Institutions Advisory Council (CDIAC) to provide the Board with direct insight and information from community bankers about the economy, lending conditions, supervisory matters, and other issues of interest to community banks.[3] Council members share firsthand knowledge and experience regarding the challenges they and their communities face, as well as their plans to address these challenges. Each Reserve Bank has its own local advisory council comprising representatives from banks, thrift institutions, and credit unions, and one member from each local council serves on the national council that meets with the Board twice a year in Washington. Each of the local advisory councils has held its first meeting, and the first meeting of the CDIAC with all of the members of the Federal Reserve Board took place on Friday, April 1. We expect these ongoing discussions will provide a particularly useful and relevant forum for improving our un-

[1] For supervisory purposes, the Federal Reserve defines banking organizations with assets of $10 billion or less as community banking organizations.

[2] For supervisory purposes, the Federal Reserve generally considers banking organizations with assets between $10 billion and $50 billion to be regional banking organizations.

[3] The CDIAC replaces the former Thrift Institutions Advisory Council, which provided the Board with information from the perspective of thrift institutions and credit unions.

derstanding of the effect of legislation, regulation, and examination activities on small banking organizations.

State of Community Banking

The economic downturn has had a significant impact on community banks and, unfortunately, many continue to struggle. Although community banks recorded an aggregate profit for 2010, one in every five community banks reported a loss. This weakness stemmed mainly from elevated loan losses and the need to bolster reserves in anticipation of future loan deterioration. Provisions for loan losses were down considerably from 2009 but remained near historically high levels. There are some positive signs, however. For example, the pace of deterioration in loan quality continued to slow during the fourth quarter of 2010 and nonperforming assets[4] fell for the third straight quarter. However, the nonperforming assets ratio is still higher than the levels that prevailed during the significant credit downturn in the early 1990s. Loans secured by real estate continue to be the main contributors behind poor asset quality, particularly loans for construction and land development.

Although community banks have sharply reduced exposures to commercial real estate lending—sometimes through heavy write-offs of problem loans—many remain vulnerable to further deterioration in real estate markets. The continued weaknesses in real estate markets offer particular challenges to community banks, which secure much of their lending with properties in their local markets. This has reduced a significant source of revenue and has caused many banks to rethink their operating models and seek alternative sources of revenue in new lending segments.

As they seek to work through loan problems with their borrowers and implement guidance issued by the supervisory agencies in 2009, community banks have continued to actively restructure loans to creditworthy borrowers who are experiencing financial difficulties. During the past year, loans restructured and in compliance with modified terms have increased more than 30 percent to $15.1 billion. This includes $3.5 billion in restructured residential mortgages. We believe these efforts will contribute to the recovery of many struggling banks and the preservation of many small businesses, but significant improvement in financial conditions will likely take considerable time for many community banks. Indeed, although banks have been aggressive in charging off losses on problem loans and restructuring loans to borrowers experiencing financial difficulties, the adequacy of loan loss reserves remains an ongoing supervisory focus. As a consequence, reserves may require further strengthening and loan loss provisions will likely continue to weigh on earnings in future quarters at many banks.

Disappointingly, outstanding loan balances have declined for nine consecutive quarters for community banks as a group, as they have for the banking system as a whole. However, we have seen evidence that many healthy community banks have continued to lend to creditworthy borrowers. While lending contracted overall from mid-2008 through 2010, this contraction was not uniform; a significantly higher proportion of smaller banks (in this case, those with assets of $1 billion or less) actually increased their lending during this period than was the case for larger banks.

Community banks have reported a number of potential causes for the low level of lending, including reduced loan demand, a tightening of underwriting standards, a lack of creditworthy borrowers, declining collateral values, and high levels of problem loans. They have also frequently raised concerns about what they characterize as heightened supervisory expectations for capital, liquidity, and the management of concentrations in loans secured by commercial real estate, which some bankers say are leading them to make fewer loans. We take these concerns seriously and have worked hard to ensure that examiners are well-trained and employ a balanced approach to bank supervision. For example, following the issuance of the interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* in October 2009,[5] an intensive training effort was conducted for examiners across the Federal Reserve System to promote consistency and balance in reviewing bank workouts of troubled commercial real estate loans. We have also undertaken a number of initiatives through our community affairs functions across the Federal Reserve System to encourage lending to creditworthy small businesses and consumers.

On a final note, community bankers and their supervisors have also been increasing their attention to other areas where lending concentrations may exist. For instance, both the Federal Reserve and many community banks are monitoring developments in agricultural lending to ensure that underwriting standards are con-

[4] Defined as nonaccruing loans plus other real estate owned.

[5] *See,* Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2009), "Prudent Commercial Real Estate Loan Workouts", Supervision and Regulation Letter 09-7 (October 30), *www.federalreserve.gov/boarddocs/srletters/2009/SR0907.htm.*

sistent with assessments of potential exposures to fluctuations in commodity prices and land values.

Effects of Recent Legislation

In our interactions with community bankers, we consistently hear that the changing regulatory environment is a key challenge and concern for community banks. Even though recent reforms are directed principally at the largest and most complex U.S. financial firms and explicitly exempt small banks from the most stringent requirements, community bankers remain concerned that expectations being set for the largest institutions will ultimately be imposed in a burdensome manner on smaller institutions or will otherwise adversely affect the community bank model.

For example, bankers have brought several provisions of the Dodd-Frank Act to our attention as particular areas of concern for community banks. One such provision is the requirement that the Federal Reserve issue a rule to limit debit card interchange fees and to prohibit network exclusivity arrangements and merchant routing restrictions. Many community bankers have also expressed a sense of uncertainty about the rulemaking authority of the new Consumer Financial Protection Bureau formed by the Dodd-Frank Act. Another concern is that the more-stringent prudential standards[6] that the Federal Reserve is required to develop for banking firms with assets greater than $50 billion and all nonbank financial firms designated as systemically important by the Financial Stability Oversight Council might ultimately filter down to smaller banks. In this regard, some concerns have been raised that the new, international Basel III prudential framework for large, globally active banks—which will require large banks to hold more and better-quality capital and more-robust liquidity buffers—may be applied to banks that are not systemic or internationally active. More generally, community banks have raised concerns that the cost of compliance with new regulations and requirements may fall disproportionately on smaller banks that do not benefit from the economies of scale of larger institutions, and that this may exacerbate consolidation of the banking sector.

In this regard, the Federal Reserve and the other Federal financial supervisory agencies will be publishing all of the Dodd-Frank proposed rulemakings for public comment. For example, last week the Federal Reserve, in conjunction with other Federal agencies,[7] issued a proposed rule that would require sponsors of asset-backed securities to retain at least 5 percent of the credit risk of the assets underlying the securities and would not permit sponsors to transfer or hedge that credit risk. We are aware that some community banks have expressed concerns about the potential impact this proposed rule might have on the availability of credit. We encourage public comments from community banks and other commenters on this and all proposals, and will carefully consider comments in drafting final rules.

Before concluding my remarks on the effects of recent legislation, let me say a few words about the transfer of savings and loan holding company supervisory authority to the Federal Reserve. We have been working in close coordination with the Office of Thrift Supervision, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation to prepare for this transfer. Our intent—to the maximum extent possible and consistent with the Home Owners' Loan Act and other laws—is to create an oversight regime for savings and loan holding companies that is consistent with our comprehensive consolidated supervision regime for bank holding companies, and we intend to issue a public notice to this effect shortly. We appreciate that savings and loan and bank holding companies differ in important ways and will remain governed by different statutes. Federal Reserve staff have been engaged in an active and constructive outreach effort to savings and loan holding companies to better understand their unique features and to help them understand our supervisory approach to holding companies.

Resilience of Community Banks

These regulatory changes will provide a new set of challenges for community banks. However, community banks have faced similar challenges in the past and have performed effectively and continued to meet the needs of their communities. Indeed, while much of the focus in recent years has been on the inability of many

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[6] These more-stringent standards for large institutions will include stronger capital and leverage requirements, liquidity requirements, and single-counterparty credit limits, as well as requirements to periodically produce resolution plans and conduct stress tests.

[7] The other agencies are the Department of Housing and Urban Development, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission. For more information, see Board of Governors of the Federal Reserve System (2011), "Agencies Seek Comment on Risk Retention Proposal", joint press release, March 31, *www.federalreserve.gov/newsevents/press/bcreg/20110331a.htm.*

community banks to withstand intense credit and liquidity pressures, it is important to note that many community banks supervised by the Federal Reserve remained in sound condition throughout the crisis. Most of these banks entered the crisis with moderate exposures to commercial real estate, moderate loan-to-deposit ratios, and ample investment securities. They tended to report solid earnings and net interest margins, very limited reliance on noncore funding, and generally strong capital levels throughout the crisis. In summary, the banks that weathered the crisis most effectively were those that adhered to the traditional community banking model.

The performance of these banks provides perhaps the best example of the resilience of the community bank model. Looking back over the crisis, these banks operated safely, soundly, and profitably despite the most challenging financial climate since the Great Depression. This speaks to the skill of their management and the soundness of their business models.

Conclusion

Community banks will continue to face a challenging environment for some time as they work through financial difficulties brought on by the economic downturn and face challenges that arise from a rapidly changing regulatory environment. The unique connection between community banks and the communities they serve is clear. The bankers who live and work in these communities know their customers and understand their local economies, and that knowledge is not easily replaced or replicated. This relationship banking is crucial to the community banking model and an important part of its viability. The Federal Reserve will continue to listen to the concerns of community banks and carefully weigh the impact of regulatory and policy changes on them, while at the same time working with them to address the future challenges they may face.

Thank you again for inviting me to appear before you today on this important subject. I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF SANDRA L. THOMPSON

DIRECTOR OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

APRIL 6, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, I welcome the opportunity to speak with you today about the state of community banking.

Community banks provide vital services in their communities; making loans to customers they know, in markets they know. Community banks are essential providers of credit to small businesses, and through the recent financial crisis, community banks have maintained steadier levels of total loan balances than their larger competitors. As our economy recovers from the most severe recession since the 1930s, a thriving community banking sector is important to help support the credit needs of local households and business borrowers.

As the supervisor of 4,414 community banks,[1] the FDIC has a keen appreciation for the important role community banks play in the national economy. The FDIC's bank examiners work out of duty stations located in 85 communities across the country. They know the community banks in their areas and are familiar with the local conditions facing those banks. Many have seen more than one previous economic down cycle and recognize the critical role that community banks play in credit availability.

Over 90 percent of all FDIC-insured institutions are community banks, and they hold close to 11 percent of aggregate industry assets. Community banks have branches in nearly all towns and urban areas, and about two-thirds of all branches in rural areas are community bank branches. Through fast, localized decision making, personal service, and a strong local presence, community banks serve the loan and deposit needs of consumers and small businesses in periods of both economic expansion and contraction.

In my testimony, I will describe the performance of community banks as of year-end 2010, identify some of the challenges and opportunities we see for community banks, and discuss some of the actions that the FDIC has taken to help smaller institutions navigate the downturn. Finally, I will discuss the effects of the Dodd-

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[1] Throughout this testimony, for purposes of data analysis, community banks are defined as banks and thrifts with total assets of less than $1 billion. The FDIC supervises a total of 4,715 banks. All data are as of December 31, 2010.

Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) on community banks.

The Financial Performance of Community Banks

After an extremely challenging 2009, community banks reported improving performance in 2010. Just as in the broader economy and in the aggregate performance of larger banks, 2010 shows signs of marking the beginning of a turnaround for community banks.

A number of community banks still face headwinds in the form of legacy problems in their real-estate loan portfolios. These headwinds are reflected in aggregate financial performance that continues to be weaker than precrisis levels. Thus, while community bank earnings rebounded from the aggregate loss reported in 2009, the average return on assets remained low and lags that of larger banks. Asset quality deterioration appears to have leveled off, but volumes of troubled assets and charge-offs remain high. In addition, community banks continue to have high concentrations of commercial real estate loans, a market segment that remains weak in many areas of the country. A more detailed discussion of community bank performance follows.

Earnings

Community banks earned $4.7 billion in 2010, in contrast to the net loss that was reported for 2009. Fewer institutions reported annual losses in 2010 than in the previous year, and two-thirds of community banks had earnings improvement in 2010, compared to only 40 percent in 2009. Most community banks set aside smaller provisions for loan loss in 2010 than they did the previous year, and lower funding costs helped net interest margins rise slightly.

The average return on assets (ROA) for community banks in 2010 was 0.33 percent. While this was a clear improvement over the prior year's loss, it was only half the overall banking industry's ROA of 0.66 percent, indicating that community bank performance continues to trail that of larger banks. The difference in performance may be attributable in part to large banks' more diversified revenue sources and to differences in asset composition—community banks are more dependent upon interest income from loans than their larger competitors are, and community banks have higher loan-to-asset ratios than large banks.

Asset Quality

Asset quality is not recovering as quickly at community banks as at larger banks. The ratio of noncurrent[2] loans to total loans for community banks fell very slightly during the fourth quarter, to 3.46 percent, and was flat compared to a year ago. Noncurrent rates and net charge-off rates for community bank loan portfolios remain lower than average industry rates, but this is a function of the differing mix of loans between small and large institutions. The retail loans that make up a larger portion of big banks' portfolios, such as credit card loans, have relatively high noncurrent rates. However, these loans are also recovering more quickly than the commercial real estate (CRE) loans that make up a larger part of community banks' portfolios.

The noncurrent rate for construction and development (C&D) loans at community banks remained stubbornly high at 12.88 percent in the fourth quarter and reflects the ongoing distress in the real estate development sector. Noncurrent rates also rose during the fourth quarter for one-to-four family residential real estate loans and nonfarm nonresidential real estate loans, but declined for commercial and industrial (C&I) loans.

Net charge-offs increased during the fourth quarter, but were lower than a year ago (net charge-offs are typically higher in the fourth quarter than in the preceding three quarters). Most community banks reported declines in net charge-offs compared to fourth quarter 2009. Community banks set aside more in provisions for loan losses than they charged off during the quarter, suggesting that community banks will continue to work through their asset quality problems in 2011.

As a result of the protracted credit quality problems, community banks' levels of other real estate owned (ORE) and restructured loans have increased. ORE represented 1.05 percent of assets at community banks and restructured loans made up another 1.19 percent. Troubled assets—ORE, restructured loans, delinquent, and noncurrent loans—represented about 5 percent of assets.

Commercial real estate markets have been hard-hit in the crisis, and it is no surprise that community banks with rapid growth or exceptionally high concentrations

[2] Noncurrent loans are loans that are 90 or more days past due or have been placed on nonaccrual status.

of CRE lending, and especially C&D lending, have suffered disproportionately. C&D loans and nonfarm nonresidential real estate loans comprise 38 percent of community bank loan balances, but during the fourth quarter represented 50 percent of their loans charged-off, almost 60 percent of their noncurrent loans, and close to three-fourths of their ORE. Given that real estate markets continue to struggle in many regions across the country, troubled CRE-related assets will continue to strain community banks' asset quality and earnings throughout this year.

Lending by Community Banks

As I stated earlier, community banks play a vital role in credit creation across the country and small businesses especially rely on community banks for loans when large institutions and nonbanks curtail their lending activity. This has been borne out by loan originations over the past several years, as community bank loan balances have increased by about 3 percent on a merger-adjusted basis since second quarter 2008. Over the same period, overall industry loan balances fell by more than 7 percent. It is also noteworthy to point out that community banks held almost 39 percent of small loans to businesses (C&I and CRE loans in amounts under $1 million and agricultural and farmland loans under $500,000) at the end of 2010, which represents about three times the community banks' share of total industry loans.

Funding and Capital

Consistent with their focus on providing traditional banking services to retail customers, community banks rely heavily on deposits to fund their balance sheets. Fourth quarter domestic deposits were equal to more than 80 percent of assets at community banks, compared to less than 60 percent of industry assets. Close to three-fourths of community bank deposit accounts are in accounts under the insurance limit of $250,000. Community banks held $53 billion in non- interest-bearing transaction accounts over $250,000 temporarily insured under the Dodd-Frank Act at the end of the fourth quarter. Again, the local focus and convenience offered by community banks provides them with a viable platform for gathering deposits, while delivering essential depository and payment services to consumers and small businesses.

Community banks have maintained capital ratios higher than the industry averages. Risk-based capital ratios rose for the fourth straight quarter and the community bank leverage ratio was just below the 2-year high.

Consolidation

At year-end 2010, there were 874 fewer FDIC-insured institutions with assets under $1 billion than at year-end 2007, as continuing consolidation and a number of failures have reduced the community bank population. From year-end 2007 through year-end 2010, the share of industry assets represented by community banks has declined from 11.4 percent to 10.8 percent, while the share of industry assets represented by the largest banks (those with total assets greater than $100 billion) has increased from 54.6 percent to 59.1 percent. However, consolidation of community banks is not primarily a result of the recent crisis, but is the continuation of a long-term trend precipitated by competition, technological advances, and innovation in the financial services industry.

Challenges and Opportunities for Community Banks

The most important challenge facing community banks at present is improving their operating performance amid the lingering effects of the financial crisis and recession. A large number of financial institutions have an elevated level of problem assets, which strains earnings and can divert management's attention from executing longer-term strategic initiatives. Moreover, communities across the country continue to suffer from high unemployment and slow job creation, and loan demand remains weak. According to the latest Federal Reserve Senior Loan Officers' Opinion Survey, only 12 percent of small banks in the survey reported increased demand for C&I loans. Tepid business expansion and continuing high unemployment are also making it difficult for businesses and consumers to service existing loans and for financial institutions to work out problems.

Many community banks remain vulnerable to additional real estate market declines as a result of their significant holdings of commercial real estate assets, both as loans and as ORE. Many institutions that relied heavily on C&D lending in the years leading up to the recession continue to be exposed to declining home prices. At the same time, commercial real estate markets remain weak in most areas.

In spite of the obstacles, and high concentrations of commercial real estate loans, many community banks weathered the financial storm well because of sound underwriting practices and corporate governance, in addition to a keen understanding of

their local market and economy. As a result, those institutions are poised to respond quickly and prudently once credit demand returns. These banks know their customers well and in turn, their customers know them, trust them, and appreciate their personal attention and responsiveness at the local level.

Community banks could also begin to see a narrowing of the cost advantage that larger institutions had previously enjoyed. Many of the reforms that are being implemented in response to the financial crisis are aimed at improving lax underwriting practices, particularly in the residential mortgage lending field. Community banks for the most part, did not relax their standards. That made it difficult for them to compete during the years of expansion leading up to the crisis. As both nonbanks and larger institutions are required by the Dodd-Frank Act to tighten standards, the community banks may see an improvement in their ability to originate good quality mortgage loans at competitive interest rates.

The FDIC and Community Banks

Throughout the real estate and economic downturn, the FDIC has advocated for policies that will help community banks and their customers navigate this challenging period and mitigate unnecessary losses. We share community banks' desire to restore profitability, strengthen asset quality, and serve the credit needs of local markets. The FDIC has worked closely with banks as they have taken steps to raise capital, enhance their loan workout functions, and revise strategic plans to remain competitive in the financial services industry. Through our regional and field offices, the Corporation actively communicates with the community banks we supervise and provides recommendations for addressing operational and financial weaknesses as appropriate.

The FDIC has joined several interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers, and to clarify outstanding guidance. For example, the Federal bank regulatory agencies issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* on November 12, 2008, which encouraged banks to prudently make loans available in their markets. The agencies also issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 12, 2010, to encourage prudent small business lending and emphasize that examiners will apply a balanced approach in evaluating loans. This guidance was issued subsequent to the October 30, 2009, *Policy Statement on Prudent Commercial Real Estate Workouts* that encourages banks to restructure loans for commercial real estate mortgage customers experiencing difficulties making payments. The CRE Workouts Guidance reinforces longstanding supervisory principles in a manner that recognizes pragmatic actions by lenders and small business borrowers are necessary to weather this difficult economic period.

The FDIC also joined the other banking agencies in issuing the *Interagency Appraisal and Evaluation Guidelines* on December 2, 2010, to clarify expectations for real estate appraisals. Clarification of these guidelines was important for the industry given changes in property values over the past several years. We also actively engage with community banks at the State level and nationally through various trade associations, which helps our agency articulate its supervisory expectations on important issues through a variety of forums. We also sponsor training events for community banks including regional and national teleconferences on risk management and consumer protection matters, as well as Directors Colleges to help bank directors better understand the supervisory process.

Potential Impact of the Dodd-Frank Act

Some community bankers have pointed to uncertainty about the effect of new regulations under the Dodd-Frank Act as a potential obstacle to their continued profitability.

However, much of the Dodd-Frank Act should have no direct impact on community banks, while certain changes in the Act provide real benefits. For example, those provisions of the Act that impose additional capital and other heightened prudential requirements on the largest financial institutions are aimed at reducing systemic risks. If properly implemented, those and other provisions of the Act should do much to return competitive balance to the marketplace by restoring market discipline; ensuring appropriate regulatory oversight of systemically important financial companies; and having rules that apply to all providers of financial services, not just insured depository institutions. In fact, as noted above, there are immediate, tangible benefits that the Dodd-Frank Act confers on community banks.

First, the deposit insurance coverage limit was permanently increased to $250,000. In addition, the law provides a guarantee of all balances in non- interest-bearing transaction accounts above $250,000 until the end of 2012. These changes

help to address one of the main sources of competitive imbalance, by giving community banks access to federally insured or guaranteed funding in larger amounts, without having to pay a fee to deposit brokers or consultants.

The Dodd-Frank Act also changes the assessment base used to calculate premiums paid to the Deposit Insurance Fund (DIF), from one based on deposits to one based on total assets. Because community banks generally rely more on deposits as a funding source than do larger banks, the Dodd-Frank Act effectively shifts a greater proportion of DIF assessments to larger banks. In aggregate, banks with assets under $10 billion should see their assessments decline by 30 percent. The final rule implementing the new assessment base took effect on April 1st.

To provide for a more stable DIF going forward, the law increases the minimum DIF reserve ratio to 1.35 percent. But it extends the period in which the DIF must be recapitalized to 2020, and also requires that the assessments needed to increase the DIF from the old minimum ratio of 1.15 percent to the new minimum ratio of 1.35 percent should be collected entirely from banks with total consolidated assets of $10 billion or more. Thus, community banks' deposit insurance assessments will not need to rise in order to meet the new target.

There are other important, if less tangible, ways that the Dodd-Frank Act should help create a more level playing field between community banks and their larger competitors.

Most—but not all—of the high risk mortgage lending that precipitated the recent crisis originated outside of insured banks. The Dodd-Frank Act requires these nonbank lenders to adhere to Federal consumer protection laws and places them under Federal supervision for the first time. The Consumer Financial Protection Bureau established by the Dodd-Frank Act will likely reduce the unfair competitive advantage that nonbank competitors have long enjoyed as under-regulated—and often unregulated and unsupervised—financial services providers.

Importantly, section 171 of the Dodd-Frank Act, the Collins Amendment, places a risk-based capital floor under the so-called advanced approaches. The floor will ensure that capital requirements for the largest banks and their bank holding companies are no lower than the level of capital required of community banks that hold similar exposures. In addition, under section 165 of the Act, large bank holding companies are subject to heightened capital standards (that is, beyond the standards required of smaller institutions), to account for the greater risk that large bank holding companies pose to the financial system. These provisions of the Dodd-Frank Act are consistent with developments taking place in the Basel Committee on Banking Supervision which, with the support of the U.S. banking agencies, has announced its intention to develop heightened capital standards for the largest banks.

Finally, the most fundamental reform in the Dodd-Frank Act is the new orderly liquidation authority for large bank holding companies and systemically important nonbank financial companies, which ends "Too Big to Fail." The FDIC regularly carries out a prompt and orderly liquidation process using its receivership authority for insured banks and thrifts that are facing insolvency. The Dodd-Frank Act for the first time gives the FDIC a similar set of receivership powers to close and liquidate systemically important financial firms that are failing. Just as important, the Act mandates that systemically important financial institutions maintain credible, actionable resolution plans that facilitate their orderly resolution if they should fail. If the FDIC and the Federal Reserve Board do not find an institution's resolution plan to be credible, we can compel the divestiture of activities that would unduly interfere with the orderly liquidation of the company. The FDIC Board adopted a proposed rulemaking for public comment last week and as Chairman Bair said at the Board meeting, "This is a big step forward in ending 'too big to fail.'"

It has been well-documented that the cost of funds for the largest banks has been lower than that for smaller banks. In fourth quarter 2010, the average cost of funding earning assets for banks over $100 billion in assets was 0.67 percent, compared to 1.24 percent for community banks. Not all of this difference is due to the perception that the largest banks are too big to fail. Their product mix and access to capital markets in the U.S. and overseas help to lower their funding costs in low interest rate environments, such as the one we are in.

Using the tools provided under the Dodd-Frank Act, we can break this cycle of subsidized risk taking and create a financial marketplace that is both more stable and more competitively balanced. Much of the regulatory cost of the Dodd-Frank Act will fall, as it should, directly on the large institutions that create systemic risk. The leveling of the competitive playing field will help preserve the essential diversity of our financial system, and prevent any institution from taking undue risks at the expense of the public.

The FDIC understands why community banks are wary. We recognize the concerns community bankers have in understanding how new legislation and regula-

tions will affect their operations. The FDIC is required or authorized by Congress to implement some 44 regulations, including 18 independent and 26 joint rulemakings. Community banks should be, and are, taking an active interest in these new regulations as they are developed.

We are implementing the provisions of the Dodd-Frank Act as transparently and expeditiously as possible. Not only is the FDIC following the normal steps used in any rulemaking process, we are also holding public roundtables to discuss issues such as our systemic resolution authority and required resolution plans, the new deposit insurance assessment provisions and core/brokered deposits. In addition, we document meetings between senior FDIC officials and outside parties that are related to the implementation of the Dodd-Frank Act.

The FDIC also is focused on how other provisions of the Dodd-Frank Act could impact community banks. For example, we are extremely concerned that, under proposed regulations, community banks may not actually receive the benefit of the interchange fee limit exemption explicitly provided for in the law. We sent a comment letter to the Federal Reserve Board detailing these concerns and encouraging the Federal Reserve to consider the practical implications of its proposed rule on community banks.

We also have engaged the FDIC's Advisory Committee on Community Banking on the Dodd-Frank Act and other issues. At the January 20 meeting of the committee, there was a discussion of ways to ease the regulatory burden on small institutions. Among the ideas discussed at that meeting were identifying which regulatory questionnaires and reports can be streamlined through automation, reviewing ways to reduce the total amount of reporting required of banks, and ensuring that community banks are aware that senior FDIC officials in the regions and in Washington are available and interested in receiving their feedback regarding our regulatory and supervisory process.

The FDIC is particularly interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. We continuously pursue methods to streamline our supervisory process through the use of technology and other means to reduce any possible disruption associated with examination activity. While we maintain a robust examination process, we are sensitive to banks' business priorities and strive to be efficient in our work.

To this end, we have established as a goal for the first quarter of 2011 to modify the content of our Financial Institution Letters (FILs)—the vehicle used to alert banks to any regulatory changes or guidance—so that every FIL issued will include a section making clear the applicability to smaller institutions (under $1 billion). In addition, by June 30 we plan to complete a review of all of our recurring questionnaires and information requests to the industry and to develop recommendations to improve the efficiency and ease of use and a plan to implement these changes. The FDIC also has challenged its staff to find additional ways of translating some of these ideas into action. This includes launching an intensive review of existing reporting requirements to identify areas for streamlining.

At the beginning of this year, we initiated a dialogue with our field and regional staffs to reinforce the FDIC's balanced approach to bank supervision. In this effort, we are reminding examiners to work cooperatively with financial institutions and to be aware of the great challenges that face community banks. Moreover, we will be engaging in a dialogue with bankers at each examination in 2011 to solicit bankers' views on aspects of the regulatory and supervisory process that may be adversely affecting credit availability.

Conclusion

Community banks remain an essential part of the financial system, and the FDIC is committed to a regulatory structure that will support a vibrant, competitive community banking sector and a level playing field between large and small banks. Throughout the financial crisis and recession, community banks continued providing credit even as larger banks pulled back. We need a thriving community banking sector to support an economic recovery and fulfill the credit and depository needs of households and businesses on Main Street.

Thank you. I am pleased to answer any questions.

PREPARED STATEMENT OF JENNIFER KELLY

SENIOR DEPUTY COMPTROLLER FOR MIDSIZE AND COMMUNITY BANK SUPERVISION,
OFFICE OF THE COMPTROLLER OF THE CURRENCY

APRIL 6, 2011

I. Introduction

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, my name is Jennifer Kelly. I have been a commissioned national bank examiner for 27 years, and I am currently the Senior Deputy Comptroller for Midsize and Community Bank Supervision for the Office of the Comptroller of the Currency (OCC), reporting directly to the Comptroller. In this capacity, I serve as the senior OCC official responsible for community bank supervision. I appreciate this opportunity to discuss the current state of the community banks the OCC supervises and the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) on those institutions.

My testimony first presents an overview of the OCC's approach to the supervision of national community banks, then addresses the present state of community banks, and concludes by sharing our perspective on the likely effects of the Dodd-Frank Act on community banks.

Let me say first that community banks play a crucial role in providing consumers and small businesses in communities across the Nation with essential financial services as well as the credit that is critical to economic growth and job creation. While we have been through an extremely difficult economic cycle that has been challenging for institutions of all sizes, I am pleased to report that conditions are beginning to stabilize for community banks, and we are seeing these institutions return to profitability. As a result, the vast majority of these banks will continue to play a vital role in supporting their communities and the Nation's financial system.

II. OCC's Approach to Community Bank Supervision

The OCC supervises over 1,200 community banks with assets under $1 billion; more than 800 of those banks have less than $250 million in assets. On July 21, in accordance with the Dodd-Frank Act, the OCC will assume responsibility for the supervision of approximately 664 Federal savings associations—including 220 mutuals—with total assets of just over $912 billion. Since the overwhelming majority of those thrifts are community institutions, the number of community institutions we supervise will increase by more than half later this year. These institutions are integral to local economies throughout the country, and we remain deeply committed to their safe and sound operation.

The OCC's community bank supervision program is built around our local field offices. Approximately 75 percent of our examination staff is dedicated to the supervision of community institutions. These examiners are based in over 60 cities throughout the United States in close proximity to the banks they supervise. Every national community bank is assigned to an examiner who monitors the bank's condition on an ongoing basis and who serves as the focal point for communications with the bank. The primary responsibility for the supervision of individual community banks is delegated to the local Assistant Deputy Comptroller (ADC), who is under the oversight of a district Deputy Comptroller who reports to me. When we assume responsibility for Federal savings associations later this year, we will increase the number of ADCs by more than 20 and open additional field offices.

Our structure ensures that community banks receive the benefits of highly trained bank examiners with local knowledge and experience, along with the resources and specialized expertise that a nationwide organization can provide. While our bank supervision policies and procedures establish a common framework and set of expectations, our examiners are taught to tailor their supervision of each community bank to its individual risk profile, business model, and management strategies. As a result, our ADCs are given considerable decision-making authority, reflecting their experience, expertise and their "on-the-ground" knowledge of the institutions they supervise.

We have mechanisms in place to ensure that our supervisory policies, procedures, and expectations are applied to community banks in a consistent and balanced manner. Every report of examination is reviewed and signed off by the responsible ADC or Deputy Comptroller before it is finalized. In those cases where significant issues are identified and an enforcement action is already in place, or is being contemplated, additional levels of review occur prior to finalizing the examination conclusions. We also have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies through periodic, ran-

domly selected reviews of the supervisory record. This is done with oversight by the Enterprise Governance Unit that reports directly to the Comptroller.

A key element of the OCC's supervisory philosophy is open and frequent communication with the banks we supervise. In this regard, my management team and I encourage any banker that has concerns about a particular examination finding to raise those concerns with his or her examination team and with the district management team that oversees the bank. Our ADCs and Deputy Comptrollers expect and encourage such inquiries. Should a banker not want to pursue those chains of communication, our Ombudsman's office provides a venue for bankers to discuss their concerns informally or to formally request an appeal of examination findings. The OCC's Ombudsman is fully independent of the supervisory process, and he reports directly to the Comptroller. In addition to hearing formal appeals, the Ombudsman's office provides bankers with an impartial ear to hear complaints and a mechanism to facilitate the resolution of disputes with our supervisory staff.

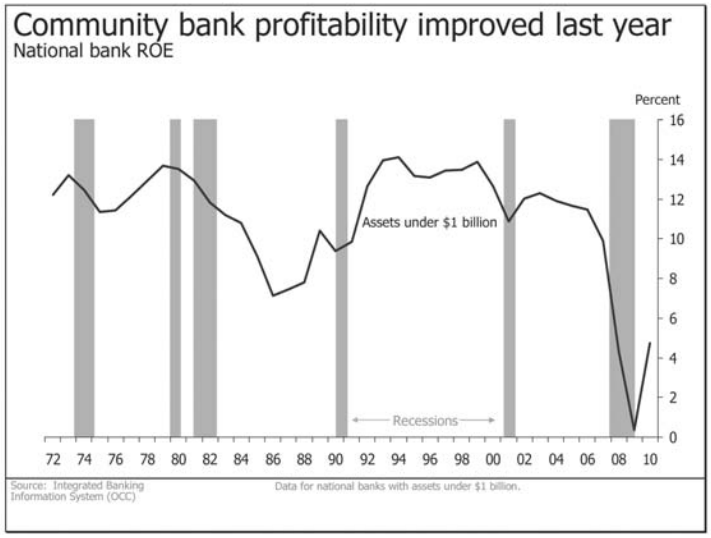
The OCC recognizes the importance of communicating regularly with the industry outside of the supervision process to clarify our expectations, discuss emerging issues of interest to the industry, and respond to bankers' concerns. We participate in numerous industry-sponsored events, as well as conduct a variety of outreach activities, including Meet the Comptroller events, chief executive officer roundtables, and teleconferences on topical issues. We also offer workshops for bank directors to help them understand and effectively execute their fiduciary responsibilities. In preparation for the transfer of Federal savings associations to OCC supervision next July, we recently presented 17 day-long programs for thrift executives in locations around the country to provide information and perspective on the agency's approach to supervision and regulation.

III. Current Condition of National Community Banks

The operating environment for community banks over the last 3 years has been particularly challenging. Lending activity—the primary revenue source for community banks—has been hampered by the overall economic climate. Although it is true that many bankers have adjusted and tightened some of their credit underwriting standards, most of the community bankers I talk to reiterate that lending is the backbone of their business and that they are seeking to make loans to creditworthy borrowers. We continue to encourage bankers to lend to such borrowers.

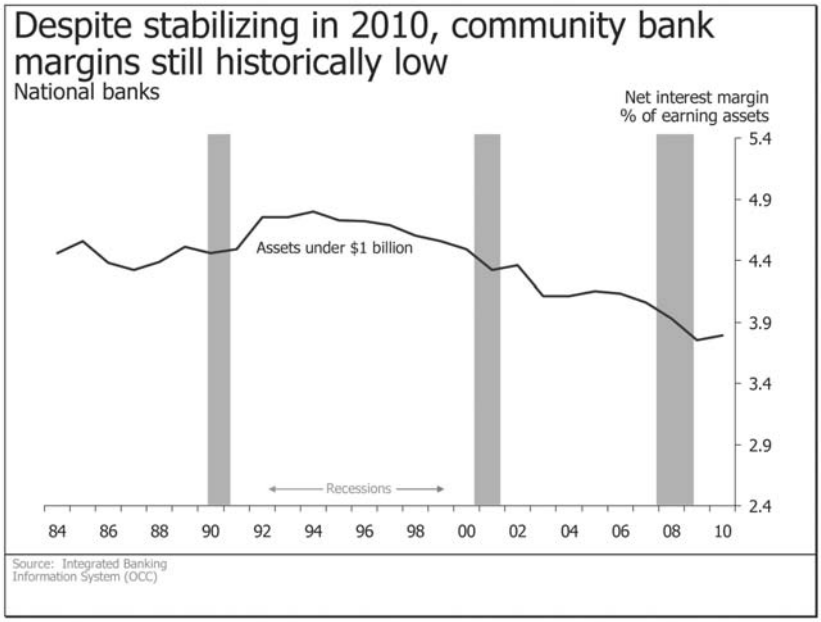
As shown in Chart 1, community bank profitability, as measured by return on equity, improved last year after a precipitous decline in the previous 2 years but remains sharply below historical experience.

Chart 1



A major factor contributing to the decline in profitability is the continued pressure on community banks' net interest margins. Tepid loan demand and the low interest rate environment are contributing to the decline in these margins: as loans and investments mature, banks are forced to replace them with lower yielding assets. While the rates banks pay for certificates of deposit and other funding sources have also declined, many core deposits are already at extremely low rates, leaving little room for further declines. As a result, community banks' margins are at historical lows (*See,* Chart 2).

Chart 2



Elevated levels of problem loans are also hampering community banks' financial performance as banks have had to increase their loan loss reserve provisions to cover loan losses. As shown in Chart 3 on the next page, the net effect of these factors has been a strain on community banks' net income.

Although similar trends are evident for the entire industry, they pose more difficult challenges for small institutions because large banks have more diverse revenue streams and greater economies of scale. When margins are under pressure, other sources of revenue take on greater prominence. But those other sources of income are also under pressure right now.

Chart 3

Community bank profitability up in 2010 but provisions remain high

National banks

Major income components	Assets under $1 B $ billions 2007	2008	2009	2010
Revenues				
Net interest income	8.4	8.7	8.8	9.0
Noninterest income	3.3	3.3	3.4	3.3
Realized Sec. G/L	-0.0	-0.3	0.0	0.1
Expenses				
Provisioning	0.5	1.4	2.3	1.6
Noninterest expense	8.0	8.5	9.2	9.1
Income Taxes	0.7	0.3	0.2	0.4
Net income	2.4	1.5	0.6	1.4

Source: Integrated Banking Information System (OCC)

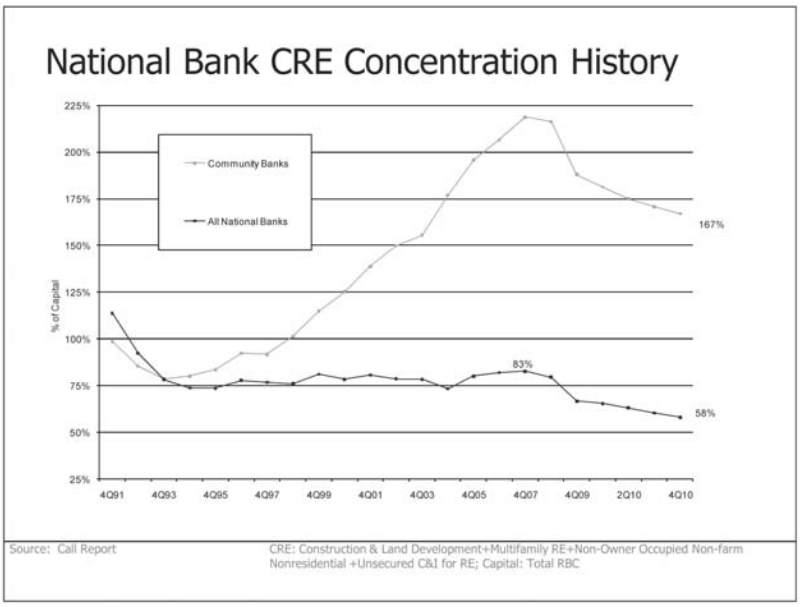
Data are merger-adjusted and held constant for banks in operation from 1Q:06 to 4Q:10.

Notwithstanding these pressures, the vast majority of national community banks remain strong: three-quarters of the community banks we supervise have supervisory—or CAMELS—ratings of 1 or 2, reflecting their sound management and strong financial condition.[1] These banks have successfully weathered the recent economic turmoil by focusing on sound banking fundamentals: strong underwriting practices, prudent limits on loan concentrations, and stable funding bases.

There remains, however, a sizeable segment of community banks that are experiencing more severe financial strains, primarily due to their exposures to the commercial real estate (CRE) markets. As shown in Chart 4, although CRE concentrations as a percentage of capital have trended downward for all national banks, they are still significant for many community banks.

[1] The Uniform Financial Institutions Rating System is commonly referred to as CAMELS. CAMELS is an acronym that is drawn from the first letters of the individual components of the rating system: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

Chart 4



CRE lending is an important product for both small banks and the communities they serve, but CRE concentrations have played a prominent role in most of the problem community banks that we supervise. The timing and effect of the distressed CRE market on individual banks' overall financial condition has varied by the size, location, and type of CRE exposure of the bank. For example, rapid deterioration of construction and development loans led the performance problems in the CRE sector and thus banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. Conversely, banks whose lending is more focused on income-producing commercial mortgages, including many smaller community banks, are continuing to experience an increase in problem loans and charge-off rates.

Although commercial property markets across the Nation have begun to show signs of stabilization, net operating income (NOI), which is one of the key drivers for CRE property values and the primary source for loan repayment, continues to decline across most CRE sectors. This translates to potential for additional losses in income-producing CRE loans which is a significant issue for community banks since that loan category is twice as large as the construction and development portfolios in aggregate.

The OCC has been raising and addressing concerns about the CRE market and, in particular, the concentrated exposures that many community banks have to this market, since early 2004 when we initiated the first of a series of targeted examinations at banks that we believed were at significant risk due to the nature and scope of their CRE activities. These supervisory efforts have continued with various targeted examinations and reviews at national banks with significant CRE concentrations. Key objectives of our CRE examinations are to ensure that bank management recognizes and addresses potential problems at the earliest stage possible—when workout efforts are likely to be most successful—and that previously identified deficiencies and shortcomings in risk management practices have been addressed. In this regard, I want to stress that the OCC has and continues to encourage bankers to work constructively with borrowers who are facing difficulties. We firmly believe that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower, and it has been our long-standing policy that examiners will not criticize prudent loan workout arrangements. This does not mean, however,

that examiners will allow bankers to ignore loans with structural weaknesses or insufficient cash flows to support repayment. While we encourage bankers to work with troubled borrowers, we also insist that banks maintain the integrity of their financial reporting by maintaining appropriate loan loss reserves and capital and, when warranted, taking appropriate charge-offs.

IV. Challenges Presented for Community Banks by the Post-Crisis Regulatory Environment

As is commonly observed, the Dodd-Frank Act resulted in the most comprehensive reform of the United States financial system in decades. Some of the best-known changes will primarily affect the largest banking institutions—for example, the new requirements to be imposed on "systemically significant" institutions; the so-called "Volcker Rule" constraints on proprietary trading and investments in hedge funds and private equity funds; new restrictions on derivatives activities; and shifting more of the cost of deposit insurance to large banks. But other requirements within the Act broadly amend banking and financial laws in ways that affect the entire banking sector, including community banks.

The challenges banks face have several dimensions: new regulation—both new restrictions and new compliance costs—on businesses they conduct, limits on revenues for certain products, and additional regulators administering both new and existing regulatory requirements. In the context of community banks, a particular concern will be whether these combine to create a tipping point causing banks to exit lines of business that provide important diversification of their business, and increase their concentration in other activities that raise their overall risk profile.

For example, the Dodd-Frank Act imposes a range of new requirements on the retail businesses that are "bread-and-butter" for many community banks. The costs associated with small business lending will increase when new HMDA-style reporting requirements become effective. Long-standing advisory and service relationships with municipalities may cause the bank to be deemed a "municipal advisor" subject to registration with the Securities and Exchange Commission (SEC) and rules issued by the SEC and the Municipal Securities Rulemaking Board. And checking account relationships with customers are likely to be reshaped to recover the costs associated with providing debit cards if debit interchange fees are restricted.

The new Consumer Financial Protection Bureau (CFPB) is charged with implementing new requirements that will affect banks of all sizes. These include new standards for mortgage loan originators; minimum standards for mortgages themselves; limits on charges for mortgage prepayments; new disclosure requirements required at mortgage origination and in monthly statements; a new regime of standards and oversight for appraisers; and a significant expansion of the current HMDA requirements for mortgage lenders to report and publicly disclose detailed information about mortgage loans they originate (13 new data elements).

The CFPB is also authorized to issue new regulations on a broad range of topics, including, but not limited to:

- additional disclosure requirements to "ensure that the features of any consumer financial product or service, both initially and over the life of the product, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances";
- new regulations regarding unfair, deceptive, or "abusive" practices; and
- standards for providing consumers with electronic access to information (retrievable in the ordinary course of the institution's business) about their accounts and transactions with the institution.

While we strongly support clearer, more meaningful, and accessible consumer disclosures, it is important to recognize that the fixed costs associated with changing marketing and other product-related materials will have a proportionately larger impact on community banks due to their smaller revenue base. The ultimate cost to community banks will depend on how the CFPB implements its new mandate and the extent to which it exercises its exemptive authority for community banks.

Community banks also may be particularly impacted by the Dodd-Frank Act's directive that Federal agencies modify their regulations to remove references to credit ratings as standards for determining creditworthiness. This requirement impacts standards in the capital regulations that are applicable to all banks. National banks are also affected because ratings are used in other places in the OCC's regulations, such as standards for permissible investment securities. As a result, institutions will be required to do more independent analysis in categorizing assets for the purpose of determining applicable capital requirements and whether debt securities are

permissible investments—a requirement that will tax especially the more limited resources of community institutions.

The Dodd-Frank Act restrictions on corporate governance apply to community banks as well as larger institutions. Banks that are public companies will be subject to several new requirements on compensation, including shareholder "say on pay" votes, disclosures on performance-based compensation arrangements, and compensation clawbacks for accounting restatements.

Regardless of how well community banks adapt to Dodd-Frank Act reforms in the long-term, in the near- to medium-term these new requirements will raise costs and possibly reduce revenue for community institutions. The immediate effects will be different for different banks, depending on their current mix of activities, so it is not possible to quantify those impacts with accuracy. In the longer term, we expect to see banks adjust their business models in a variety of ways. Some will exit businesses where they find that associated regulatory costs are simply too high to sustain profitability, or they will decide how much of the added costs can, or should, be passed along to customers. Others will focus on providing products and services to the least risky customers as a way to manage their regulatory costs. Some will elect to concentrate more heavily in niche businesses that increase revenues but also heighten their risk profile. While we know there will be a process of adaptation, we cannot predict how these choices will affect either individual institutions or the future profile of community banking at this stage.

V. Conclusion

Community banks play a critical role in providing financial services to our Nation's communities and businesses. The OCC is committed to providing balanced and fair supervision of nationally chartered community banks and the Federal savings associations that we assume responsibility for in July.

We are mindful of the economic challenges, and the regulatory and compliance burdens facing community banks, and that implementation of the Dodd-Frank Act may accentuate these challenges. It is our goal to implement the Dodd-Frank Act in a manner that accomplishes the legislative intent without unduly harming the ability of community banks to fulfill their role of supporting local economies and providing the services that their customers rely on. It will be extremely important that we hear from community banks during the notice and comment process of our rulemaking efforts to help determine whether we achieved this goal and whether additional changes or alternatives could be considered to lessen the burden on community banks.

PREPARED STATEMENT OF JOHN P. DUCREST

COMMISSIONER, LOUISIANA OFFICE OF FINANCIAL INSTITUTIONS, AND CHAIRMAN, CONFERENCE OF STATE BANK SUPERVISORS

APRIL 6, 2011

Introduction

Good afternoon, Chairman Brown, Ranking Member Corker, and distinguished Members of the Subcommittee. My name is John Ducrest, and I serve as the Commissioner of Financial Institutions for the State of Louisiana. I am also the Chairman of the Conference of State Bank Supervisors (CSBS). It is my pleasure to testify before you today on behalf of CSBS.

CSBS is the nationwide organization of banking regulators from all 50 States, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands. State banking regulators supervise, in cooperation with the Federal Deposit Insurance Corporation and Federal Reserve, over 5,600 State-chartered insured depositories. Further, the majority of State banking departments also regulate a variety of nonbank financial services providers, including mortgage lenders. For more than a century, CSBS has given State supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to State banking and financial regulators and represents its members before Congress and the Federal financial regulatory agencies.

Today's hearing comes at a critical time for the community banking system. Community banks are currently operating in a very challenging business and regulatory environment. I thank you, Chairman Brown, and the Members of the Subcommittee for holding such a timely hearing. Understanding the current challenges and opportunities facing community banks is an important part of understanding the overall health of the economy. Even more importantly, the subject of today's hearing logi-

cally leads us to significant questions about the longer-term prospects for the community banking business model.

In my testimony I will discuss my perspectives as a State banking regulator on the critical role community banks play in economic development, job creation, and market stabilization. I will also address the current regulatory environment in which they operate. Additionally, my testimony will identify concerns that my State banking commissioner colleagues and I have about the impact of regulations and policies on community banks. Finally, I will provide some recommendations aimed at strengthening the community banking system.

Why Community Banking Still Matters

Over the past several months, my fellow State regulators and I have heard the very loud concerns of community bankers regarding their future. These concerns come from the feared trickle-down effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act and other regulatory actions deemed necessary to address identified weaknesses in the banking system. This will undoubtedly add to the compliance burden being shouldered by the industry. While consumer compliance is significant, in this context, compliance also includes bank secrecy, corporate governance, accounting rules, and reporting requirements. In addition, community banks are facing an uncertain future as the structure and role of larger institutions in the economy is evolving and the future of mortgage finance is being debated.

We believe these concerns are very real and are worthy of our collective attention. This should be a serious, national concern. In our view, the viability of the community bank model has significant systemic consequences, which if left unaddressed will cause irreparable harm to local economies and erode critical underpinnings of the broader economy.

The challenges the community banking system is facing are already having an impact upon local economic development, as some local economies remain stalled or even eroded by more limited credit availability. As you meet with bankers in your office and in your State, I encourage you to ask them about the loans which are not being made. While some banks are not positioned to lend due to their financial condition, many banks are not making residential real estate loans due to the increased compliance burden. In addition, commercial real estate (CRE) loans are not being made due to the stigma of an entire asset class. We cannot accept this as collateral damage in the interest of consistency and national policy.

Small Business Lending

The vital role small businesses play in the national economy is widely recognized. Small businesses are often considered the "engine" of the U.S. economy and drive employment across the Nation. Small firms:

- Represent 99.7 percent of all employer firms in the United States;
- Employ half of all private sector employees;
- Pay 44 percent of total U.S. private payroll;
- Generated 65 percent of net new jobs over the past 17 years;
- Made up 97.5 percent of all identified exporters and produced 31 percent of export value in FY2008; and
- Produce 13 times more patents per employee than large patenting firms.[1]

Just as small businesses are recognized as critical to the health of our national economy, the U.S. banking system remains the most important supplier of credit to small businesses in the country. While the volumes are large, banks with over $50 billion in assets allocate only 24 percent of their loan portfolios to small business loans. Banks with less than $10 billion in assets invest 48 percent of their loans in small business (*See,* Exhibit 1). There is a very significant difference in the type of small business lending conducted by the smaller banks. In general, lack of extensive financial data for smaller firms makes it more difficult for lenders to ascertain if a small business is "creditworthy." This makes community banks particularly well suited for small business lending. The largest banks tend to rely upon transactional banking, in which hard, quantifiable information drives performance and products are highly standardized. Community banks, however, engage in relationship banking, involving the use of soft information which is not readily available or quantifiable. Synthesis of soft information requires more human input, usually acquired by direct exchanges between the lender and the borrower, and relies upon lenders em-

[1] U.S. Small Business Administration, Advocacy Small Business Statistics and Research, Frequently Asked Questions, *http://web.sba.gov/faqs/faqindex.cfm?areaID=24.*

powered with decision-making authority.[2] These types of loans are economically significant at the local level, providing jobs and economic activity. Collectively, they are significant for the national economy as well.

Maintaining the Availability of Credit

In addition to providing critical financial support to small businesses, community banks have also proven a reliable source of credit for individuals in smaller communities. The Nation's largest institutions have a tremendous presence in metropolitan areas, but may not provide services to residents of small or rural areas (*See,* Exhibit 2). Community banks, with their geographically focused service areas, provide the necessary financial products and access to credit for residents of rural and smaller communities. While community banks are essential to the very existence of some communities, I would highlight that the value of the relationship lending model provides needed services and credit to businesses and consumers in communities of all sizes.

Through strong and weak economic conditions and in times of crisis, community banks provide much-needed stability to the financial system by continuing to make credit and financial services available to individuals and small businesses. For example, during the crisis in the capital markets, the Nation's largest banks all but ceased all lending activity to preserve capital to remain solvent. Community banks, however, continued to make credit available to individuals and businesses and helped prevent a complete collapse of the U.S. economy.

In my home State of Louisiana, we have experienced firsthand the role that community banks play in providing economic stability during times of crisis. In the wake of Hurricane Katrina, community banks were the leaders in reopening their doors in the affected areas of the State. Specifically, locally based institutions quickly reopened at alternative locations in order to restore and reinforce public confidence in the State's banking system, provided valuable information about conditions in the affected areas, and provided much needed assistance through their lending activities to the rebuilding efforts in the affected areas. My department worked with our regulated depository institutions to assist the evacuees in their greatest time of need, by encouraging these institutions to institute extraordinary measures, such as: waiving fees for customers and noncustomers seeking traditional banking services; increasing credit limits, ATM and debit card withdrawal limits and lines of credit limits for customers; extending repayment terms on loans, easing credit extension terms for new loans, and restructuring existing debt; and working with other institutions to pool resources in order to provide cash, the most essential item in the immediate aftermath of Hurricane Katrina. In general, the financial services industry reacted quickly and aggressively to work with their customers in any way possible to restore the availability of credit and cash in the affected areas of Louisiana.

Diversity

The recent financial crisis has reminded us all of the necessity of having a strong, stable and diverse banking industry in the United States. A diverse banking industry characterized by banks of varying sizes, complexities, specialties, and locations ensures consumers have access to credit and banking services in every corner of the country and around the globe and through every part of the business cycle. Despite the recent collapse of the capital markets and the ensuing recession, the United States still boasts approximately 7,600 insured depository institutions, ranging in size from $1.3 million to over $1.6 trillion in assets.

The past few decades, however, have been marked by a decrease in the total number of insured financial institutions and stunning consolidation of the industry's assets into the largest institutions. In the last 25 years, we have lost 12,362 banks. This represents 62 percent of the total as of December 31, 1985 (*See,* Exhibit 3). While a significant portion of consolidation may be market driven, we do not believe all of the drivers and long-term impact of consolidation are fully understood. As the industry consolidates, the system is increasingly dominated by the largest institutions. In the last 10 years, the top 5 banks have increased their market share from 24 percent to 42 percent of total assets. This industry consolidation raises concerns because of the critical role many smaller institutions play in the communities and States in which they operate.

To ensure a diverse industry, the community banking system must be able to thrive alongside of, and compete with, other banks, regardless of size. A generally agreed upon, but rapidly approaching outdated, definition of a community bank is

[2] Hein, Scott E., Timothy W. Koch, and S. Scott MacDonald, "On the Uniqueness of Community Banks", *Economic Review* (First Quarter, 2005).

an insured depository institution with $1 billion or less in assets. Perhaps a better definition is an institution with a local focus and scope of activities, with the corresponding experience and expertise to excel at relationship lending. A community bank is to a local business what Wall Street is to a Fortune 50 company: not just a lender, but a financial and business adviser.

A strong community banking system is absolutely critical to the well-being of the United States economy. As discussed above, a diverse financial system characterized by strong community banks ensures local economic development and job creation, provides necessary capital for small businesses, and provides stability and continued access to credit during times of crisis. Therefore, it is critical that policies and decisions made in Washington, DC, carefully consider the impact on smaller banks and the communities they serve. Put simply, how community banks are impacted by Dodd-Frank and other regulatory measures is too important not to understand.

The Current Environment for Community Banks

Despite indicators that the national economy and some of the Nation's largest financial institutions are showing signs of improvement, community banks continue to operate—or in too many cases, struggle to survive—in a very challenging environment. The Nation's biggest banks have returned to profitability faster than smaller banks. As of the 4th quarter of 2010:

- Only 12.15 percent of banks over $10 billion in assets remain unprofitable.
- In contrast, 21 percent of institutions under $1 billion in assets remain unprofitable.

During the collapse of the capital markets, the Nation's largest institutions were granted unprecedented and extraordinary Government assistance through a variety of programs and policies to not only remain solvent but to facilitate a return to economic health. Community banks have not received the same extraordinary assistance, and have been operating under an economic recession largely not of their making. In addition, the regulatory environment for community banks has proven unforgiving for miscalculations of risk. Since the start of the crisis in 2008, 348 banks have failed. The overwhelming majority of these banks have been community banks. Most of these failed institutions have been acquired by other community banks, while banks with assets greater than $100 billion have bought only 7 percent of the failed banks. While failures are disruptive at the local level, it is important to note that the regulatory and resolution process for this part of the industry worked. The community banking system is healing itself. We must ensure there is a structure and policies in place which encourage the active participation of community banks in the market. In my State and in my communities, I see needs that will not be met by the biggest institutions. Therefore, we must create an environment that does not drive people and capital away and attracts new entrants to the market. Increasingly, I am hearing a desire from community bankers to merge or sell their institution because they are overwhelmed by regulatory burden and the perception of a Federal system which no longer supports their business model. The model of other concentrated banking systems, like Japan, where collapse was followed by long-term stagnation, should be better understood before we continue down the perhaps irreversible road of further consolidation.

CSBS appreciates that the Dodd-Frank Act was drafted with an eye to preserving the community banking system. CSBS views the Dodd-Frank Act as a reaffirmation of the importance of the dual-banking system and all that it entails: a system of regulatory checks and balances that serves as a counterweight to consolidation both of regulatory authority in Washington, DC, and of influence into a handful of money-center banks; a diverse and competitive industry marked by charter choice and innovation; and access to credit for individuals and businesses in every corner of the country. However, we also understand that uncertainty about the impact of Dodd-Frank, especially when combined with a challenging business environment and general concerns about the direction of regulation, could create a sense of a crushing regulatory environment.

CSBS believes that community bank-oriented Dodd-Frank provisions such as the change in the deposit insurance assessment base which favors smaller, less-risky community banks and the elevation of deposit insurance coverage to $250,000 for individual accounts are critical for community banks. Additionally, the coordination that Dodd-Frank requires among State and Federal regulators, such as the newly created Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC), serve the important goals of improving regulation efficiently and giving voice to a community bank regulatory perspective. Earlier this year, the CFPB signed its first information-sharing memorandum of understanding with CSBS and several State banking departments, a positive indicator that the

CFPB intends to leverage the work of State regulators in protecting consumers and in bringing efficient compliance supervision to the community banking system.

Finally, CSBS appreciates the bill attempts to address the problems created by providing explicit Government guarantees for a cadre of megabanks considered "too big to fail." Addressing—and hopefully eliminating—the competitive advantages created by the perception and reality of being "too big to fail" has direct consequences for community banks. However, whether, and to what extent "too big to fail" has truly been rectified remains unclear. From the standpoint of State banking regulators, evaluating the success of efforts to eliminate "too big to fail" means looking at:

- Whether the cost of funds for institutions becomes more competitive, regardless of the institution's size. Currently, megabanks enjoy a significant advantage in this area and are able to obtain funds at a much more affordable rate than community banks, giving them a clear operational advantage to the majority of the Nation's banks. As demonstrated by Fannie Mae and Freddie Mac, a funding advantage and perceived Federal guarantee can translate into market dominance.
- The efficacy of Dodd-Frank's resolution regime for large complex financial institutions. In a properly functioning, market-driven industry, bank resolutions must be allowed to occur when an institution becomes insolvent. Dodd-Frank did put a resolution regime in place, but until an institution that was once considered "too big to fail" is resolved in an orderly manner, such a regime will remain an empty threat to the biggest banks, and more importantly their investors and creditors, as they operate without fear of consequences for risky actions.
- Whether the banking industry in the United States remains diverse, with institutions of all sizes operating in communities around the Nation by regular chartering of *de novo* institutions to fully serve the dynamic U.S. economy.
- Application of the Dodd-Frank concentration limit. This concentration limit, if implemented successfully, will do much to prevent banks from becoming "too big to fail" and will help ensure a competitive industry.
- Whether the ratings agencies consider being systemic or too big to fail a sign of strength and safety and a reason for a higher rating.
- Whether the cost of being systemic must be real and encourage an overall reduction in risk to the economy. Regulatory policy should clearly dissuade institutions from becoming too big to fail.

The Dodd-Frank Act was a sweeping overhaul of financial regulation and will require significant commitment, time and resources to fully implement. As a result, we are still unaware of the full scope of the impact of Dodd-Frank will have upon the industry as a whole, and community banks specifically. For example, we share our Federal counterparts' concerns about the impact of the interchange fee provision could have upon community banks. As we discussed in a comment letter to the Federal Reserve Board, we do not fully understand the full impact this provision could have. In the near-term, given the condition of the industry, we fear near-term negative consequences for earnings and further impediments to the long term viability of the community banking model (*See,* Exhibit 4).

The financial crisis and recession exposed weaknesses in risk management and supervisory practices which need to be addressed. These include:

- Concentrations;
- Loan underwriting;
- Funding sources, such as brokered deposits and wholesale funding;
- Capital standards; and
- Standards and expectations for *de novo* institutions.

Unfortunately, the potential solutions to these issues only increase the concern of community bankers. A broad brush approach, bright line limitations, and a checklist of risk management requirements will surely over-tax the industry. We need to ensure that regulatory policy in these areas does not further undermine the very industry it is attempting to strengthen. FDIC Chairman Bair's recent comments about community banks and CRE lending reflect this sentiment:

> I believe that supervisory policies need to reflect the reality that most community banks are specialty CRE lenders and that examiners need to focus on assuring quality underwriting standards and effective management of those concentrations. Though hundreds of small banks have become trou-

bled or failed because of CRE concentrations, thousands more have successfully managed those portfolios. We need to learn from the success stories and promote broader adoption of proven risk-management tools for banks concentrated in CRE.[3]

Recommendations To Address Concerns and Preserve Community Banking System

The economic crisis, the resulting recession, and now enhanced regulatory burden have combined to create an incredibly challenging operating environment for community banks. More consideration must be made by policy makers to understand the long-term impact our decisions and actions have upon the community banking system. To that end, I have a few suggestions for implementing a revamped regulatory regime while still encouraging the success of the community banking system.

First, there must be continued coordination and consultation between Federal and State regulators to best understand how local and national economies will be impacted by new regulations. I believe the most effective system of financial supervision is one characterized by both State and Federal financial regulation, what my colleague from New York, Superintendent of Banks Richard Neiman, refers to as "cooperative federalism." A system of supervision based on cooperative federalism allows for comprehensive, effective and efficient supervision of the banking industry. Key components of a State/Federal supervisory system are the proximity of State regulators to the entities we supervise, and our ability to identify emerging threats or trends in the banking industry, as well as the ability of Federal regulators to implement regulations on a national scale and applicable to all market participants.

Second, more analysis is needed to fully understand and appreciate the valuable relationship between community banks and small business. My fellow State regulators and I know anecdotally that the community banking system is at peril, and therefore the small business sector in the United States is also in jeopardy. However, the lack of data and analysis in this area has failed to provide a clear enough understanding to appreciate industry diversity and a viable and competitive community banking system. Significant resources at the Federal level exist to perform such analysis and would provide tremendous benefit to the national economy, but also to your State and local economies. Across the country, different communities benefit from unique community banks that are specifically tailored to meet their needs. Gathering data to better understand and appreciate the business models of community banks will provide greater appreciation for this significant issue on a greater scale and will provide clear justification for a national priority to ensure public policy enables and does not overly burden community banking.

Finally, CSBS recommends that Congress and the Federal regulators investigate ways to tailor regulatory requirements to institutions based upon their size, complexity, geographic location, management structure, and lines of business. The current "one size fits all" approach to regulation, both in terms of safety and soundness and compliance supervision, has fallen harder on community banks and driven dramatic consolidation and bifurcation of the banking industry. Perhaps it is time to explore a bifurcated system of supervision. After all, a bank with a single branch in one State has a dramatically different business model than Bank of America or Citigroup, so it should not be held accountable to the same supervisory structure as institutions which employ thousands of people and operate in hundreds of nations.

Conclusion

As I mentioned at the beginning of my testimony, addressing the challenges facing community banks now is very important and a meaningful exercise. However, as important as understanding the current condition of community banking is, an awareness that decisions made and actions taken today will have a long-term impact on the viability of the community banking model is critical. After the Nation recovers from the recession and the provisions of the Dodd-Frank Act are implemented, what will our banking industry look like? We must ensure industry diversity and full access to credit across the country by creating an environment which benefits all institutions, but particularly the community banks which are so vital to providing stability, access to credit, and support for the small business sector.

CSBS stands ready to work with Members of Congress and our Federal counterparts to create a regulatory regime which encourages industry diversity, creates a

[3] Remarks by FDIC Chairman Sheila C. Bair to the ICBA National Convention, San Diego, California, March 22, 2011, *http://www.fdic.gov/news/news/speeches/chairman/spmar2211.html.*

level playing field for all institutions, and will ultimately strengthen the local economies and the U.S. economy.

Thank you for the opportunity to testify today, and I look forward to answering any questions you may have.

Exhibit 1

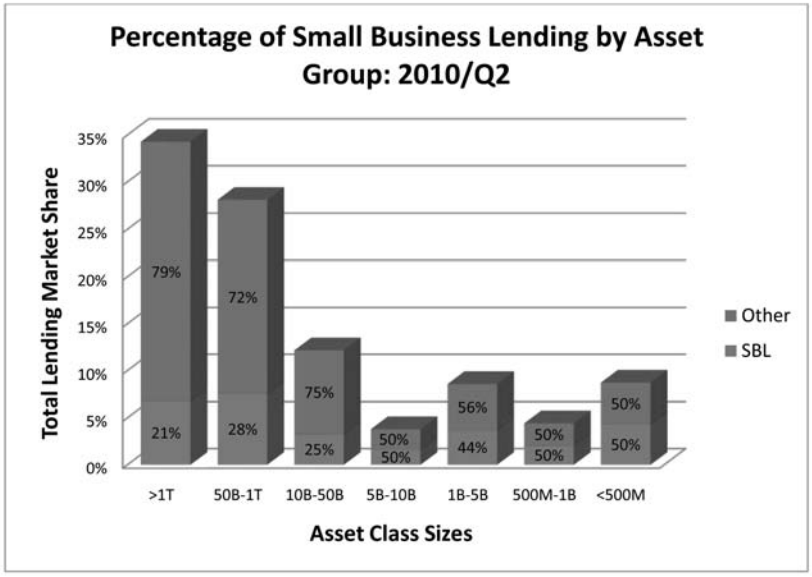
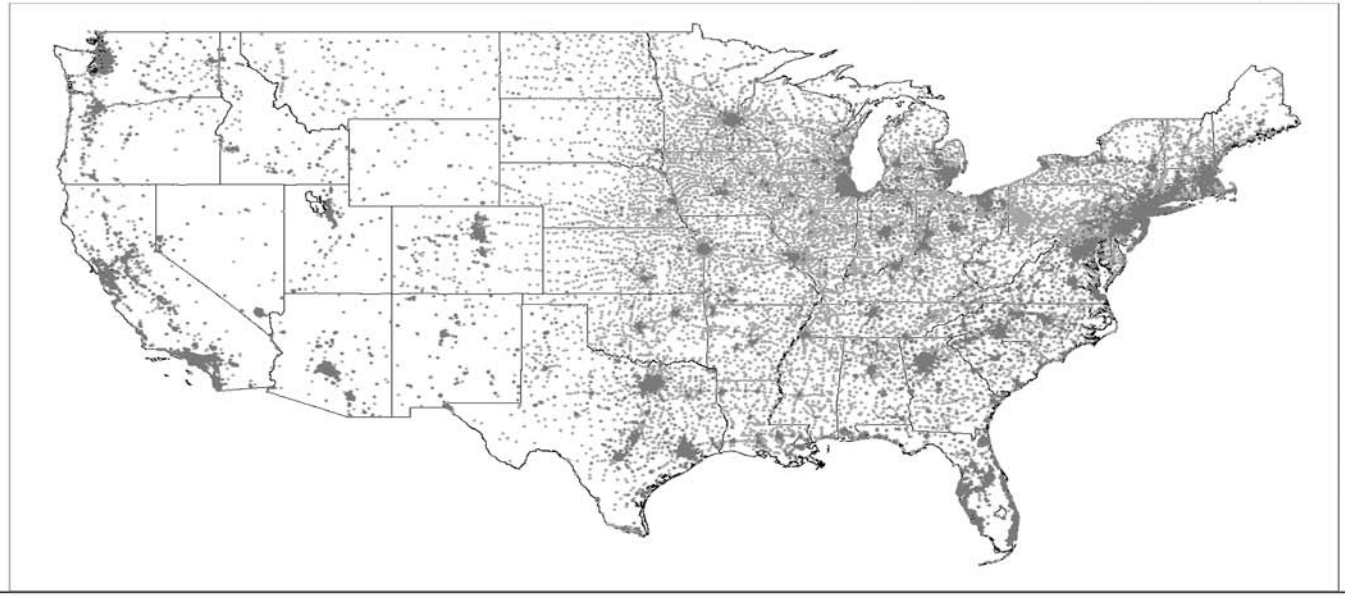


Exhibit 2

Branch locations of Top 7 (red) overlaid on all others (green) as of October 19, 2009

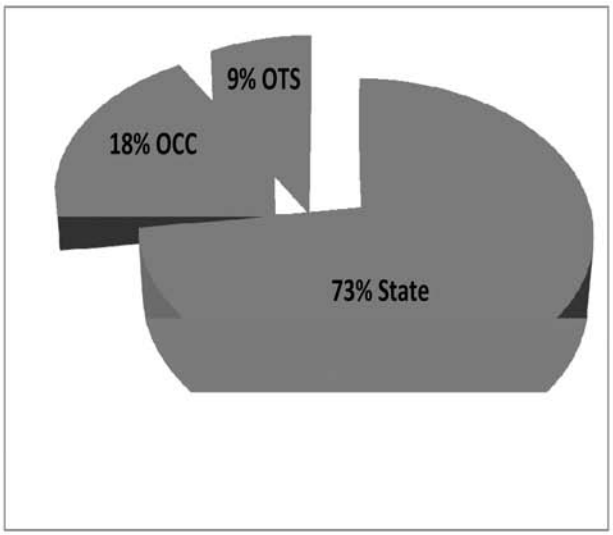


FinPro
Building value together

Exhibit 3

Percentage of Charters by Authority

As of 12/31/2010



Numbers of Charters by Authority

	STATE	%	OCC	%	OTS	%	TOTALS	Change
12/31/2010	5,611	73%	1,386	18%	669	9%	7,666	-355
12/31/2009	5,855	73%	1,465	18%	701	9%	8,021	-293
12/31/2008	6,034	73%	1,540	19%	740	9%	8,314	-393
12/31/2006	6,216	71%	1,723	20%	768	9%	8,707	-1,046
12/31/2000	6,607	68%	2,231	23%	915	9%	9,753	-1,952
12/31/1995	7,676	66%	2,858	24%	1,171	10%	11,705	-1,662
12/31/1992	8,388	63%	3,593	27%	1,386	10%	13,367	

12/31/1985	**Hight Point**	20,028
	Change from 1985 to 2010	-12,362
	Percentage	-62%
	Percentage per annum	-2%

Exhibit 4

February 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, D.C. 20551
Docket No. R-1404
RIN No. 7100-AD63

Dear Ms. Johnson,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Reserve Board's Notice of Proposed Rulemaking (NPR) regarding Debit Card Interchange Fees and Routing. We are concerned that the NPR's response may disproportionately disfavor community banks engaged in debit card issuance, thus raising safety and soundness concerns and potentially driving further consolidation in the banking industry. Accordingly, CSBS recommends extending the rulemaking process to allow time for further study of the implications of the interchange fee alternatives and the small debit card issuer exemption.

Considering the magnitude of this regulation, we do not believe the full impact on the industry is understood. If economic pressures force small debit card issuers to operate at a 12 cent interchange fee, it is possible that many banks will stop issuing cards because their costs do not utilize the same economies of scale as larger financial institutions. This scenario raises safety and soundness concerns as a large revenue stream will be ceased, and will also incentivize further consolidation between debit card issuers and potentially drive customers to alternative products outside of the banking system. Due to these uncertainties, CSBS believes it would be prudent to fully understand the economic consequences across the dual banking system and determine the benefit, if any, to the consumer. We appreciate the opportunity to comment, and would be glad to coordinate any efforts to include state chartered banks in the interchange cost study process.

Sincerely,

Neil Milner
President & CEO

PREPARED STATEMENT OF WILLIAM A. LOVING

PRESIDENT AND CHIEF EXECUTIVE OFFICER, PENDLETON COMMUNITY BANK, FRANKLIN, WEST VIRGINIA, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

APRIL 6, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, my name is William A. Loving, Jr., and I am President and CEO of Pendleton Community Bank, a $250 million asset bank in Franklin, West Virginia. I am pleased to be here today to represent the nearly 5,000 members of the Independent Community Bankers of America. Thank you for convening this hearing on "The State of Community Banking: Challenges and Opportunities."

We appreciate your interest in the community banks of this country, which will undoubtedly play a significant role in any broad based economic recovery because we serve rural, small town, and suburban customers and markets, that are not comprehensively served by large banks. Our business is based on long-standing relationships in the communities in which we live. We make loans often passed over by the large banks because a community banker's personal knowledge of the community and the borrower gives him firsthand insight into the true credit quality of a loan, in stark contrast to the statistical model used by a large bank in another State or region of the country. These localized credit decisions, made one-by-one by thousands of community bankers, will restore our economic strength.

Community banks are prodigious small business lenders. We provide small business credit in good times as well as challenging times—supporting a sector responsible for more job creation than any other. In his recent speech before the ICBA annual convention, Federal Reserve Chairman Ben Bernanke shared new Federal Reserve Bank research that shows that while overall small business lending contracted during the recent recession, lending by a majority of small community banks (those of less than $250 million in assets) actually increased, and small business lending by banks with asset sizes between $250 million and $1 billion declined only slightly. By contrast, small business lending by the largest banks dropped off sharply. The viability of community banks is linked to our small business customers in the communities we serve, and we don't walk away from them when the economy tightens.

When community banks thrive they create a diverse, competitive financial services sector offering real choice, including customized products, to consumers and small businesses alike. An economy dominated by a small number of large banks wielding undue market power and offering commodity products would not provide the same level of competitive pricing and choice. Promoting a vibrant community banking sector is an important public policy goal.

Community Banks Remain Strong

The past few years have been tumultuous for community banks, but the vast majority of them are well capitalized and are helping to lead the economic recovery. Still, community banks were not unaffected by the financial collapse. The weakened economy has caused many consumers to tighten their belts and reduced the demand for credit. Despite the wave of failures and consolidations since the financial crisis, I fully expect the community bank business model will thrive in the future, to the benefit of consumers, small business, and the economy. Many ICBA members have been in business for more than 100 years and have survived the Great Depression and numerous other recessions. The community banking sector will remain vibrant, but policy makers must help by providing relief from overly burdensome regulations.

Oppressive Examination Environment

In addition to contracting demand for credit and impairing asset quality, the financial crisis harmed community banks by provoking an overreaction among bank examiners. The most frustrating aspect of this exam environment is the disconnect between the examiners in the field and the directives from Washington.

A November 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers in order to help initiate and sustain an economic recovery. It stated, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Unfortunately, this policy is often neglected by examiners in the field, especially in the regions most severely affected by the recession. Field examiners are second guessing bankers and independent professional appraisers and demanding unreasonably aggressive write-downs and reclassifications of viable commercial real estate loans and other assets. The misplaced zeal of these examiners is having a chilling effect on lending. Good loan opportunities are passed over for

fear of examiner write down and the resulting loss of income and capital. The contraction in credit is having a direct, adverse impact on the recovery.

Community Banks Are Disproportionately Impacted by Regulation

Community banks have little in common with Wall Street firms, megabanks, or shadow banks and did not cause the financial crisis or engage in abusive consumer practices. Community banks have a much different risk profile because their business model is built on long-term customer relationships, and they cannot succeed without a reputation for fair treatment. For these reasons, ICBA believes it is appropriate to tier regulation of the financial services industry. Overly prescriptive regulation would only reduce community banks' flexibility in serving the unique needs of their customers. Moreover, regulation has a disproportionate impact on community banks because they have fewer resources to dedicate to compliance.

We are pleased the Dodd-Frank Act exhibits a clear preference for tiered regulation of the financial sector—one of the most important precedents of that legislation. We believe Congress should further advance this trend by enacting legislation to provide much needed regulatory relief for community banks, their customers, and their communities. Such legislation should also reduce the tax burden on community banks and narrow the competitive gap between tax-paying community banks and tax-exempt credit unions.

Areas in which ICBA seeks relief include:

- Requiring FASB to conduct a cost/benefit analysis for any proposed accounting change;
- Lowering Small Business Administration origination and program fees for rural and small business borrowers;
- Restoring dividend payments on GSE preferred stock;
- Increasing the SEC shareholder registration threshold;
- Amending the Dodd-Frank Act to restore bank reliance upon external credit ratings; and
- Extending the 5-year net operating loss (NOL) carry back provision.

The Communities First Act (CFA), a bill meeting the broad objectives outlined above, was introduced and advanced during the 109th and 110th Congresses with bi-partisan support. In the 110th Congress, CFA was introduced in the House by then-Small Business Committee Chairwoman Nydia Velazquez (D-NY). The Senate version was introduced by then-Senator Sam Brownback (R-KS).

The 2006 Financial Services Regulatory Relief Act (FSRRA) and other laws were welcome down payments on needed regulatory and tax relief for community banks. These laws have included provisions taken from prior versions of CFA, notably doubling to $500 million the asset size of banks eligible for the extended 18-month exam cycle. Our communities would benefit from the further relief provided by similar legislation in 2011.

The Dodd-Frank Act

The Dodd-Frank Act was generational legislation and will permanently alter the landscape for financial services. Every provider of financial services—including every single community bank—will feel the effects of this new law to some extent. Undeniably, it will result in additional compliance burden for community banks and will be challenging for them. The full and ultimate impact won't be known for years, depending on how the law is implemented and how the market adjusts to it. There's still an opportunity to improve some negative provisions in the law—with the help of this Committee and Congress—and provisions that could be helpful to community banks are still at risk of being weakened in the implementation.

Debit Interchange

By a wide margin, the most troubling aspect of the Dodd-Frank Act is the debit interchange, or "Durbin," amendment. Despite the statutory exemption for institutions with less than $10 billion in assets, which many Senators thought would help community banks; we believe small financial institutions cannot be effectively carved out. Chairman Bernanke, the regulator charged with implementing the new law, conceded this point in a recent hearing before the Senate Banking Committee. Visa's announced two-tiered pricing system, however well-intentioned, also will not work. Small issuers will feel the full impact of the Durbin amendment over time. It's too easy to focus on the large issuers and lose sight of the thousands of community bank issuers who will be harmed if the Federal Reserve proposal is implemented. Not only are small issuers not carved out in practice, they would be disadvantaged relative to large issuers, and a likely consequence of the Federal Re-

serve's proposed rule, if implemented, is further industry consolidation, higher fees, and fewer choices for consumers.

Why won't the carve-out work? The reasons are twofold. First, in addition to the interchange price-fixing provisions of the law and the Federal Reserve proposal, other less-discussed provisions shift control of transaction routing from the card issuer to the merchant. These provisions apply to all financial institutions, regardless of size, and negate the benefit, if any; small financial institutions would gain from the interchange price-fixing exemption. Granting retailers the ability to route debit card transactions over the network of their choice—the card issuer currently designates the network on which its card is routed—will allow retailers to bypass the two-tier system. Further, large retailers will be able to incentivize customers to use the rate-controlled cards issued by the largest financial institutions, discriminating against community banks and their customers. Community bank cards will either be subject to the lower rate or their cards will be neglected by retailers.

There's a second way in which the carve-out fails to shield small issuers. In any two-tier system, the small issuer interchange rate, to the extent that small issuers actually receive it, will surely be lower than the current interchange rate. The payment card networks will be under considerable pressure from their clients with more than $10 billion in assets to narrow the gap between the two tiers.

For these reasons, a tiered system will not protect community banks. Over time, community bank interchange revenue will drop sharply with a direct impact on community bank customers.

What would happen if the current Federal Reserve proposal were implemented? ICBA recently completed a survey of its members, and the results demonstrate that the Federal Reserve proposal would alter the economics of community banking and fundamentally and adversely change the nature of the relationship between a community bank and its customers. Among the survey results: Community banks would be forced to charge their customers for services currently offered for free and that customers have come to expect and value—debit cards, checking accounts, online or mobile banking. Community banks will have difficulty offering their customers—both consumers and small businesses—competitive rates on deposits and loans. It will be harder to qualify for a debit card. Finally, 20 percent of survey respondents say they will have to eliminate jobs or halt plans to open new bank branches—extending the impact from individual consumers to communities. To use my bank as an example, in 2010 we had about 6,250 debit cards outstanding and our profit for the year was approximately $132,000 pretax. If the Federal Reserve proposal goes into effect, I estimate that we could lose, based upon the lowest proposed interchange rate, approximately $237,000 pretax on our debit card program—lost income that we would have to make up through higher fees on our products and services.

Our global payments system works so well that thousands of small community banks are able to stand toe-to-toe and offer services to consumers in direct competition with banks like Citigroup and Bank of America, while providing the quality of relationship service only a community banker can give. The new law and the Federal Reserve proposal would threaten the ability of community banks to compete with large issuers and would bring about further industry consolidation, to the detriment of consumers and small businesses in small town and rural America.

ICBA is grateful to Senators Tester and Corker for introducing S. 575, the "Debit Interchange Fee Study Act," which would delay implementation of the Durbin amendment for 2 years.

Mortgage Risk Retention

Community banks make commonsense mortgages supported by sound, conservative underwriting. As the banking regulatory agencies implement Section 941 of the Dodd-Frank Act, which requires mortgage originators to retain credit risk on nonqualified residential mortgages, ICBA strongly urges them not to define "qualified residential mortgage," or QRM, too narrowly. An unreasonably narrow definition of QRM will drive thousands of community banks from the residential mortgage market, leaving it to only a few of the largest lenders. Too narrow a definition will also severely limit credit availability to many borrowers who are creditworthy though unable to make significant down payments. In ICBA's view, the definition of QRM should be relatively broad and encompass the largest portion of the residential mortgage market, consistent with the stronger underwriting standards called for by the Act. An unduly narrow definition of QRM will disadvantage community banks because they lack access to the increased capital needed to offset risk retention requirements, despite conservative underwriting. What's more, community banks operating in rural areas will be driven out of the market by Farm Credit System direct lenders who carry an exemption for the loans or other financial assets that they make, insure, guarantee or purchase.

We are currently reviewing the proposed rule released last week, which is over 300 pages and raises scores of questions. While I am sure we will offer many suggested changes, overall, for the community banking industry, there are many positive provisions in the proposal, notably, the exemption from the QRM standards and risk retention requirements for loans sold to Fannie Mae and Freddie Mac, as long as they have Government capital. Because the vast majority of residential mortgages originated by community banks are conforming loans sold to Fannie Mae and Freddie Mac, the proposal would preserve the ability of community banks to continue to provide their customers with long-term mortgages. ICBA is also pleased that the proposed rule does not impact mortgage loans held in portfolio and focuses the risk retention requirement on securitizers, not originators.

Consumer Financial Protection Bureau

While we are pleased the Dodd-Frank Act allows community banks with less than $10 billion in assets to continue to be examined by their primary regulators, ICBA remains concerned about CFPB regulations, to which community banks will be subject. ICBA strongly opposed provisions in the Dodd-Frank Act that excluded the prudential banking regulators from the CFPB rule-writing process. Bank regulators are in the best position to balance the safety and soundness of banking operation with the need to protect consumers from unfair and harmful practices and provide them with the information they need to make informed financial decisions.

The Act gives the prudential regulators the ability to comment on CFPB proposals before they are released for comment and an extremely limited ability to veto regulations before they become final. This veto can only be exercised if, by a 2/3 vote, FSOC determines that a rule "puts at risk safety and soundness of the banking system or the stability of the financial system," an unreasonably high standard and one that should be amended. ICBA supports changing the standard so the FSOC is permitted to veto a CFPB rule that could adversely impact a subset of the industry in a disproportionate way. We believe this standard would give prudential regulators a more meaningful role in CFPB rule writing.

Absent such legislation, ICBA encourages the CFPB to reach out to community banks as they contemplate rules—before proposed rules are issued—to better understand how proposed rules would impact community bank operations and community bank customers. In particular, any rules that privilege "plain vanilla" products (credit cards, mortgages, *etc.*) would adversely impact community banks, who are frequently the only providers who are willing to customize products to meet customer needs.

Any enhanced consumer protection laws should focus on the "shadow" financial industry which has been most responsible for victimizing consumers while avoiding serious regulatory scrutiny. This segment of the financial services industry should be brought under the same regulatory and supervisory umbrella as commercial banks. ICBA supports a balanced regulatory system in which all financial firms that grant credit are subject to meaningful supervision and examination. Under Dodd-Frank, the CFPB has discretion in defining nondepository "covered persons" subject to CFPB rules, examination and enforcement. ICBA urges the CFPB to broadly define "covered persons."

Community banks are already required to spend significant resources complying with voluminous consumer protection statutes. CFPB rules should not add to these costs. The Dodd-Frank Act gives the CFPB authority to exempt any class of providers or any products or services from the rules it writes considering the size of the entity, the volume of its transactions and the extent to which existing law already has protections.

ICBA urges the CFPB to use this authority to grant broad relief to community banks and/or community bank products where appropriate.

The Dodd-Frank Act is a mixed outcome for community banks. I've noted some of our concerns, but the legislation also gave us an opportunity to advance long sought priorities.

Too-Big-To-Fail

ICBA has long expressed concerns about too-big-to-fail banks and the moral hazard they pose, well before the financial crisis. Community banks are more finely tuned to these concerns because we and our customers feel the direct impact. It's challenging for us to compete against megabanks whose too-big-to-fail status gives them funding advantages. For this reason, we're pleased the Act takes steps to mitigate too-big-to-fail.

ICBA supported the creation of the Financial Stability Oversight Council (FSOC) whose duties include identifying and responding to risks to financial stability that could arise from the failure of a large, interconnected bank or nonbank. We are

pleased that Dodd-Frank provides for enhanced prudential standards for systemically risky firms, including higher capital, leverage, and liquidity standards, concentration limits and contingent resolution plans. Firms subject to these higher standards should include, but not necessarily be limited to, large investment banks, insurance companies, hedge funds, private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special purpose vehicles, and nonbank mortgage origination companies.

We also support the FDIC's new resolution authority to empower it to unwind large, systemically risky financial firms. The Government must never again be forced to choose between propping up a failing firm at taxpayer expense and allowing it to fail and wreak havoc on the financial system. Powerful interest groups are lobbying doggedly to undermine the too-big-to-fail provisions of Dodd-Frank, which are essential to creating a robust and competitive financial services sector to the benefit of consumers, businesses, and the economy. We urge this committee to ensure that these provisions are upheld and enforced.

Deposit Insurance

ICBA was a leading advocate for the deposit insurance provisions of the Act, including the change in the assessment base from domestic deposits to assets (minus tangible equity), which will better align premiums with a depository's true risk to the financial system and will save community banks $4.5 billion over the next 3 years. The deposit insurance limit increase to $250,000 per depositor and the 2-year extension of the Transaction Account Guarantee (TAG) Program, which provides unlimited deposit insurance coverage for non- interest-bearing transaction accounts, will help to offset the advantage enjoyed by the too-big-to-fail megabanks in attracting deposits.

Small Business Lending Fund

ICBA fully supports the $30 billion Small Business Lending Fund (SBLF) program. This program will provide capital for interested community banks to increase small business lending in their communities and boost economic growth. With the private capital markets for small and midsized banks still largely frozen since the financial crisis, SBLF provides an important alternative source of capital for interested healthy banks, structured to incentivize increased lending. We urge Treasury to complete the term sheets for Subchapter S and Mutual banks so they too can have access to tier 1 SBLF capital as Congress intended.

Closing

Thank you again for your interest in and commitment to community banks and for the opportunity to testify today. I've outlined some of the more significant regulatory challenges we face in the months ahead. Negotiating these challenges will help us to serve our communities and promote the economic recovery—a goal we share with this Committee. Thank you for hearing our concerns. We look forward to working with you.

PREPARED STATEMENT OF TOMMY G. WHITTAKER

PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE FARMERS BANK, PORTLAND, TENNESSEE, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

APRIL 6, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, my name is Tommy Whittaker, President and Chief Executive Officer, The Farmers Bank, Portland, Tennessee. The Farmers Bank was chartered in 1912 and is a $560 million institution with 11 offices and 152 employees. We serve Robertson and Sumner Counties in northern middle Tennessee, with a population of approximately 130,000 people. I appreciate the opportunity to present the views of the ABA on the state of community banking and the challenges and opportunities that we face. The ABA represents banks of all sizes and charters and is the voice of the Nation's $13 trillion banking industry and its two million employees.

At my bank, as is true of my banker colleagues around the country, we are intensely focused on building and maintaining long-term relationships with our customers. It is because of these relationships The Farmers Bank will be celebrating a century of service to our customers and community in 2012. We cannot be successful without such a long-term philosophy and without treating our customers fairly.

We are proud to say we have been in business for almost 100 years, but our long tradition of service is not unique among banks. In fact, there are 2,735 banks—35 percent of the banking industry—that have been in business for more than a cen-

tury; 4,937 banks—64 percent—have served their local communities for more than half a century. These numbers tell a dramatic story about the staying power of banks and their commitment to the communities they serve.

The success of The Farmers Bank is inextricably linked to the success of the communities we serve, and we are very proud of our relationships with them. They are, after all, our friends and neighbors.

Let me give you just a glimpse of The Farmers Bank's close ties with our communities. We have $348 million in loans on our books. Included in that number are approximately 175 loans, totaling $3.8 million to our farmers for agricultural operations, 750 loans, totaling $29.2 million to our local businesses for their commercial and business needs, 633 loans, totaling $191.2 million to developers for commercial construction projects and farmers for purchase of farm land, and 1,765 loan, totaling $116 million for the construction and financing of 1 to 4 family homes. In addition, we have $4 million in loans to our local municipalities that help them fund improvements to services to their cities.

Not only do we provide the funding to meet the credit needs for our communities, our people are truly a part of these communities. For example, each year our bank participates in the ABA's National Teach Children To Save Day. In 2010, we had 26 employees volunteer their time in fifteen area schools. We had another 22 employees involved in community organizations, such as The Chamber of Commerce, Lions Club, Rotary Club, and numerous other Civic Clubs. Moreover, in the last 2 years, our bank has donated over $112,000 for scholarships, community events, and other local projects.

When a bank sets down roots, communities thrive. A bank's presence is a symbol of hope, a vote of confidence in a town's future. The health of the banking industry and the economic strength of the Nation's communities are closely interwoven. We strongly believe that our communities cannot reach their full potential without the local presence of a bank—a bank that understands the financial and credit needs of its citizens, businesses, and Government. I am deeply concerned that this model will collapse under the massive weight of new rules and regulations. The vast majority of banks never made an exotic mortgage loan or took on excessive risks. They had nothing to do with the events that led to the financial crisis and are as much victims of the devastation as the rest of the economy. We are the survivors of the problems, yet we are the ones that pay the price for the mess that others created.

Banks are working every day to make credit and financial services available. Those efforts, however, are made more difficult by regulatory costs and second-guessing by bank examiners. Combined with hundreds of new regulations expected from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional community banks, handicapping our ability to meet the credit needs of our communities.

Managing this mountain of regulation will be a significant challenge for a bank of any size. The median-sized bank has only 37 employees—for them, and for banks like mine, this burden will be overwhelming. Historically, the cost of regulatory compliance as a share of operating expenses is two and a half times greater for small banks than for large banks. Moreover, it creates more pressure to hire additional compliance staff, not customer-facing staff. It means more money spent on outside lawyers to manage the risk of compliance errors and greater risk of litigation. It means more money to hire consulting firms to assist with the implementation of all of the changes, and more money hiring outside auditors to make sure there are no compliance errors. It means more risk of regulatory scrutiny, which can include penalties and fines. All of these expenditures take away precious resources that could be better used serving the bank's community.

The consequences are real. Costs are rising, access to capital is limited, and revenue sources have been severely cut. It means that fewer loans get made. It means a weaker economy. It means slower job growth. With the regulatory over-reaction, piles of new laws, and uncertainty about Government's role in the day-to-day business of banking, meeting local community needs is difficult at best.

Without quick and bold action to relieve regulatory burden we will witness an appalling contraction of the banking industry, with a thousand banks or more disappearing from communities all across the Nation over the next few years. These are good banks that for decades have been contributing to the economic growth and vitality of their towns, cities, and counties but whose financial condition is being undermined by excessive regulation and Government micro-management. Each bank that disappears from the community makes that community poorer.

Congress must be vigilant in overseeing regulatory actions that unnecessarily restrict loans to creditworthy borrowers. Holding oversight hearings like this one is critical to ensure that banks are allowed to do what they do best—namely, meet the credit needs of their communities.

In my testimony today, I'd like to focus on three key themes:

- New rules substitute Washington bureaucratic judgment for that of local bankers
  - Increasingly, the Government has inserted itself in the day-to-day business of banking. The Government should not be in the business of micro-managing private industry. Traditional banks tailor products to borrowers' needs in local communities, and prescriptive rules inevitably translate into less access to credit and banking services.
  - The most egregious example is the price-controls on interchange fees resulting from the Federal Reserve's implementation of the Durbin Amendment in the Dodd-Frank Act. Such actions will have significant unintended consequences. The legislation introduced by Senators Tester and Corker—S. 575—rightly recognizes that the Federal Reserve's rule will cause significant and immediate harm to community banks, consumers and the broader economy. The ABA strongly supports S. 575 and urges fast action to adopt this important legislation.
- New laws end up punishing community banks that had nothing to do with the crisis
  - Each change in law adds another layer of complexity and cost of doing business. Dodd-Frank rules threaten to drive community banks out of lines of business altogether, particularly mortgage lending and services to municipalities. It has also stimulated an environment of uncertainty and added new risks that will inevitably translate into fewer community financial services.
- The consequences for consumers and the economy are severe
  - The Dodd-Frank Act will raise costs, reduce income, and limit potential growth, all of which drives capital away from banking, restricts access to credit for individuals and business, reduces financial resources that create new jobs, and retards growth in the economy.

I will discuss each of these in detail in the remainder of my testimony.

I. Individual Rules Substitute Washington Bureaucratic Judgment for That of Bankers in Local Communities

Increasingly, the Government has inserted itself in the day-to-day business of banking. Micro-managing private industry should not be the role of Government. Inevitably it leads to negative unintended consequences.

The most egregious example is the price-controls for interchange fees being promulgated by the Federal Reserve under the Durbin Amendment. The result devastates retail bank profitability, stifles innovation, lowers productivity in our economy and forces a number of individuals out of the protection of the banking system.

The price-controls proposed by the Federal Reserve in the implementing rule will reduce interchange income by as much as 85 percent. Some will say that the so-called "carve-out" from the Federal Reserve's rule under Dodd-Frank for community banks (under $10 billion in assets) will protect community bank earnings. Nothing could be further from the truth. *Having two different prices for the exact same product is not sustainable.* The price cap proposed by the Federal Reserve is so severe that it creates enormous economic incentives for retailers to adopt strategies to favor the cards with lower interchange rates. Market share will always flow to the lowest priced product, even if those lower prices are mandated only for some. The result for small banks is either a loss of market share, loss of revenue that supports free checking and other valuable services, or both.

Revenue from interchange in many cases does not cover the cost of providing debit card services. With the Federal Reserve's proposal, debit cards would be completely unprofitable. In fact, the proposed rule dictates that banks must lose money on every debit card transaction we process unless we charge consumers more. It makes no sense to force any provider of any service to offer products below the cost of producing them. I cannot offer financial services if I cannot cover the costs of doing so and provide a reasonable return to my shareholders.

Consumers have embraced debit cards for obvious reasons—they are fast, safe, and accepted around the world. It is consumers who will be severely affected by the Government-mandated price control in the Federal Reserve's proposed rule. It will cause new consumer fees, probably including checking account fees, and likely push low-income customers out of the banking system.

Such an important change did not receive the thoughtful and thorough consideration in Congress it deserved. The process, in fact, was deeply flawed. *It should be revisited and Congress should take immediate action to stop the proposed Federal Reserve interchange rule from being implemented.*

The ABA is grateful for the willingness of Senators Tester and Corker, and the many other cosponsors of S. 575 to reconsider the harmful, unintended consequences that will result from the Federal Reserve's proposal to implement the Durbin Amendment.

S. 575 rightly recognizes that the Federal Reserve's rule will cause significant and immediate harm to community banks, consumers and the broader economy. Various concerns over the proposed rule have been raised in recent weeks by bank regulators, including Federal Reserve Chairman Ben Bernanke and Sheila Bair, chairman of the Federal Deposit Insurance Corporation, and by numerous lawmakers from both sides of the political aisle.

The clear implication is that more time to study the impact of this provision is definitely warranted, especially considering that the Durbin Amendment was adopted at the 11th hour, without hearings, Committee action or informed debate.

It is for these and other reasons that we strongly support S. 575 and are thankful that the Senate has taken the first step toward stopping the Fed's rule and thereby protecting consumers, banks and the broader economy. We urge quick action to enact this important piece of legislation.

II. The Cumulative Burden of Hundreds of New or Revised Regulations Will Lead to a Massive Consolidation of the Banking Industry

Banks have to be profitable and provide a reasonable return to investors. If they do not, capital quickly flows to other industries that have higher returns. The Dodd-Frank Act, in combination with intense regulatory over-reaction, has increased expenses, decreased potential revenue, and limited community bank access to capital. Added to greater uncertainty about new regulatory and legal risks, these pressures directly take resources away from the true business of banking—making loans in local communities.

The impact of Dodd-Frank and bank supervision on community banks can be broken down into four categories: (1) higher operating costs to comply with scores of new rules; (2) pressures on capital; (3) restraints that may drive community banks out of lines of business; and (4) greater uncertainty and risk. As I will discuss in the next section, all of these will have severe consequences for consumers and communities that banks serve.

1. Dodd-Frank Rules Increase Costs of Doing Business

The Dodd-Frank Act will have an enormous and negative impact on all community banks. Already there are nearly 2,000 pages of new proposed rules and there will be many thousands more as the 200+ rules under the Act are promulgated. This is on top of the 50 new or expanded regulations affecting banks over the 2 years leading up to the enactment of the Dodd-Frank Act. This flood of new regulations is so large that regulators are urging banks to add new compliance officers to handle it.

The Farmers Bank is typical of many community banks in the U.S., and I know how demanding the crush of paperwork is for my staff. It is hard enough to deal with one new regulation or a change in an old one, but with reams of new proposals and reams of final regulations, it is overwhelming. We used to close many of our loans internally with our loan officers assuring compliance with all the requirements. This model simply will not work now with all the new requirements and we are very likely to seek outside compliance help to assure that we are in compliance.

Managing compliance with these new requirements adds time and costs—all of which makes it more difficult and costly to make loans to our customers. It is a sad commentary when our investment dollars this year and next—and probably longer—will be spent on compliance with the Dodd-Frank Act rather than making new loans, products and services available. There are many community banks smaller than mine, and I cannot imagine the pressure they face with fewer employees. The cumulative burden of hundreds of new or revised regulations may be a weight too great for many smaller banks to bear.

Of particular concern is the additional regulatory and compliance burden expected once the Bureau of Consumer Financial Protection (CFPB) becomes fully operational. This new bureaucracy—expected to hire over 1,200 new staff—will certainly impose new obligations on community banks—banks that had nothing to do with the financial crisis and already have a long history of serving consumers fairly in a competitive environment.

One of the claims was that small banks would be exempt from the new CFPB. But small banks are not exempt. All banks—large and small—will be required to comply with rules and regulations set by the CFPB, including rules that identify what the CFPB considers to be "unfair, deceptive, or abusive." Moreover, the CFPB can require community banks to submit whatever information it decides it "needs."

There are also many other new regulatory burdens flowing from the Dodd-Frank Act empowerment of the CFPB which will add considerable compliance costs to every bank's bottom line.

It is true that although the CFPB will not regularly examine community banks for compliance with its rules, it can join the prudential regulator by doubling up during any such exam at the CFPB's sole discretion. It is also true that bank regulators will examine for compliance at least as aggressively as the CFPB would do independently. In fact, the FDIC has created a whole new division to implement the rules promulgated by the new CFPB, as well as its own prescriptive supervisory expectations for laws beyond FDIC's rule-making powers. Thus, the new legislation will result in new compliance burdens for community banks and a new regulator looking over their shoulders.

Dodd-Frank also adds to the compliance burden by unleashing a fragmented enforcement mechanism that empowers Attorneys General to invent their own interpretations of Federal standards and bring actions without regard for the exam conclusions of the CFPB or the prudential regulators. This generates increased regulatory uncertainty and litigation risk that will chill innovation and raise barriers to market competition, especially for banks without an army of lawyers to navigate the enforcement minefield.

Where the CFPB should focus its energies is on supervision and examination of nonbank financial providers. Many of the problems that led to the financial crisis began outside the regulated banking industry and creation of the CFPB was largely a result of this enormous gap in the system that ultimately led to problems. *We urge Congress to ensure that this focus on nonbanks is a priority of the CFPB.*

My bank's philosophy—shared by community banks everywhere—has always been to treat our customers right and do whatever we can to make sure that they understand the terms of the loans they are taking on and their obligations to us. We will continue to do this, but now there will be many new hurdles that we will have to jump to serve our customers' most basic needs that will inevitably add cost, time, and hassle for my customers.

The bottom line is the more time bank personnel devote to parsing regulatory requirements, the less time they can devote to the financial and credit needs of bank customers. Adding such a burden on banks that had nothing to do with the financial crisis constitutes massive overkill. In the end, this cumulative burden will only impede fair competition among trusted providers seeking to serve responsible customers.

Much needs to be done to reverse the burdens Dodd-Frank threatens to impose through the CFPB. We recommend the following steps as only a beginning:

- Eliminate the expansive definition of "abusive" practices since appropriate use of existing unfair and deceptive practices authority is more than adequate;
- Prohibit Attorneys General from enforcing Federal standards subject to Federal supervision, or at least limit such actions to remedy only conduct occurring after the last CFPB or prudential regulator examination; and
- Prevent States and prudential regulators from augmenting or interfering with consumer protections otherwise covered by CFPB rules.

2. Access to New Capital for Community Banks Is Problematic

Capital is the foundation upon which all lending is built. Having sufficient capital is critical to support lending and to absorb losses when loans are not repaid. In fact, $1 worth of capital supports up to $10 in loans. Most banks entered this economic downturn with a great deal of capital, but the downward spiral of the economy has created losses and stressed capital levels. Not surprisingly, when the economy is weak, new sources of capital are scarce.

The timing of the Dodd-Frank limitations on sources of capital could not have been worse, as banks struggle to replace capital used to absorb losses brought on by the recession. While the market for trust preferred securities (which had been an important source of capital for many community banks) is moribund at the moment, the industry needs the flexibility to raise capital through various means in order to meet increasing demands for capital. Moreover, the lack of readily available capital comes at a time when restrictions on interchange and higher operating expenses from Dodd-Frank have already made building capital through retained earnings more difficult.

These limitations are bad enough on their own, but the consequences are exacerbated by bank regulators piling on new requests for even greater levels of capital. As I travel the country, I often hear how regulators are pressing many banks to increase capital-to-assets ratios by as much as 4 to 6 percentage points—50 to 75 percent—above minimum standards. For many banks, it seems like whatever level of

capital they have, it is not enough to satisfy the regulators. This is excess capital not able to be redeployed into the market for economic growth.

Thus, to maintain or increase capital-to-assets levels demanded by the regulators, these *banks have been forced to limit, or even reduce, their lending.* The result: the banking industry becomes smaller while loans become more expensive and harder to get.

Ever-increasing demands for more capital puts a drag on the economy at the worst possible time for our Nation's recovery. Moreover, it works at cross purposes with banks' need for the strong and sustainable earnings that will be the key to addressing asset quality challenges. *Therefore, anything that relieves the increasing regulatory demands for more capital will help banks make the loans that are needed for our Nation's recovery.*

3. Dodd-Frank Rules May Drive Community Banks Out of Lines of Business

Congress must be vigilant in its oversight of the efforts to implement the Dodd-Frank Act to ensure that rules are adopted only if they result in a benefit that clearly outweighs the burden. Already we are seeing proposals—such as those implementing the rules regarding interchange, municipal advisors, and swaps transactions—that fail that simple test. Some rules under Dodd-Frank, if done improperly, will literally drive banks out of lines of business. New rules on registration as municipal advisors and on mortgage lending are two particularly problematic provisions.

New SEC rules on municipal advisors—if done improperly—will drive community banks out of providing basic banking products to local and State governments

ABA believes that Dodd-Frank intended to establish a regulatory scheme for unregulated persons providing advice to municipalities with respect to municipal derivatives, guaranteed investment contracts, investment strategies or the issuance of municipal securities. Most community banks, like The Farmers Bank, do not deal in bonds or securities. But community banks do offer public sector customers banking services and we are regulated closely by several Government agencies.

The Securities and Exchange Commission has proposed a very broad definition of "investment strategies" that would cover traditional bank products and services such as deposit accounts, cash management products and loans to municipalities. This means that community banks would have to register as municipal advisors and be subject to a whole new layer of regulation on bank products for no meaningful public purpose. The result of this duplicative and costly regulation: community banks like mine may decide not to provide banking services to their local muncipalities, forcing these local and State entities to look outside of their community for the services they need. This proposal flies in the face of the President's initiative to streamline Federal oversight and avoid new regulations that impede innovation, diminish U.S. competitiveness, and restrain job creation and economic expansion.

We urge Congress to oversee this implementation and ensure that the rule addresses unregulated parties and that neither Section 975 of Dodd-Frank nor its implementing regulation reaches through to traditional bank products and services.

New proposed mortgage rules likely to drive many community banks out of mortgage lending

The housing and mortgage markets have been battered in recent years and are still struggling to recover. Addressing the systemic problems which led to the crisis is critical, but care must be taken to avoid unnecessary actions that do not address systemic issues and which could further destabilize the fragile recovery. *We have grave concerns that the risk retention proposal issued by the regulators last week will drive community banks from mortgage lending and shut many borrowers out of the credit market entirely.* It is true that the proposal's immediate impact is muted by the fact that loans sold to Fannie Mae and Freddie Mac while they are in conservatorship escape risk retention. However, once the rule's requirements are imposed broadly on the market (should they be adopted) they would likely shut out many borrowers entirely and act to destabilize an already fragile market. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, it is important that risk retention requirements be rational and non disruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

Therefore, ABA urges Congress to ensure that the regulators revise the risk retention regulation before it is imposed on the mortgage market broadly. Specifically we recommend:

- Exemption from risk retention provisions must reflect changes in the market already imposed through other legislative and regulatory change.

  • In the Dodd-Frank Act, Congress determined that some form of risk retention was desirable to ensure that participants in a mortgage securitization transaction had so-called "skin in the game." The goal was to create incentives for originators to assure proper underwriting (*e.g.,* ability to repay) and incentives to control default risk for participants beyond the origination stage. There have already been dramatic changes to the regulations governing mortgages.[1] The result is that mortgage loans with lower risk characteristics—which include most mortgage loans being made by community banks today—should be exempted from the risk retention requirements—regardless of whether sold to Fannie Mae and Freddie Mac or to private securitizers. Exempting such "qualified residential mortgage" loans (QRM) is important to ensure the stability and recovery of the mortgage market and also to avoid capital requirements not necessary to address systemic issues. However, the QRM as proposed is very narrow and many high-quality loans posing little risk will end up being excluded. This will inevitably mean that fewer borrowers will qualify for loans to purchase or refinance a home.

  • For example, for the loan to qualify, borrowers must make at least a 20 percent down payment—and at least 25 percent if the mortgage is to be a refinance (and 30 percent if it is a cash-out refinance).

  • Certainly loans with lower loan-to-value (LTV) ratios are likely to have lower default rates, and we agree that this is one of a number of characteristics to be considered. However, the LTV should not be the only characteristic for eligibility as a "Qualified Residential Mortgage," and it should not be considered in isolation. Setting the QRM cutoff at a specific LTV without regard to other loan characteristics or features, including credit enhancements such as private mortgage insurance, will lead to an unnecessary restriction of credit. To illustrate the severity of the proposal, even with private mortgage insurance, loans with less than 20 percent down will not qualify for the QRM.

  • ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank.

- The Risk Retention Requirements as proposed will inhibit the return of private capital to the marketplace and will make ending the conservatorship of Fannie Mae and Freddie Mac more difficult.

  • The proposal presented by the regulators will make it vastly more difficult to end the conservatorship of Fannie and Freddie and to shrink FHA back to a more rational portion of the mortgage market. As we observed earlier, under the proposed rule, loans with a Federal guarantee are exempt from risk retention—including loans sold to Fannie Mae and Freddie Mac while they are in conservatorship. Because of their conservatorship status, the GSEs have the backing of the Federal Government. FHA loans (as well as other federally insured and guaranteed loan programs) are also exempt. Since almost 100 percent of new loans today being sold are bought by Fannie and Freddie or insured by FHA—and as long as these GSEs can buy loans without risk retention—it will be dramatically more difficult for private securitizers to compete. In fact, the economic incentives of the proposed risk retention strongly favor sales of mortgages to the GSEs in conservatorship and not to private securitizers. Thus, this proposal does not foster the growth of private label securitizations that would reduce the role of Government in backing loans.

  • Equally important is the fact that the conservatorship situation is unsustainable over the long term. That means that eventually, these highly narrow and restrictive rules would apply to a much, much larger segment of the mortgage market. That means that fewer borrowers will qualify for these QRM mortgage loans and the risk retention rules make it less likely that community banks will underwrite non-QRM—but prudent and safe—loans. Some community banks may stop providing mortgages altogether as the requirements and compliance costs make such a service unreasonable without considerable volume. Driving community banks from the mortgage marketplace would be

[1] For example, changes have been made under the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), and the Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act. In addition, the Federal bank agencies have just announced significant changes to appraisal standards.

counterproductive as they have proven to be responsible underwriters that have served their borrowers and communities well.

The imposition of risk retention requirements to improve underwriting of mortgage loans is a significant change to the operation of the mortgage markets and must not be undertaken lightly. *ABA urges Congress to exercise its oversight authority to assure that rules adopted are consistent with the intent of the statute and will not have adverse consequences for the housing market and mortgage credit availability.*

There are other related concerns affecting housing that need to be addressed by Congress as well. In particular, Congress needs to make the "Qualified Mortgage" in Title XIV a true safe harbor and ensure that it does not unnecessarily constrict credit. Title XIV of Dodd-Frank sets out new consumer protections for mortgage loans. As defined in Title XIV, a Qualified Mortgage (QM) is one which has specific features and is underwritten in such a way that it is presumed to meet these consumer protection standards. That presumption, however, can be rebutted—subjecting the lender to significant potential liability. The Qualified Mortgage definition (as set in statute and as refined through regulation) also serves as a limitation on the Qualified Residential Mortgage (QRM) standard discussed above because the QRM cannot be broader than the QM. As the law stands now, the Federal Reserve Board (and eventually the CFPB after the transfer of powers) can unilaterally narrow both the QM and QRM.

To avoid inadvertent and unintended impacts on safety and soundness as well as credit availability, ABA strongly urges Congress to require that any changes which could narrow the eligibility requirements for the QM be undertaken jointly with the regulators responsible for determining eligibility under the QRM.

4. Regulatory Risk and Uncertainty Are Rising, Reducing Incentive To Lend

Businesses—including banks—cannot operate in an environment of uncertainty. Unfortunately, Dodd-Frank increases uncertainty for banks, and as a consequence, raises credit risks, raises litigation risks and costs (for even minor compliance issues), leads to less hiring or even a reduction in staff, makes hedging risks more difficult and costly, and restricts new business outreach. All of this translates into less willingness to make loans. In fact, banks' biggest risk has become regulatory risk. Let me illustrate the regulatory risk and uncertainty with four examples: (1) the unknown burden that will arise from the Bureau of Consumer Financial Protection; (2) the potential lawsuits that may arise on preemption; (3) the potential risk of future price controls following the precedent set by the Durbin Amendment; and (4) the potential loss of effective methods to hedge risk from rules on use of swap contracts.

The Nature and Extent of Rules From CFPB Are Unknown

As discussed above, the CFPB has significant authority to create new rules for consumer lending. What will happen is unknown, but it does create potential litigation risk for actions taken now that may conflict with the ultimate rules devised. The expectation of significant new disclosures will translate into less willingness to lend (and therefore less credit extended overall), greater costs for any loans that are made, and higher costs to borrowers that still have access to credit to cover the added risks undertaken by banks.

Preemption Uncertainty and State Attorneys General Given More Power

One important example of uncertainty and unease created by Dodd-Frank arises from the provisions regarding preemption. Congress explicitly preserved in the Dodd-Frank Act the test for preemption articulated by the United States Supreme Court for deciding when a State law is preempted by the Federal laws that govern national banks' activities. Nevertheless, any mention of the preemption standard in a statute is likely to generate lawsuits from those who argue that the standard somehow has changed.

The standard for Federal thrifts has changed, from an "occupation of the field" test to the same "conflicts" test that has applied, and continues to apply, to national banks. This creates uncertainty, will lead to years of litigation, and places savings associations at greater risk of suits over whether a patchwork of State laws applies.

The Dodd-Frank Act preemption provisions will affect all banks, including State-chartered banks and thrifts that benefit from wild-card statutes. State attorneys general will have greater authority to enforce rules and regulations, specifically including those promulgated by the CFPB. Moreover, in the case of State-chartered institutions, the State AGs may enforce the Dodd-Frank Act even in the absence of implementing regulations. This means that State AGs soon may be in the business of deciding what is an unfair, deceptive, or abusive act or practice for State banks.

Price Control Precedent Poses Future Risks

As discussed above, Government involvement in price controls related to interchange fees will create many negative unintended consequences. But the concern about the Durbin Amendment goes far beyond the impact on my bank, my customers, and the economy. It sets a dangerous precedent, suggesting that financial institutions may be subject to future, unknowable price controls on other financial products and services, undermining important free-market principles.

We have always accepted the operational, reputational, and financial risk associated with developing new products and services and making them available to millions of consumers. Now financial institutions risk losing their investments of billions of dollars into improvements of existing products and services, and the creation of new ones, through Government price controls. Why would any business invest in an innovative product knowing the Government *ex post facto* will interfere and completely dismantle its free-market business model by imposing price controls? The Durbin Amendment serves as a strong disincentive for innovation and investment by financial institutions in other emerging payment systems and financial products and services. In the end, it is the American public who suffers.

Banks Face Uncertainty and Higher Risk as Regulators Implement Swaps Rules

It is difficult, if not impossible right now, for banks to determine how the new swaps regulatory framework mandated by Dodd-Frank will affect the way banks do business. We do not know yet how the swaps exchanges will operate, what impact the clearing requirements will have on banks' ability to customize swaps, or even which banks and transactions will be subject to each of the new rules. For example, while other end users will be exempt from complex and costly clearing requirements, we are waiting to find out if our community banks will receive the same treatment. If not, then these banks might not be able to use swaps and the end result would be reduced lending, increased risk for banks, and higher costs for customers if banks cannot hedge the risk.

Beyond the uncertainty of the current situation, it is critical to ensure that banks have sufficient time to consider the implications that the proposed swaps regulations will have on their ability to manage business risks. Considering the number of new rules that are needed and the way they are interconnected, doing them hastily could cause serious economic harm.

We urge Congress to actively oversee the Commodity Futures Trading Commission (CFTC) and SEC as they implement the new swaps requirements to be sure there are no adverse affects on lending or competition for U.S. banks. We also encourage Congress to enact legislation explicitly granting small banks the same exemption from swaps clearing requirements that is available to other end users.

III. Consequences for Banks, Consumers, and the Economy Are Severe

Certainly, I want my bank to be successful, as do all of my fellow bankers throughout the country. Every day, we are facing new challenges that threaten our very existence. But for community banks, it goes beyond just our parochial interests to be successful. We are very much a part of our community. It is why every bank in this country volunteers time and resources to make their communities better. If the relentless pressures on our small banks are not relieved, the loss will be felt far beyond the impact on any bank and its employees. It will mean something significant has been lost in the community once served by that bank.

Ultimately, it is consumers that bear the consequences of Government imposed restrictions. The loss of interchange income will certainly mean higher costs of using debit cards for consumers. Greater mortgage restrictions and the lack of certainty on safe harbors for qualified mortgages means that community banks may no longer make mortgage loans or certainly not as many. Higher compliance costs mean more time and effort devoted to Government regulations and less time for our communities. Increased expenses often translate into layoffs within the bank.

Thus, jobs and local economic growth will slow as these impediments inevitably reduce the credit that can be provided and the cost of credit that is supplied. Fewer loans means fewer jobs. Access to credit will be limited, leaving many promising ideas from entrepreneurs without funding. Capital moves to other industries, further limiting the ability of banks to grow. Since banks and communities grow together, the restrictions that limit one necessarily limit the other.

Lack of earning potential, regulatory fatigue, lack of access to capital, limited resources to compete, inability to enhance shareholder value and return on investment, all push community banks to sell. The Dodd-Frank Act drives all of these in the wrong direction and is leading to consolidations. The consequences for local communities are real. As the FDIC noted: "The conversion of a once-main-office to a

branch is sometimes accompanied by reductions in customer services, customer service hours, and managerial authority and decision-making discretion."

The Farmers Bank will survive these changes. I fear that many other community banks may not. I have spoken to many bankers throughout the country who describe themselves as simply miserable. Some have already sold their banks; others plan to do so once the economic environment improves. The Dodd-Frank Act was intended to stop the problem of too-big-to-fail, yet now we have even bigger institutions; ironically, the result may be that some banks will be too-small-to-survive the onslaught of the Dodd-Frank rules.

Conclusion

An individual regulation may not seem oppressive, but the cumulative impact of all the new rules plus the revisions of existing regulations is oppressive. The regulatory burden from Dodd-Frank and the excessive regulatory second-guessing must be addressed in order to give all banks a fighting chance to maintain long-term viability and meet the needs of local communities everywhere.

It is important to understand that our bank, indeed, any small business, can only bear so much. Most small banks do not have the resources to easily manage the flood of new rules. Higher costs, restrictions on sources of income, limits on new sources of capital, regulatory pressure to limit or reduce lending in certain sectors, all make it harder to meet the needs of our communities. Ultimately, it is the customers and community that suffer along with the fabric of our free market system.

PREPARED STATEMENT OF PAUL REED

PRESIDENT, THE FARMERS BANK AND SAVINGS COMPANY, POMEROY, OHIO, ON BEHALF OF THE OHIO BANKERS LEAGUE

APRIL 6, 2011

Mr. Chairman, Members of the Financial Institutions Subcommittee, my name is Paul Reed. I am president and chief executive officer of The Farmers Bank and Savings Company in Pomeroy, Ohio. Farmers is a community bank serving a largely Appalachian market. I was born and raised in my community. That same can be said of most of the other bankers in my market. We serve those we grew up with.

I appreciate your invitation to testify on behalf of the Ohio Bankers League. My association represents most of Ohio's commercial banks, savings banks, and savings and loan associations.

I hope to address three themes in my testimony:

- A good community bank plays a unique role in economic development important to public policy.
- The regulatory structure in 2008 unintentionally but effectively empowered abuse.
- Dodd-Frank does too little to simplify and rationalize an extraordinarily complex and ineffective financial regulatory structure.

I'll start my testimony with a question—why should community banking matter to Congress?

My answer is pretty simple. While larger financial institutions care about their customers, they do not care where they live. That doesn't make big guys bad. It does mean community banks are a critical element of economic redevelopment in many communities.

As a community bank I have a vested interest in the economic and social health of my local market. If my customer cannot find a good job in my community and leaves, I cannot follow him. So my bank's operations must closely sync with what my community needs.

The news media has become very sloppy with the term bank, so let me call myself a traditional bank. There is a difference, important to national policy, between a traditional bank and the various forms of investment companies. I need my customer to be successful. I want long term customers. I win if my customer is successful. Contrast that with the investment bank for which the deal is too often an end in itself rather than the means to the end.

Because I have a practical loan size limit, my bank has always focused on small business. That is our expertise. I am close to my customers which, if I do my job well, will give me added insight. I should be able to make more loans safely than my bigger, distant competitors. Many successful small businesses in Ohio, including those that have grown to be large, started with a close call on a loan, made by a community bank which could say yes safely because it knew its customer.

Recently, walking down a hallway in my bank, I overheard a customer talking to another bank officer. The customer said "I didn't know what to do; but knew if I came to see you, you would." Any good community bank hears that sentiment every day.

As we forge recovery from a very painful recession, small businesses in the communities I serve need me to customize financial tools to answer their needs. I know you want me to do that; but the thousands and thousands of pages of regulation we labor through crush our ability to respond effectively, efficiently, and quickly. Looking to the future, Dodd-Frank will add more thousands of pages of new regulations.

This last statement should not be interpreted as opposition to effective regulatory modernization. The country needs effective, efficient financial regulation. We all will suffer if we fail to achieve it. Long before the financial crisis, most bankers I know had been calling for a streamlined, modern system which justified public confidence. Without question our regulatory safety net had developed severe flaws. Dodd-Frank improves parts but it does not do enough. As a community banker, I appreciate the steps taken to try to benefit me. Unfortunately, I fear there are unintended consequences Congress did not consider. Let me provide a few examples.

Deposit Insurance. In Dodd-Frank, Congress changed the basis for deposit insurance premiums from deposits to assets. That change has been touted by some as a great victory for community banks that fund most of their loans from local deposits. Ignored in that analysis are FDIC's subsequent actions to increase its target reserve ratio from 1.25 to 2.0, an increase of 60 per cent. Moreover, the FDIC eliminated the threshold beyond which it would charge no premium because the fund was judged adequately capitalized. Today, I am paying premiums at a historically high rate because an obsolete regulatory structure failed to catch bad guys in time. These changes mean that I will continue to pay more than I have historically paid, not less, for a very long time.

It does make sense to build the insurance fund reserves in good times; but please consider that every dollar I pay in deposit insurance translates into ten dollars I cannot lend. We need to stop the traditional swing of the regulatory pendulum from too lax in good times, to too punitive in the wake of economic troubles. It is the good actors who will pay this greatly inflated bill. The increase is huge despite the many other changes which will limit future risk to the fund. And under it all, the overly complex, inflexible regulatory structure that let the bad guys run rampant is too little changed.

Capital. Capital is a challenge for community banks. Historically, most community bank capital came from the leaders of our communities who wanted a locally focused bank. That source was doubly helpful because investors cared about long term benefit to the community as well as the return on their investment. A troubled economy both increases the need for capital while it reduces the ability of those traditional sources to invest. A further barrier to investment comes from an expensive regulatory regime for traditional banks which artificially constrains the potential return on any investment.

A tool the marketplace had evolved to address this dilemma was the trust preferred security. Some of the early banks closed by regulators proved to have invested in poorly underwritten trust preferred securities. As a result FDIC lost money. In reaction the Senate adopted the Collins amendment to Dodd-Frank that will likely kill this source of funding for community banks. Dodd-Frank created nothing to replace it. The right response would have been to limit banks' ability to directly invest in these securities. It was counterproductive to cripple the use of trust preferred securities as a tool for healthy community banks looking to raise funds from investors outside the banking industry.

Too-Big-to-Fail. Community banks and the Nation were grievously harmed by financial institutions grown too-big-to-fail. The risks from a Fannie or AIG were not new, yet nothing substantive was done to control them. We heard there was no Government guarantee of the very big against failure. Of course there was.

For years I faced funding costs higher than the largest financial institutions because the marketplace knew they were guaranteed against failure. Proportionally I also paid far higher regulatory costs than my large competitors.

The marketplace does not believe Dodd-Frank has ended too-big-to-fail. *The Wall Street Journal* recently reported that the funding costs for the biggest institutions are still 78 basis points lower than mine. While we all supported ending too-big-to-fail, the market suggests we have not done so. And we continue to aggressively, if unintentionally, to forge what is in affect "too small to survive."

Debit card transaction fees. I know the intent of Dodd-Frank was to exempt community banks from the rule that set a ceiling on debit interchange fees at roughly a fourth of my cost. However, my understanding is the choice of the transaction

processor is the retailer's. Processors competing for business from the big box stores will drive down the price I am paid. In the real world, the exemption will prove fiction.

The campaign by retailers focused on the big and only told part of the story. When my customers use debit cards I provide them, it saves a merchant on each transaction over their acceptance of checks or cash. Additionally, it is the bank that faces the risk of fraud. Only the merchant will have the contact when it can check to see that the card is not stolen. Few check. In 2009, a case of fraud involving a single merchant cost me more than our entire interchange income for the year.

Banking is very competitive. Competition has driven banks to spend interchange income on benefits we hope will attract customers—free checking accounts, convenient branches, more ATMs. Now my debit account income will be far less than my expense. Home Depot tells financial analysts my loss will translate into $35 million in an annual, windfall profit to its shareholders. Where is the consumer benefit?

A focus on trees ignoring the forest. In the lead-up to the global financial meltdown, a significant portion of the financial services market evaded governmental oversight. People motivated by greed flowed into the enforcement vacuum. Some were criminals. Many newer market entrants evaded governmentally imposed costs of doing business.

Banks must meet significant capital requirements. We must pay the full cost of regular, onsite, extensive examination. We pay for deposit insurance. We pay material sums for personnel and paperwork required by voluminous, too often poorly crafted regulation. Government says banks are the most important financial service provider. It sets up an extensive system to prevent failure and protect consumers if it does happen. Then policy and practice perversely tilt the competitive playing field steeply against traditional banks. And community banks suffer the greatest harm because scale provides compliance efficiency.

Consumer Financial Protection Bureau. To right consumer wrongs Congress created the CFPB. It promises clearer, simpler disclosures and universal coverage. The goal is right, but Congress chose to exempt a substantial percentage of financial service providers. Many exempted companies offer direct or functional substitutes for what I sell. Inevitably that very artificial wall will spawn more providers operating outside it.

I do have a community bank exemption from direct examination by CFPB. Congress determined that my primary regulator will continue to enforce compliance rules, now written by the new bureau. CFPB will handle the big guys. That exemption sounds like it should be helpful to me; but please understand any time a rule changes, whether for good or bad, traditional banks face a significant burden in replacing forms, systems, and then retraining. The smaller the bank, the harder it will prove to absorb these costs without losing competitiveness.

Today and tomorrow my regulator will regularly come into my bank with a large examination team to probe every aspect of my operations. That is effective but it is also a huge disruption to business. In contrast, no Government compliance examiners visited my nonbank competitor's office. There is little reason to believe they will tomorrow either. And to the extent the new bureau does examine my non bank competitor; the cost of that exam will be paid for by the Federal Reserve System. I get a bill.

I want to emphasize this point. The consumer's safety net failed to keep pace with the marketplace. It failed to recognize and oversee new providers of functionally equivalent products and services. As a result costs were imposed on banks but not on new non bank competitors. That meant banks continually struggled to be price competitive. Government regulation often had the perverse impact of motivating consumers to use a company where they would have little or no protection. One reason many of these problematic new financial companies escaped attention was that they were individually small; but they became very large in number and even larger in damaging impact. CFPB is not being developed to catch or prevent abuse in small companies where history suggests it will likely occur.

There had long been warning voices within Congress; but for a variety of reasons Congress as a whole rarely acted. One relevant example—if you read transcripts from Senate Banking Committee hearings four decades ago, you will find then Chairman William Proxmire repeatedly pointing to risks to the public in Freddie and Fannie that arguably led both to fail.

Did we fail to act because an existing agency was perceived as too politically powerful, or even if inefficient, that its purpose was too worthy? Did inconsistent Congressional oversight mean we failed to detect a foundation built on sand? Did divided Committee jurisdiction cost Congress important perspective?

Over the years we have responded to crises by adding agency after agency. I cannot detect grand design. I would argue we mistook actions for progress.

Predictably the multiplicity of inward looking financial regulators resulted in glaring holes in our safety net. One good example—AIG told State insurance departments that debt swaps weren't insurance. The SEC apparently thought they were insurance. Ultimately no one looked to see if AIG had the money to make good on its commitments.

Theoretically, to prevent conflict of interest U.S. policy separates finance from commerce. We haven't always adhered to that separation in practice. An example—we allowed Detroit automobile companies to form captive finance companies that subsidized rates from the price of the cars. It was hard for a bank that wasn't selling the car, to compete with a 0 percent loan. Even though it was a shell game, no Government agency intervened. Unfair competition largely drove banks out of the auto finance business. The new auto lenders got bigger, began mortgage lending, and soon grew so big they became "too big to fail." To add to the injury, we then pretended they had been banks all along. We bailed the failed companies out in part by using the deposit insurance fund which traditional banks had capitalized.

We failed to address other conflicts of interest. Unless a mortgage broker closed a loan it didn't get paid. In some cases the broker received a bonus if it convinced the consumer to buy unneeded extra features. As a result the broker's needs fundamentally differed from the borrower's. Yet no one in Government checked for misrepresentation or fraud.

A car salesmen closing an auto loan faces the same conflict. Dodd-Frank attempted to address the problem of the mortgage broker. However, it specifically exempts the car salesman. We lack a comprehensive theoretical regulatory concept. As a result we get very different answers to very similar questions over time.

I have heard some observers conclude that the financial melt down was the result of deregulation. Specifically, some have cited the Gramm, Leach, Bliley Act. Whether you liked GLBA or not, there was little deregulation in that bill. It simply acknowledged what had already happened in the marketplace. What was completely absent from the bill was any modernization of financial regulation to cope with that new marketplace reality.

The OBL shared our concern about the shortcomings of Gramm Leach Bliley with the then chairman of the House Financial Services Committee. He acknowledged the shortcoming; but observed regulatory turf had grown so entrenched in Washington, that it would take a crisis to trigger modernization. Well, we have now suffered that crisis. And we have gotten a 2,300 page bill. Some of its provisions do represent progress. But I believe it missed fundamental flaws that continue to plague our regulatory system.

The news last week brought an example of obsolete design when six Federal agencies jointly issued a rule on mortgage risk retention in response to the Dodd-Frank mandate. My point is not the rule—but six agencies? That is the post Dodd-Frank world. Can so many be nimble, efficient, effective, or timely? Can they detect the new marketplace abuse? Or will the traditional agencies assume, as was the case consistently on our path to financial meltdown, that the abuse was somebody else's responsibility. In practice complexity seldom supports effective or efficient.

As this country began to be victimized by predatory lending mortgage securitization had allowed the invention of the mortgage broker—tens of thousands of them. My understanding is the FTC had jurisdiction over non bank consumer lending. Yet the FTC's structure was not well suited to overseeing mortgage closings in this new, very decentralized environment. Congress hadn't given FTC examiners so it didn't systematically examine.

This new form of consumer loan broker wasn't paid unless the loan closed. It wasn't penalized if the borrower couldn't repay. That structure created powerful incentive to the broker to falsify and lie. No Government agency looked to find the ones who were doing so.

In Ohio alone we estimate there were 12,000 mortgage brokers at the high point. Theoretically their lending was covered by the many Federal consumer protection laws dealing with mortgages. Mortgage documents arriving on Wall Street appeared correctly filled out; but no one checked for fraud or that consumers had been told the truth. Consumers labored to protect themselves. Federally required mortgage closing forms were so lengthy and complex that few read, let alone understood, them. Where the lender was honest, there was no harm. When it was not, we got predatory lending. Ohio became a national scandal of predatory lending. When my State belatedly got around to licensing those brokers, it discovered a very high percentage had criminal records.

Dodd-Frank does address those mortgage brokers. I hope that will result in better consumer protection. But I fear we have missed the lesson. Will we quickly detect and effectively respond to the next marketplace invention which seeks to avoid governmental imposed costs of consumer protection? History suggests that is unlikely.

Why did dishonest mortgage brokers escape detection for so long? They were small.

Individually they were inconsequential. Collectively they collapsed the global financial world. No Federal regulator saw them as their responsibility. States pled poverty even when they saw the problem.

Historically, our laws have tended to address specific types of companies. Dodd-Frank attempted to refocus on the product; but my understanding is that is the model the new Financial Consumer Protection Bureau is using to organize itself focused on provider not product or service. If that is correct I think that is the wrong model.

Would it not make more sense to make rules consumer centric?

Should not all functionally equivalent products be regulated equally?

Should not Government imposed costs of business fall on all competitors evenly?

Should the consumer have some assurance of honest treatment regardless of provider?

If compliance costs do not favor one competitor over another, then competition works to the consumer's advantage. We need to end regulatory gaps driven either by regulatory or Congressional committee jurisdiction at the expense of the consumer.

No one ever would have designed the regulatory structure we have today on purpose. It is the product of historic accident, not grand design. That it has worked as well as it has is amazing. It speaks to the many good people that work for the agencies. That it has not worked as well as the American public deserves, is testimony to the fact many successive Congresses have failed to systematically address evolution of the marketplace. We have an alphabet soup of moving pieces in this protective engine. Many of the pieces were machined to fit engines in a different century. And today's engine, using those parts, gets very bad mileage and breaks down frequently.

Before Dodd-Frank we had too many regulators, and too many holes between them. Dodd-Frank gave us more regulators. We still have the gaping holes. I am asked to believe that's progress.

Let me close with a few suggestions.

Community Bank Regulator. The Dodd-Frank Act did eliminate an agency. In July the Office of Thrift Supervision disappears, giving the OCC jurisdiction over federally chartered savings and loan institutions and the FDIC that authority over State charters.

Nevertheless, community banks will wind up with more regulators. We have already discussed CFPB. There are other examples.

Today OTS examines both savings and loan companies and their holding companies. That makes sense to me. Corporate veils shouldn't frustrate public protection. Transactions in either the parent or the bank can affect the safety of the other. Dodd-Frank transfers thrift holding company jurisdiction to the Federal Reserve. It transfers regulation of the bank to one of two other agencies. Two different regulators with overlapping turf create opportunity for inefficiency and ineffectiveness.

I would submit that Congress might have served the consumer and country better by creating a community bank regulator, merging the current oversight of smaller, healthy banks and their holding companies conducted by either OCC, FDIC, OTS, or Federal Reserve. Freed of small bank exam responsibility, the agencies could concentrate on areas of greatest national risk. The new community bank regulator could focus on rules and examinations that work for small banks and their customers.

Community Bank Examinations. I want to briefly address the bank examination process itself. Its current form can drive focus on form over substance. I understand it is easier to check to see if there is a policy in a file, than it is to determine whether practice works. It is easier to check to see that collateral protects against any loss, rather than to evaluate lender judgment in trying to help a small business navigate through the land mines of a serious recession. I do understand the risk Washington would take when it tells examiners that if a bank's management team in both ethical and competent that their job is to help the bank navigate the mine field with advice and counsel. Some judgments will be wrong. Nevertheless, the question should always be what approach leads to the greatest success not that which best shields the regulator from blame.

I have great respect for the individuals that make up the teams that examine my bank. They are bright and well intentioned. But too little in exams really deals with what is most important to my community. During my last exam, a few weeks ago, there was little discussion over the regulator's decision to downgrade a loan to a small business which had been a long time customer of the bank. The business was troubled but we were paying close attention and working closely with the business

to try to help it survive. We had already taken steps to fully protect the bank, and the customer was making payments. The regulator's decision cut the funds I had available to lend and hampered my flexibility in working with my customer. In contrast there was extensive discussion on issues like depreciation schedules of minor amounts which had little to do with my bank's safety and nothing to do with the well-being of its customers.

We have evolved a system that is safest for regulators. The goal must be one that is safer for the communities I serve. I believe one reason for the system we have is that Congress flails regulators when they are wrong. It rarely commends them for taking risks that result in benefit for the economy.

More Rigorous Oversight. I can claim no expertise in politics, but I suspect a Senator would not be rewarded were he to go back home and campaign on the slogan "I didn't introduce a single new bill; but I worked hard to make sure that existing law and the rules worked well." However it is exactly that rigorous, unrelenting, painstaking, unglamorous oversight we will need if we are to reinvigorate the American economy and avoid a recurrence of the financial meltdown that began in 2008.

I do recognize that we, as constituents, literally expect you to be expert on everything in the universe. Demands on your time are unrelenting. You individually cannot spend as much time looking and listening as I want. However, you can systematically get your aides out of the artificial environment defined by the beltway. Get them back home talking with consumers, small businesses, farmer and community bankers, so they understand the financial world your constituents live in. And please dramatically expand systematic, rigorous oversight. Be vigilant. Study carefully. Act only when the case to do so is compelling. When you act, do so with comprehensive vision that considers unintended consequence.

If you want to protect the consumer you must simplify the structures that serve that end. Consumers must know how they are protected and who protects them. Forge a modern regulatory system that:

- looks through their eyes;
- treats all functional competitors equally;
- is designed to stop the bad guy from causing harm; but in ways that do not keep good guys from innovation in response to legitimate customer needs.

Thank you for the important step you take today.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY CHAIRMAN SHERROD BROWN

Ron Phipps
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April 6, 2011

The Honorable Sherrod Brown
Chairman, Subcommittee on Financial Institutions and Consumer Protection
Senate Committee on Banking, Housing, and Urban Affairs
713 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Brown:

On behalf of 1.1 million members of the National Association of REALTORS® (NAR), CCIM Institute and the Institute of Real Estate Management (IREM), who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry, thank you for holding today's Financial Institutions and Consumer Protection subcommittee hearing on the "State of Community Banking: Opportunities and Challenges."

REALTORS® have a vested interest in the success of community banks, because these institutions provide the majority of our clients with the capital they require to run their small business or purchase a home. When these institutions are unhealthy, that contagion permeates into the communities they serve. Therefore, I would like to take this opportunity to express REALTORS'® concerns with the financial health of our nation's community banks and the threat posed to them by continued concentration of financial services activity in larger, national lending institutions.

Commercial Lending

High vacancy rates, plummeting prices, and sluggish sales activity in the commercial real estate industry, along with high commercial real estate loan exposure at community banks, have caused a significant decrease in commercial real estate and small business lending. This reduction in credit has resulted in job layoffs and business failures, accelerating a negative economic cycle.

Over $1 trillion of commercial real estate loans will mature over the next few years, with a very limited capacity to refinance. If not addressed, the swelling wave of maturities could place further stress on many community banks and borrowers. In addition to addressing the issues facing the commercial real estate industry, improving access to capital for small businesses is also greatly needed. Small businesses employ nearly half of all Americans and account for 60% of U.S. job creation. However, lending to small businesses declined by $43 billion last year. Moreover, community banks, which hold 52% of all small business loans, were accountable for nearly half of that drop.

NAR believes that policymakers should pursue measures to help commercial borrowers with notes coming due to refinance and community banks recapitalize. One approach to consider might be to allow banks to amortize losses attributable to commercial real estate lending over a 7-10 year period. Another approach may be to encourage more private-equity investments in many of these financial institutions in order to turn around and recapitalize struggling banks and bring much-needed equity into the banking system.

Additionally, NAR supports S. 509, the "Small Business Lending Enhancement Act of 2011," introduced by Senator Udall (D-CO). This bill will increase the cap on member business lending from 12.25% to 27.5% of total assets for well-capitalized credit unions.

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

We believe this legislation will help fill the current lending gap facing the commercial real estate and small business sectors.

Residential Lending

Another issue that has the potential to exacerbate problems for community banks is the definition of Qualified Residential Mortgage (QRM), which is currently under debate within the financial regulatory arena. A definition that does not optimize the amount and underwriting flexibility of product included in this category will be detrimental to community lenders and borrowers.

A narrow QRM definition will further the concentration of housing finance among the big, national lenders that we are currently witnessing. Under a narrow QRM, community banks will have a lesser capacity to conduct residential mortgage lending due to the requirement that they retain a significant amount of capital (5%) on their balance sheet for each mortgage should they want to participate in the securitization market. The alternative, not participating in the securitization market and keeping the whole loan on balance sheet while in portfolio, reduces the community lender's abilities to participate in the residential mortgage market even further. The exit of community lenders from the residential mortgage space will push more business to the large, national banks, ceding them the ability to set prices and underwriting criteria while continuing to increase their size and dominance of the market. All of these effects are detrimental to consumers and taxpayers since as mortgage capital becomes more restricted, mortgage finance costs rise, and the then bloated national institutions become "Too *Bigger* to Fail."

REALTORS® believe that federal regulators and Congress should honor the intentions of Senators Isakson, Hagan, and Landrieu by crafting a qualified residential mortgage (QRM) exemption that includes a wide variety of traditionally safe, well underwritten products such as 30-, 15-, and 10-year fixed-rate loans, 7-1 and 5-1 ARMs, and loans with flexible down payments that require mortgage insurance.

A poor QRM policy that does not heed their intention will displace a large portion of potential homebuyers and housing finance participants, slow economic growth, hamper job creation, and further retard our tenuous economic recovery.

Conclusion

The National Association of REALTORS® believes that recovery of our communities and overall economy will not occur unless our community banks are healthy and able to participate in all business sectors, especially real estate. Housing has been the vehicle that the nation has relied on to pull us out of bad economic times. Housing may not be able to pull the nation out of this downturn alone, but it will not be part of the solution if our community banking partners are prevented from working with us to ensure a housing and economic recovery.

Thank you for the opportunity to share our thoughts. NAR stands ready, willing and able to work with you and our community banking partners to ensure that they are able to effectively participate in our local marketplace.

Sincerely,

Ron Phipps, ABR, CRS, GRI, GREEN, e-PRO, SFR
2011 President, National Association of REALTORS®

LETTER SUBMITTED BY SANDRA L. THOMPSON, DIRECTOR OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

March 10, 2011

Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, N.W.
Washington, D.C. 20551

Re: Comment on Proposed Rulemaking on Debit Card Interchange Fees and Routing (Docket No. R-1404 and RIN No. 7100 AD63)[1]

Dear Mr. Chairman:

The Federal Deposit Insurance Corporation (FDIC) appreciates the opportunity to comment on the proposed rule by the Board of Governors of the Federal Reserve System that would implement the debit card interchange and transaction processing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] The FDIC commends the Board for its work on the difficult task of implementing this very complex and important section of the statute. We offer comments on how the proposed rules could be modified to better implement all of the intended protections of Dodd-Frank.

As the federal regulator of most community banks in the United States, the FDIC is concerned about the potential impact of the Board's proposed rule on small bank issuers of debit cards and their customers in contravention of Congressional intent. Specifically, we are concerned that these institutions may not actually receive the benefit of the interchange fee limit exemption explicitly provided by Congress, resulting in a loss of income for community banks and ultimately higher banking costs for their customers.

Although small banks are statutorily exempt from the fee caps set by the Dodd-Frank Act, the exemption may be unavailable in practice because of market-driven factors not addressed by the Board's proposal. First, small banks may be unable to receive any tangible benefits from the statutory exemption if card networks do not implement a two tier fee schedule that will enable small banks to receive fees above the proposed cap. If the statutory exemption for small issuers is not protected and becomes unavailable in practice to community bank issuers, this could create a bias toward large bank issuers that have lower marginal costs and greater opportunities to substitute income from non-core banking operations or alternative products.

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[1] 75 Fed. Reg. 81722 (Dec. 28, 2010).
[2] *See* Pub. L. No. 111-203 § 1075 (codified at 15 U.S.C. § 1693o-2).

Second, the Board's proposal to implement the network exclusivity and routing restrictions could result in additional costs and operational challenges for community banks, which would place significant pressure on community bank bottom lines, as well as on their competitive positions. Moreover, there is a possibility that merchants may discriminate against community bank issued cards at the point-of-sale by explicitly or ambiguously encouraging the use of large bank cards with lower fees.

The combined potential impact of small bank issuers' inability to benefit from the fee cap exemption and increased operational costs and challenges would undermine Congress's intent to protect community bank issuers. If market forces reduce interchange fees overall, such costs and loss of revenue will heavily impact those community banks that significantly depend on revenue from debit card transactions. This, in turn, may affect a community bank issuer's ability to provide its customers with free or lower cost products and services. We are especially concerned about the potential impact the proposed rule could have on the ability of low- and moderate-income consumers to gain access to affordable small bank products and services. Our specific concerns include:

I. The Board should ensure against evasion of the protections Congress intended to provide community banks and minimize the potential negative impact on consumers.

Community banks may be forced to reduce their debit card interchange fees if card payment networks do not implement a two-tier fee schedule. The proposed rule assumes the creation of a two-tiered interchange rate structure, yet there is no requirement for card payment networks to provide a two-tier fee schedule to preserve the exemption for community banks that Congress created. Without such a requirement, it will be up to the networks to decide on adjustments to their fee structure. A potential outcome is that if the networks decide that it is not in their best economic interest to offer a two-tier fee structure, they will not do so. This could result in forcing community banks to compensate for their loss of fee income by imposing higher fees on their customers, including transaction and other bank related product and service fees. Consumers who are financially vulnerable, especially low- and moderate- income individuals and families, may feel the hardest impacts as they are least able to handle additional expenses. In addition, an increase in fees for basic banking services could easily drive such consumers to non-bank financial service providers. Such developments would be a financial step backwards for consumers, as non-bank service providers do not provide the security and consumer protections offered by more traditional accounts at insured financial institutions and do not help consumers build a credit history.

- **Recommendation.** The Board should use its authority, including its anti-evasion authority, under the Electronic Fund Transfer Act to protect the statutory exemption created by Congress and to address the practical implications of the proposal, such as whether the payment card networks will have the discretion and ability to prevent community bank issuers from receiving an exemption to the fee cap by failing to maintain two-tiered fee schedules, making the small bank exemption irrelevant.

II. More information is needed on what lower interchange fees would mean for small issuers.

Regardless of the proposal's fee cap, small issuers will likely face market pressure regarding their fees. The FDIC is concerned that in practice small issuers may not receive fees above the Board's proposed fee cap of 12 cents, which would have an undetermined financial impact on community banks.[3] The FDIC has been unable to identify any research that shows the incremental costs for small bank issuers. Consequently, we are concerned that the proposed 12 cent fee cap may not fully consider the incremental costs for small issuers and encourage the FRB to conduct more work in this area.

- **Recommendation.** Absent an effective exemption for community banks from the interchange fee cap, the Board should expand its survey methodology to gain information on the costs incurred by issuers of all asset sizes and revise its fee cap proposal as appropriate.

III. Network exclusivity requirements could fundamentally alter card processing framework.

The requirement to establish nonaffiliated signature/PIN-based networks should be implemented in a manner that is least disruptive to the marketplace and creates the least burden for community banks. As the Board is aware, many debit cards today satisfy Alternative A, which would require that a debit card could access at least one signature-based payment processing network and one unaffiliated PIN-based payment processing network. By contrast, the second, more expansive proposed routing alternative (Alternative B) would likely require wholesale re-issuance of debit cards and extensive changes in payment network processes and agreements. Such costs would impose a tremendous burden on community banks.

- **Recommendation.** The FDIC strongly urges the Board to adopt Alternative A as the least burdensome method of providing merchants with more choice in selecting a payment processing network.

IV. Fraud prevention costs are not included in the fee cap.

The Dodd-Frank Act gives the Board authority to make an adjustment to the fee standard for fraud prevention. The Board has deferred decision on allowance of a fraud adjustment, a key component affecting the fee standards. A fraud prevention adjustment not only could provide incentives to reduce fraud but directly affects the calculation of the fee standard.

- **Recommendation.** Given the significant increase in debit card use, we encourage the Board to establish a fraud related fee policy that promotes and encourages innovations and improvements in fraud prevention throughout the industry. At a minimum, the Board should conduct research to identify fraud prevention costs faced by issuers of all sizes and specify a

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[3] According to the proposed rule, the Board only surveyed the costs of issuers with assets in excess of $10 billion in assets. *See* 75 Fed. Reg. at 81724-25.

placeholder amount to be allowed for the adjustments to interchange fees to enable issuers and others to fully evaluate the proposed fee standard.

The FDIC encourages the Board to consider our concerns and recommendations as it proceeds with implementation of the debit card interchange fee and routing provisions of the Dodd-Frank Act. We are extremely concerned about the proposed rule's impact on community banks and consumers in contravention of Congressional intent. We urge the Board to use its authority to make the small bank fee cap exemption real, as Congress intended, to avoid unnecessary adverse consequences for consumers and small bank issuers, and to implement alternatives that would present the least operational challenges for community banks.

Sincerely,

Sheila C. Bair

cc: Jennifer J. Johnson, Secretary

LETTER SUBMITTED BY JENNIFER KELLY, SENIOR DEPUTY COMPTROLLER FOR MIDSIZE AND COMMUNITY BANK SUPERVISION, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 4, 2011

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, D.C. 20551

Subject: Docket No. R-1404: 12 CFR Part 235; Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

I am writing to convey comments of the Office of the Comptroller of the Currency on the Board's proposed Regulation II, which implements section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act concerning interchange transaction fees for electronic debit transactions.[1] The proposed rule has two main components. First, it implements the statutory prohibition on network exclusivity arrangements and merchant routing restrictions. Second, the proposal contains two alternative approaches, each of which sets maximum permissible debit card interchange fees for covered banks. The comments in this letter relate to the second component of the proposal.

Section 1075 clearly is designed to limit the types of costs that debit card issuers can recover through fees. Within that framework, however, we believe the proposal takes an unnecessarily narrow approach to recovery of costs that would be allowable under the law and that are recognized and indisputably part of conducting a debit card business. This has long-term safety and soundness consequences – for banks of all sizes – that are not compelled by the statute.

Background

Section 1075 of the Dodd-Frank Act added a new section 920 to the Electronic Fund Transfer Act[2] (EFTA), regarding debit card interchange transaction fees. Section 920(a)(3) of the amended EFTA requires the Board to prescribe regulations "to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[3] The statute also directs the Board to

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank or the Dodd-Frank Act). The proposal was published at 75 Fed. Reg. 81722 (Dec. 28, 2010).
[2] 15 U.S.C. §§ 1693-1693r.
[3] 15 U.S.C. § 1693o-2(a)(3).

distinguish between the issuer's incremental cost to authorize, clear, and settle a particular transaction, which the Board must consider, and other costs that are not specific to a particular electronic debit transaction, which the Board may not consider.[4] The statute also permits, but does not require, the Board to allow for an adjustment to an interchange fee to account for an issuer's costs in preventing fraud, provided the issuer complies with standards established by the Board relating to fraud-prevention activities. In addition, the statute exempts from interchange fee regulation issuers that, together with their affiliates, have assets of less than $10 billion.

The statute was clearly designed to prevent the recovery of certain types of costs that are a part of the cost of doing a debit card business. Under Section 920(a)(2) "[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer *with respect to the transaction*."[5] In establishing standards for determining whether an interchange transaction fee is reasonable and proportional, section 920(a)(4) requires the Board to "consider the functional similarity between – (i) electronic debit transactions; and (ii) checking transactions . . . " and "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction."[6] The Board, however, may not consider "other costs incurred by an issuer which are not specific to a particular electronic debit transaction . . . ."[7]

Within the constraints of this statutory framework, we believe there is flexibility for the Board to consider alternative approaches that could enable debit card issuers to recover identifiable costs of conducting a debit card business. For example, the statute directs the Board to set "standards for assessing" whether a fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction; it does not say that the Board should set the allowable fee. . The statute also allows costs in addition to those related to authorization, clearance, and settlement (ACS) if those costs are specific to a particular electronic debit transaction.

In a brief filed recently in a case seeking to enjoin the enforcement of Section 1075 and a future regulation issued by the Board thereunder, the Board in fact *agreed with* both of these points:

> Under the statute, the Board can consider non-ACS costs that are specific to a particular electronic debit transaction. See 15 U.S.C. § 1693o-2(a)(4)(B)(ii). In addition, the statute's requirement that the Board "establish standards" for assessing debit interchange fees does not obligate the Board to set a specific rate for debit interchange fees. See 15 U.S.C. § 1693o-2(a)(3)(A).[8]

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[4] 15 U.S.C. § 1693o-2(a)(4)(B).
[5] 15 U.S.C. § 1693o-2(a)(2) (emphasis added).
[6] 15 U.S.C. § 1693o-2(a)(4).
[7] *Id.*
[8] *TCF National Bank v. Bernanke, et. al*, No. 4:10-cv-04149-LLP (D. S. D.), Memorandum in Support of Defendants' Motion to Dismiss Plaintiffs' Claims for Failure to State a Claim Upon Which Relief Can Be Granted and For Lack of Subject Matter Jurisdiction and Defendants' Response in Opposition to Plaintiffs' Motion for a Preliminary Injunction at 28 (filed Feb. 18, 2011) (Brief). The OCC is named as a defendant in this case and joined in the Brief.

These points are discussed in more detail below.

Establishing standards for reasonable and proportional interchange fees

Section 920 (a)(3) instructs the Board to "prescribe regulations . . . to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." As the Board acknowledges in the Brief, to which the OCC is also a party, "the statute's requirement that the Board 'establish standards' for assessing debit interchange fees does not obligate the Board to set a specific rate for debit interchange fees." Yet, the Board's proposal focuses solely on two options that involve setting specific fee caps per transaction: (1) an issuer-specific interchange fee with a safe harbor (initially set at 7¢ per transaction) and a cap (initially set at 12¢ per transaction); and (2) a cap (initially set at 12¢ per transaction) applicable to all covered issuers. These are rate caps that will result, by the Board's own estimates, in at least a 70% reduction of interchange revenue. The impact of a revenue reduction of this magnitude has not been studied, but it is clear that it will change how financial institutions, both large and small, will do business, with obvious negative impacts on their ability to recover their costs of operation and unpredictable collateral consequences for their customers. We therefore urge the Board to reconsider its rate-cap based approach in light of the flexibility it acknowledges it has to pursue other choices.

Allowable Costs

Even if the Board chooses to implement the statutory direction to "establish standards" through a rate-cap approach, we believe the Board has not given appropriate consideration to the costs that should be taken into account in calculating the allowable rate. We urge the Board to reconsider the following points:

The Board did not propose rates that are pegged to issuers' actual costs, stating that it would be difficult for issuers accurately to report those costs so that bank examiners checking for compliance with the proposal could compare costs to fees received. Yet, the proposed rule requires issuers to collect that data and report those costs to the Board on a regular basis. If the Board continues to view the statute as requiring the setting of rates, it seems reasonable to link such rates to the actual cost data the Board expects issuers to be able to collect and report.

We believe that the statute does not limit allowable costs only to those related to ACS, provided the other costs are specific to a particular electronic debit transaction. Under the language of the statute, the fee that a debit card issuer may charge must be reasonable and proportional to the cost incurred by the issuer with respect to a transaction (section 920(a)(2)), and the Board must establish standards for assessing whether such an interchange fee is reasonable and proportional to such cost (section 920(a)(3)). In prescribing regulations establishing those standards, the Board is required to "distinguish between" the "incremental cost" incurred by the issuer in "authorization, clearance, or settlement of a particular transaction," which are to be considered in

transaction, which are not to be considered (section 920(a)(4)(B)). This distinction and direction to consider particular types of costs is simply not drafted as an exclusive set of the recoverable costs described in section 920(a)(2). The Brief acknowledges that this flexibility exists. Yet, the proposal is premised on the position that the debit interchange fee may *only* reflect the incremental authorization, clearance, and settlement costs incurred in a specific debit card transaction. We therefore urge the Board to reconsider and expand the types of transaction-specific costs that are clearly identifiable as part of conducting a debit card business.[9]

In its proposal, the Board declined to consider such costs in light of the statute's direction to consider the functional similarities between debit card and check transactions, and the fact that these costs are not charged to merchants in check transactions. We respectfully suggest that the Board's approach did not fully consider this direction. Consideration of the similarities between check clearing and debit clearing necessarily includes recognition of where the two are *not similar*. For example, when a merchant swipes a customer's debit card, it is "approved" by the issuing bank and the merchant is guaranteed to receive payment ("good funds"). In contrast, a merchant who accepts a customer's check bears the risk that the check will bounce. Private guarantees for checks cost approximately 1% of the transaction value, while debit card issuers provide this service for free. The merchant benefit and issuer costs of the guarantee of good funds are factors appropriately within the scope of the statutory directive to compare debit card and check transactions.

The Board also has proposed to exclude any network switch fees as allowable costs, even though these are incremental costs required to authorize a transaction and therefore allowable under even the most narrow reading of the statute. The statute mandates that the Board consider inclusion of transaction-specific ACS costs, which would include switch fees, and we urge the Board to reconsider its exclusion of a type of cost that Congress clearly signaled an intent to allow.

Fraud Adjustment

Section 920(a)(5) allows the Board to increase the interchange fee to include "reasonably necessary… costs incurred by the issuer in preventing fraud in relation to electronic debit transactions." The Board currently is not proposing a specific increase in the fee as a fraud adjustment; rather, it is offering two general alternatives for comment. The first would allow issuers to recover costs for their current fraud-prevention efforts, while the second would only allow issuers to recover costs for major technological innovations.

We are concerned that adopting the second alternative would make the Board the gatekeeper for determining which innovations are significant enough to be eligible for the adjustment. Moreover, adopting the second alternative could discourage issuers from engaging in incremental improvements to existing fraud prevention technologies. The OCC encourages national banks to develop technologies to prevent fraud across all product lines and to implement

[9] Such costs include transaction processing costs, transaction-based cardholder inquiries, transaction-based rewards programs or revenue-sharing, and non-sufficient funds handling.

improvements whenever feasible, whether they be product-specific or cut across multiple product lines. This is simply sound banking practice. Allowing cost recovery for only certain technologies, and only when applicable in merchant debit card transactions, runs counter to that fundamental goal.

We look forward to consulting with the Board as the final rule is developed.

Sincerely,

John Walsh

John Walsh
Acting Comptroller of the Currency

PREPARED STATEMENT SUBMITTED BY THE RETAIL INDUSTRY LEADERS ASSOCIATION

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee:

On behalf of the Retail Industry Leaders Association (RILA), we respectfully submit the following statement for the record with respect to the Subcommittee's hearing titled "The State of Community Banking: Opportunities and Challenges." Our comments are specifically focused on the importance of Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which provides critically needed reforms to the system for setting interchange fees with respect to debit card transactions in this country.

By way of background, RILA is the trade association of the world's leading and most innovative retail companies. RILA promotes consumer choice and economic freedom through public policy and industry operational excellence. Its members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs and operate more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

Section 920 of the Electronic Fund Transfer Act (EFTA), added by Section 1075 of the Dodd-Frank Act, requires that the Board prescribe regulations to ensure that debit card swipe fees are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" for the purpose of "authorization, clearance, or settlement of a particular electronic debit transaction . . . ." On December 28, 2010, the Federal Reserve Board (Board) published a Notice of Proposed Rulemaking, Debit Card Interchange Fees and Routing, in the Federal Register (NPRM), which sets out proposed rules for implementing new Section 920.[1]

As an executive committee member of the Merchants Payments Coalition (MPC), RILA has helped to develop the substantial materials that the MPC has submitted to the Board with respect to the NPRM including a submission at the pre-rulemaking stage,[2] a submission on January 20, 2011, concerning the Board's request for comments on the fraud-prevention adjustment permitted under Section 920(a)(5),[3] and a detailed submission on February 22, 2011, providing views and recommendations regarding the range of issues set out in the NPRM.[4] RILA endorses each of the MPC submissions in their entirety, in particular the most recent comprehensive comment letter. RILA members have provided substantial expertise and input into the MPC's submissions, reflecting the wide support from both RILA members and the broad merchant community.

RILA offers the following comments to the Subcommittee in order to stress the underlying need for Section 920 and the NPRM to address, at least in part, the fact that the market in which interchange fees are set for debit and credit cards is fundamentally broken and to stress that the structure of Section 920 can accomplish the objective of restoring some needed competition with respect to debit interchange fees if implemented consistently through the NPRM.

Interchange Fees Are Set in a Broken Market

To place the importance of Section 920 and the NPRM in context, it is essential to keep in mind how we came to this point, with interchange fees in the United States today among the highest in the world. In a functioning market, efficiencies are gained as volume increases and technology advancements are made. Competition among parties further ensures that these improvements are translated into lower costs and/or enhanced services. Yet, as discussed in detail in the MPC prerulemaking submission and the attached report on debit interchange fees prepared for RILA by James C. Miller III, Ph.D. (Miller Report),[5] in the case of interchange fees, the United States has seen just the opposite. As volume and technology have lowered the costs of operating the system, the card networks have dramatically increased interchange rates on merchants year after year. At the same time, merchants are forced to accept debit cards widely due to the overwhelming market

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[1] 75 Fed. Reg. 81,722 (proposed December 16, 2010).

[2] MPC, Pre-NPRM submission to Director Louise L. Roseman (Nov. 2, 2010), available at: *http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.*

[3] MPC, Fraud-adjustment submission to Director Louise L. Roseman (Jan. 20, 2011), available at: *http://www.federalreserve.gov/SECRS/2011/February/20110203/R-1404/R-1404_012011_61804_561400767649_1.pdf.*

[4] MPC, NPRM submission to the Board (Feb. 22, 2011), not yet available on the Board's Web site.

[5] James C. Miller III, "Addressing the Debit-Card Industry's Market Failure", (Feb. 2011)—copy attached.

dominance of Visa and MasterCard, which collectively controlled 84 percent of the market in 2009.[6]

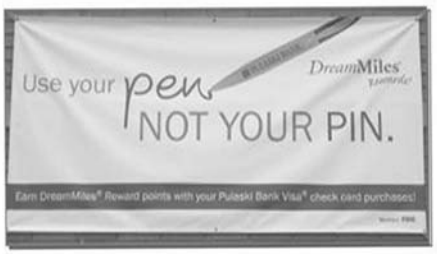
Networks will claim that vigorous competition exists in the interchange marketplace, yet this competition is only in order to take market share away from network competitors by offering card issuers more generous interchange rates, to the detriment of the businesses, universities, charities, and even local, State, and Federal Governments, all of which accept debit and credit card cards for payment. While governments and utilities generally have the ability to surcharge debit and credit card users to recoup some of these losses,[7] merchants must pass along these costs to consumers in the form of higher prices, or they must absorb them, which generally results in reduced services to consumers.

This drive by the networks to increase interchange rates to the benefit of card issuers means that the only competition that exists among the networks is competition to raise interchange fees, unlike the fierce competition that exists in the retail industry to lower prices and offer better services to consumers day in and day out. The fact remains that banks compete every day on a host of products and services, including interest rates, terms of demand deposit accounts, *etc.,* but this is not the case with interchange rates. Instead, every issuing bank agrees to the exact same pricing schedule for exactly the same product, thereby precluding any downward pressure on interchange prices.

Steering Toward Less Secure, More Expensive Transactions

For years card issuers have steered customers to less secure, more expensive payment alternatives. With respect to debit cards, most issuers only offer rewards points for signature debit transactions, while some offer double points for signature debit transactions but no rewards for transactions made using a Personal Identification Number (PIN) debit transaction. Such efforts to steer consumers away from PIN debit transactions is particularly perverse since PIN debit is far more secure than signature debit. In fact, one RILA member reports that the incidence of fraud on signature debit transactions in its stores is 1 in 9,000 transactions, while the incidence of fraud on PIN debit transactions in its stores is 1 in 11,000,000 transactions. Even card issuers acknowledge the inherent beneficial security aspects of using a PIN, as they require customers using their own automatic teller machines (ATM) to key in a PIN number rather than using a signature to authenticate a transaction.

Other banks are far more aggressive in their marketing of less secure, more expensive signature debit transactions to their customers *versus* the use of PIN debit transactions. For example, Pulaski Bank, a community bank headquartered in St. Louis, Missouri, at one point in 2009 ran a marketing campaign promoting its DreamMiles® Rewards card, hanging a banner outside of one of its branches that read "Use your pen NOT YOUR PIN" (emphasis original), as reflected in the picture below.[8]



Similarly, CP Federal Credit Union of Jackson, Mississippi, encourages its customers to "Use your PEN not your PIN!" (emphasis original).[9] The credit union, which reported assets of just over $300 million in 2010, qualifying it for the small issuer exemption, tells customers to "Choose CREDIT over debit!" (emphasis origi-

[6] Miller report at paragraph 4.

[7] For example, the Internal Revenue Service charges a "convenience fee" up to several percentage points depending on whether a credit or debit card is used for such tax payments. *See,* Internal Revenue Service, "Pay Taxes by Credit or Debit Card", available at: *http://www.irs.gov/efile/article/0,,id=101316,00.html.*

[8] Photograph of Pulaski Bank branch signage, Bentonville, Arkansas (Apr. 27, 2009).

[9] CP Federal Credit Union, ATM and Debit Cards general information (accessed on Feb. 22, 2011), available at: *http://www.cpfederal.com/ASP/Products/product_4_6.asp.*

nal) and claims that selecting the credit option when prompted is "safer, easier and NOW! even more beneficial" (emphasis original) because the cardholder is only offered rewards points when making a signature debit purchase.

Other banks employ "surcharges" that are far more direct in their messaging to consumers: sign for your debit card transactions or else you will be charged extra for the more secure PIN transaction. Chevy Chase Bank, which was acquired in 2008 by Capital One Bank of McLean, Virginia, surcharges consumers an additional $0.50 for transactions made on a debit card when a PIN is entered, yet the transaction is free if the consumer signs for the purchase.[10] Capital One Bank continues to impose these surcharges for account holders who were previously Chevy Chase Bank customers.

Finally, the networks themselves steer customers towards less secure technology through promotions. For example, in recent years Visa has run promotions on everything from the Olympics, to the Super Bowl and the World Cup, in which consumers may qualify to win tickets for life to one of the various sporting events by using their debit cards for purchases. Upon closer examination of the fine print, however, only signature debit transactions qualify for the promotions, while PIN debit transactions do not.

We bring these examples to the Subcommittee's attention only to show how card networks and card issuers employ a multitude of tools to steer customers toward less secure, more expensive signature debit payments, all in an effort to drive the collection of higher interchange fees. These fees are paid on every purchase with a debit card by the merchant—and ultimately by consumers overall through higher prices, whether the purchase is made by cash, check or plastic. When combined with the fact that Visa and MasterCard have already rolled out, or are in the process of introducing, more secure chip-and-PIN technology in the European Union, Australia, Canada and even Mexico, American merchants are paying among the highest interchange rates in the world while using inferior 1960s magnetic stripe technology that increases the fraud costs and chargebacks that merchants, again, must pay.

New Section 920 Provides Limited, but Essential, Interchange Reforms

Against the backdrop of a broken market for setting interchange fees and its perverse incentives to maintain a more fraud-prone market, the reforms adopted by Congress in the Dodd-Frank Act are critically needed and narrowly tailored to help restore a semblance of competition with respect to debit card interchange fees. As the Miller Report concludes:

> In the case of interchange fees—and debit interchange fees in particular—the case for regulatory intervention is strong. This is truly a case of market failure: networks with monopoly power over merchants are setting prices for merchants' access to their networks on behalf of their (frequently overlapping) card-issuing members, utilizing agreements in which every bank participating in those card networks agrees to charge merchants exactly the same interchange fees, regardless of who issued the card. Thus, regulatory intervention is warranted to provide the catalyst to return this market to the competitive norm and thus increase the market's overall efficiency.
>
> The pricing solution chosen by section 920(a) and the Board's proposed interchange fee standard approximates the pricing outcome that would obtain in a fully competitive market—that is, prices based on costs, not demand.[11]

We applaud the extensive work that the Board and its staff have already done to develop the regulations required by Congress in new Section 920 of the EFTA. While we again commend to the Subcommittee the MPC's detailed views and recommendations regarding the alternatives and other issues set out in the NPRM, we stress the following key points from the MPC submission:

- With respect to the regulation of interchange fees, Alternative 1 is preferable, but the safe harbor and cap should be much closer to the average per-transaction costs of authorization, clearance, and settlement (ACS), which issuers themselves report to be no greater than 4 cents and First Annapolis Consulting reports to be 0.33 cents for PIN debit transactions (and 1.36 cents for signature transactions).
- With respect to the prohibitions on network exclusivity, Alternative B should be fully implemented by April 2012. As a transitional measure, Alternative A should be adopted within three months after the Board issues final rules and

[10] *See*, Chevy Chase Bank Schedule of Fees for Personal Accounts (2009).
[11] Miller Report at paragraphs 22–23.

network fees charged to merchants should be capped at current levels until Alternative B is fully implemented.

- With respect to merchant routing, the proposal set forth in the NPRM that prohibits networks or issuers from directly or indirectly inhibiting merchants from routing their transactions should be adopted.
- With respect to preventing circumvention and evasion, the MPC has proposed an amended version of the net compensation proposal, which would include a general anticircumvention provision and close remaining loopholes.
- With respect to the adjustment for fraud prevention costs, the MPC has proposed standards drawn from and marrying the best aspects of both approaches discussed in the NPRM to balance the interests of issuers and merchants and motivate the implementation of potentially paradigm-shifting fraud prevention technologies without prescribing a particular technology.

The Small Issuer Exemption Will Work

An additional issue that bears particular mention, especially given today's Subcommittee hearing, is the exemption in the statue that allows banks and credit unions with assets under $10 billion to continue to collect the same debit card interchange fees that they receive today, notwithstanding the new interchange reforms. Section 920(a)(6) of the EFTA states that "this subsection shall not apply to any issuer that, together with affiliates, has assets of less than $10,000,000,000, and the Board shall exempt such issuers from regulations prescribed under paragraph (3)(A)." We believe that Congress was abundantly clear in this language that the limitations on interchange fees do not apply to small issuers.

Claims by credit unions and banks that such a small issuer exemption would not work fail to take into consideration the perverse incentives of the debit and credit card issuance market, in which banks and credit unions make decisions about whether to issue their cards under the Visa or MasterCard network based on which company offers them the highest level of interchange fees. Once Section 920 is implemented, exempted issuers will continue to make issuing decisions based on which network offers the highest interchange. Neither Visa nor MasterCard has any more incentive to lower debit card interchange rates for exempted financial institutions as a result of Section 920 than either had in the preceding years. For example, if post-implementation Visa were hypothetically to lower its rates for exempted institutions, these institutions would logically migrate to MasterCard because it would still offer higher rates to attract additional business (and the same would hold true if MasterCard, for example, were to lower its rate). Nothing in the Board's NPRM would fundamentally change this incentive structure for the exempted banks and credit unions. In fact, this structure is likely the reason for Visa's announcement earlier this year that it would institute a two-tier rate system for covered and exempted institutions once the final rules are implemented.[12] And, with history as a guide, we anticipate that MasterCard will announce a similar arrangement in the near future.

We believe that the concerns of exempted banks and credit unions with assets under $10 billion are due either to misinformation, or worse, to scare tactics employed by the card networks to keep exempted institutions lobbying in opposition to the NRPM. These tactics were exposed in a recent American Banker article in which Eric Grover, a payments consultant, was quoted as saying that higher interchange for small banks and credit unions "makes total sense" and that the only reason that networks did not put to rest unjustified concerns about why a two-tiered system would work was that it "was simply intended to scare credit unions and small banks to keep them lobbying" against the overall interchange reforms.[13]

In addition to inaccurate claims that the networks will discriminate against small banks and credit unions, some have asserted that merchants would also refuse to accept a Visa or MasterCard issued by a small bank or credit unions. That claim completely overlooks the so-called Honor-all-Cards rule imposed by the networks, which prevents merchants from discriminating by issuer, large or small.[14] In other

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[12] First Data has also announced a similar two-tier pricing structure for its Star PIN-debit network. *See,* Kate Fitzgerald, "Two-Tier Debit Interchange Rate Plan OK With First Data", *ISO & Agent Weekly* (Feb. 10, 2011), available at: *http://www.paymentssource.com/news/first-data-debit-interchange-3005055-1.html.*

[13] Sean Sposito, "Visa Plans Two-Tiered Interchange Rates After Fed Rules", *American Banker* (Jan. 10, 2011).

[14] The Honor-all-Cards rule is one of many network rules to which merchants are subject. If a merchant agrees to accept Visa or MasterCard, it must abide by these rules or face the substantial fines upwards of $5,000 a day. *See,* Section 5.8.1 of MasterCard's operating rules at p.

Continued

words, if a merchant accepts Visa cards, it must accept cards issued by a single branch community bank with assets under $10 billion and also any debit cards issued by Bank of America, regardless of the issuer of the debit card.

Benefits to Consumers

RILA would like to address head-on the claims by opponents that interchange fee reforms will only lead to increasing costs for consumers. If these claims held any validity, then when interchange fees tripled over the past decade, bank fees would have fallen by a corresponding amount. Instead, bank fees, too, have exploded during the same time period. The retail industry is fiercely competitive, with annual profit margins ranging between 1 percent and 3 percent. With such a competitive marketplace, retailers have no choice but to pass along cost savings to consumers. Retailers, after all, are in the business of selling goods, and in the fiercely competitive retail market, as the price of retail goods falls, consumers are drawn to the lowest prices and best service available. Accordingly, retailers will return savings to consumers by lowering prices, reinvesting in new and current employees, opening new stores, and offering additional services to consumers.

Over the past few months, banks have also used scare tactics on consumers and opinion leaders, blaming the interchange reforms in Section 920 of the EFTA for the death of free checking. Such predictions are ungrounded. For example, TCF Bank of Wayzata, Minnesota, announced shortly after enactment of the statute that as a covered financial institution, it would have to eliminate the "free checking" services it offers its customers, and replace it with various service fees to recoup revenue. However, only one month after proclaiming the death of free checking, TCF Bank announced that it was reinstating free checking because consumers demanded it.[15] Other banks are more upfront about the illusion of free checking, with Bank of America spokeswoman Anne Pace saying that "Customers never had free checking accounts."[16] According to Pace, "They always paid for it in other ways, sometimes with penalty fees." And, for the small issuing banks, any impact on free checking is particularly specious since, as noted above, the statute expressly excludes small issuers for the limitations on interchange fees imposed by Section 920.

Any Delay of Final Rules and Implementation Is Unnecessary

RILA applauds the thorough and comprehensive work that the Board has done in the development of the NPRM, including the surveys of card issuers, networks and merchant acquirers, on which RILA provided separate comments. Board Chairman Ben Bernanke's recent remarks that the Board would be unable to issue final regulations by April 21, 2011, but that it would meet the statutorily mandated July 21, 2011, for final regulations to take effect is proof-positive that the Board is engaged in a thoughtful, fact-based process. Congress should not step in to interfere with this process and prejudge the final rules which have yet to be issued by the Board.

Opponents of the reforms have made clear their desire to use delay of the final rules as a way to thwart and unravel interchange reforms embodied in Section 920. RILA urges Congress to reject appeals for any delay in the issuance of the final rules. Doing so would not be in the public interest and would only allow the card networks and their issuing banks to perpetuate the broken market with respect to interchange fees while continuing to collect exorbitant interchange fees on debit card transactions that bear no relationship to the costs of processing the transaction.

Conclusion

RILA appreciates the opportunity to submit its views to the Subcommittee on the importance of Section 920 and its implementation by the Board rulemakings. The interchange reforms enacted in Section 920 are critically needed and will help restore a degree of competition to this broken market to the benefit of consumers and merchants, small and large, across the Nation. RILA and the broader merchant community urge the Subcommittee to let the Federal Reserve rulemaking process play out, and we will vigorously oppose any attempts to delay, amendment, or repeal these essential reforms.

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114 at *http://www.mastercard.com/us/merchant/index.html;* and Visa's operating rules at pp. 406–407 at *http://usa.visa.com/merchants/operations/op_regulations.html.*

[15] *See,* Chris Serres, "TCF Is Putting an End to Totally Free Checking", *Minneapolis Star Tribune* (Jan. 21, 2011), available at: *http://www.startribune.com/business/82255367.html.*

[16] Pallivi Gogoi, "Say Goodbye to Traditional Free Checking", Associated Press (Oct. 19, 2010), available at: *http://finance.yahoo.com/news/Say-goodbye-to-traditional-apf-1888087707.html.*

ATTACHMENT

"Addressing the Debit-Card Industry's Market Failure"—Report of James C. Miller III

A. Background and Expertise

1. I have been asked by the Retail Industry Leaders Association to offer my opinion regarding the Federal Reserve Board's (Board's) proposed rules implementing the "Durbin Amendment" to the Dodd-Frank Wall Street Reform and Consumer Protection Act—adding section 920 to the Electronic Fund Transfer Act (EFTA Act)—from the perspective of their appropriateness as a regulatory intervention in the market for electronic payments. In particular, I have focused on the appropriate policy response to collusive or otherwise parallel conduct by the major firms in an industry where there is asymmetry between the competitiveness of buyers and sellers.

2. As set out more fully in my curriculum vitae (Exhibit 1), this assessment is based on my extensive academic and governmental experience in the field of Government regulation (and deregulation). After a career in university teaching and research, I served in the Reagan Administration as the first Administrator of the Office of Information and Regulatory Affairs at the Office of Management and Budget (1981), as Chairman of the Federal Trade Commission (1981–1985), and as Director of OMB and Member of the President's Cabinet (1985–1988). Presently, I serve on the boards of several mutual funds and corporations, such as Clean Energy Fuels Corp., as well as the Board of Governors of the U.S. Postal Service. I hold a Ph.D. in economics from the University of Virginia and am the author or coauthor of over 100 articles in professional journals and nine books, including *Economic Regulation of Domestic Air Transport: Theory and Policy* (Brookings Institution, 1974), *Reforming Regulation* (American Enterprise Institute, 1980), *The Economist as Reformer: Revamping the FTC, 1981–1985* (American Enterprise Institute, 1989), and *Monopoly Politics* (Hoover Institution, 1999).

B. The Debit Card Industry

The existence of market power

3. The major card networks have monopoly power over merchants. In today's marketplace, merchants have no rational choice but to accept debit cards when presented by their customers, since the use of debit cards is so large and growing. Of the over $7 trillion in consumer expenditures for goods and services in 2009, approximately $1.6 trillion was transacted with debit and prepaid cards (for comparison, $1.8 trillion was transacted with credit cards and $1.6 trillion with cash.)[17] Because of their dominance of the card market, Visa and MasterCard control the costs merchants pay to accept debit cards as a means of payment.

4. There are several reasons for this conclusion. First is the history of development of the two major networks. Both Visa and MasterCard were organized by large banks and controlled by them. As they grew, it became increasingly worthwhile for major banks to issue both networks' cards to their customers. And since the banks controlled both systems—their representatives sat on the boards of both—it was only natural that the two card networks would establish schedules of services and prices that are nearly identical. By 2009, Visa accounted for 61 percent of all debit-card transactions, MasterCard for 23 percent, and a handful of regional networks for the rest.[18] Merchants have little choice but to accept cards from at least one of these two giant networks, and for survival reasons they usually sign with both. Accordingly, the market for debit card transactions—vigorously competing merchants on the one side and monopolistic card networks on the other—is quite asymmetric.

5. It is my understanding that over time the two card networks have charged consistent and increasingly higher interchange fees to merchants, all of whom are captive and have no countervailing pressure available to apply. In short, while banks have faced competition in many lines of their businesses, they have had no difficulty in monopolizing the market for card acceptance.

6. Moreover, I understand that debit cards were initially provided by regional networks using PIN authentication and the processing infrastructure of ATM-networks. These networks charged either zero (at-par) interchange fees or paid interchange fees to merchants to compensate them for their investment in PIN pads. After 1990, Visa and MasterCard began to promote their "signature" debit cards, processed over their credit-card networks. Signature debit interchange fees were set at the much-

[17] Nilson Report, Issue 962 (December, 2010), pp. 1 and 10–11.
[18] Nilson Report, Issue 961 (December, 2010). p. 10.

higher rates paid for credit-card interchange. I also understand that, around 1990, Visa purchased Interlink, which was among the leading PIN debit networks in the United States, and began to increase its interchange fees. As Visa continued to drive up Interlink interchange rates, the competing PIN debit networks raised their rates to maintain levels of issuance under the pricing umbrella created by Visa. The result has been a convergence of PIN and signature debit rates. Thus, the level of interchange fees charged for Visa's and MasterCard's PIN products, and those of the regional PIN networks, followed an upwards path, despite little evidence of increasing costs in making such transactions.

7. Monopoly power is also evidenced by the prices established by the card networks. The pricing schedules of Visa and MasterCard show a pattern of what economists call "third degree price discrimination"—which can take place only if there is monopoly power.[19] While the cost of a transaction hardly varies by type of merchant or size of a sale, the interchange fee does. Grocery stores, for example, typically pay a low base fee, whereas restaurants and airlines pay much higher interchange fees.[20] And the fee increases with the amount of the sale. It is easy to see that the card networks are establishing relatively low fees for merchants with relatively high (price-) elasticities of demand for payment cards, and higher fees for those with less elastic demands. The same is true with respect to size of sale: the larger the sale, the less elastic the demand. Again, in a truly competitive market, sellers are not able to divide the market and charge different prices to different consumers unrelated to differences in costs.

8. That this form of discriminatory (monopolistic) pricing is the norm was spelled out recently in Congressional testimony by Visa's General Counsel: "Products and services in this economy should be *fairly priced based on the value provided,* not some limited concept of cost, and certainly not on some artificially selected portion of those costs."[21] Again, in a competitive market, prices are related to costs, not to the benefits derived.

9. While debit-card networks establish very high, monopolistic fees for merchants, the issuing banks compete strongly for new card holders—which, of course, leads to more debit-card purchases and more interchange fee revenue. This competition for new card holders (or retention of current card holders) takes a peculiar form, however. The various issuing banks (in alliance with, and incentivized by, the card networks' schedule of charges) offer cards with extensive benefits. "Points" are the ubiquitous benefit—a sort of currency that can be traded for travel, goods, and even redemptions in cash. I also understand that special favoritism in the form exclusive offers on goods is also common.

10. The very existence of this extensive nonprice competition is itself an indication that the debit-card market is not fully competitive. If the banks and the card networks were not charging the merchants monopolistic rates, and instead were charging them truly competitive rates, the extent of such nonprice competition for cardholders would be much less. That is, such supracompetitive margins, built into the current interchange fee schedules, lead to marketing efforts that tend to "compete away" those very margins.

The setting of monopolistic interchange fees

11. The cards networks' rules and procedures make clear that each card system is the contractual "hub" through which their interchange fees are set—nominally in the best interests of all participants in the payment system, but actually on behalf of their card issuers.

12. Indeed, Visa's General Counsel has advised the Board that interchange fees should not reflect the costs of any particular card issuer, because the networks set fees for all of their issuers. "We believe that this approach [implementing the rate model at the network level] is the most practical and efficient for a number of reasons, including *the fact that the payment card networks currently set the interchange rates for debit transactions over those networks* . . . [and that] . . . *issuers do not in practice set interchange fees; rather, these fees are set by networks* and issuers accept transactions from different networks."[22]

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[19] *See,* for example, D. Salvatore, "Microeconomics: Theory and Applications" (2003), p. 334.

[20] *See,* for example, "Visa USA Interchange Reimbursement Fees" (October 16, 2010), p. 2; and (Visa) "Interlink Interchange Reimbursement Fees" (October 16, 2010), p. 2.

[21] Prepared Statement of Joshua R. Floum before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (February 17, 2011), p. 6; emphasis added.

[22] *See,* Letter from Joshua R. Floum to Louise Roseman, Director, Division of Reserve Bank Operations and Payment Systems, Federal Reserve Board (November 8, 2010), pp. 13 and 17; emphasis added.

13. In turn, once interchange fees are set, under the Visa and MasterCard rules—which are binding contracts between each network and its issuers and acquirers—the networks' members use those rates in their payment card transactions.[23]

14. Finally, the networks' "honor all cards" rules bind merchants to this result. Once a merchant decides to accept Visa or MasterCard debit cards, for example, it must accept all debit cards of that type bearing the network's logo. There is no need for each bank to negotiate with individual merchants to accept its debit cards. Thus, networks' current rules enable each debit-card-issuing bank to take advantage of the network's monopoly power to obtain excessive interchange fees.

15. Deposit accounts are not offered in isolation, but as a means of generating funds that enable banks to make loans—which, in turn, provide interest revenue. For example, in the case of checks, the customer's bank absorbs all the cost of the transaction (except for fees that may be charged by the merchant's bank for depositing a check). Banks have traditionally done so precisely because demand deposits enable the bank to make loans, on which the bank earns interest, and because the relationship opens opportunities for the bank to provide other (remunerative) services to the customer.

C. EFTA Act, Section 920

16. I have reviewed Section 920 of the EFTA Act, the Board's proposed rulemaking implementing that section,[24] and major submissions to the Board pursuant to that proceeding. Section 920(a) requires the Board to establish standards governing debit-card interchange fees. The statute defines those fees as "any fee established, charged, or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction."

17. The scope of price intervention required by the statute is narrow: it does not address prices charged by an acquiring bank for its role in processing the merchant's debit-card transactions, nor does it restrict the fees that a card network may charge acquiring and issuing banks for its role in processing such transactions (except to prevent evasion of the interchange fee standards). As I will discuss below, this limitation on the Board's regulatory power is appropriate, as such additional constraints are not needed to accomplish the objective of making the card market more competitive. By its terms, the statute does not address independent action by a debit-card issuer to charge transactions fees directly to merchants (possibly through the merchant's acquiring bank) when one of the issuer's cardholders purchases goods or services from the merchant, leaving such transactions to the ordinary forces of competition. This competition could take many forms and would be based on rivalry among individual card issuers (without reliance on networks or honor-all-cards rules) to gain acceptance of that card as a payment mechanism at individual merchants. There would be no need for regulation to limit fees that might be charged as a result of interaction between individual merchants and individual issuers, as long as those fees are transparent and are subject to the discipline of market competition. Thus, in such a competitive environment, there would be no need for regulators to specify what costs such fees might or might not recover.

18. In contrast, section 920(a) addresses fees collected by debit-card issuers when those fees are charged by or through a network, thus enabling an issuer to utilize the network's market power. In this regard, while subsection 920(b)(2) gives merchants the right to provide discounts and other incentives for differing forms of payment—cash, checks, debit cards, or credit cards—it is my understanding that the "honor-all-cards" requirements of Visa and MasterCard, for example, will continue to require nondiscriminatory acceptance of cards from every issuer of the relevant type of card offered by the card network.

19. Section 920(a) simply ensures that when debit-card issuers rely on card networks' market position to obtain compensation from merchants as a result of card acceptance, the level of those fees are not set at a supracompetitive level but are "reasonable and proportional" to the card issuers' incremental costs for authorization, clearance, and settlement of those transactions.

20. Importantly, Section 920(b)(1) sets in motion potential longer-term structural reform by (a) ensuring that card issuers offer multiple networks for the routing of debit-card transactions for each type of card authorization method, and (b) giving each merchant the ability to direct and/or prioritize the choice of network to be used

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[23] *See,* for example, Visa International Operating Regulations (Public Version, April 1, 2010), pp. 57 and 961–962; Visa, Inc. SEC Form 10-K (November 19, 2010), p. 13; and MasterCard Rules, Section 9.4 (October 29, 2010). The rules technically permit issuers and acquiring banks to enter into bilateral interchange arrangements, but as noted in paragraph 12, such bilateral arrangements have not occurred in practice.

[24] Federal Reserve Board, Notice of Proposed Rulemaking, 75 Federal Register (December, 28, 2010), pp. 88722 *et seq.*

in a debit-card transaction. To the extent that these provisions are implemented in an effective and timely manner, networks may, arguably for the first time, compete on price for merchants' business.

D. An Appropriate Response to Market Failure

21. Throughout my career I have been a consistent skeptic about the ability of Government intervention to improve the functioning of the marketplace. But sometimes a free market does not—or for any number of reasons cannot—correct a divergence from the competitive norm. The persistence of such divergences over time, uncorrected by unencumbered economic forces, is among the few scenarios in which I believe there is reason for Government to examine and possibly correct the underlying cause.

22. In the case of interchange fees—and debit interchange fees in particular—the case for regulatory intervention is strong. This is truly a case of market failure: networks with monopoly power over merchants are setting prices for merchants' access to their networks on behalf of their (frequently overlapping) card-issuing members, utilizing agreements in which every bank participating in those card networks agrees to charge merchants exactly the same interchange fees, regardless of who issued the card. Thus, regulatory intervention is warranted to provide the catalyst to return this market to the competitive norm and thus increase the market's overall efficiency.

23. The pricing solution chosen by section 920(a) and the Board's proposed interchange fee standard approximates the pricing outcome that would obtain in a fully competitive market—that is, prices based on costs, not demand. Further, the relevant costs identified in the statute and incorporated by the Board in its notice are those costs that I understand are directly incurred in processing each transaction: the costs of authorization, clearance, and settlement.[25]

24. Most significantly, section 920(a) requires regulation only of debit-card interchange fees established by payment card networks. Issuers are free to charge fees for card acceptance negotiated directly with merchants as long as the imposition of these fees is not characterized by market failure, including network honor-all-cards rules. Thus, the proposed regulations appear to be consistent with both the limited mandate of section 920 and the policy prescriptions embodied in that provision.

25. It is also notable that the regulatory scope of Section 920 is narrow. It does not regulate any fees that a debit issuer imposes individually and directly (rather than through a network) on merchants or other parties. There should be no market failure associated with such issuer-specific fees as long as they are subject to the discipline of market competition. It is appropriate, therefore, that Section 920 was drafted to leave such fees unregulated under those conditions.

26. Finally, the rules proposed by the Board to implement subsection 920(b)(1) to provide multiple network options on a card and to mandate merchant selection of network routings, promise a longer-term marketplace solution. If implemented to require at least two network choices for each PIN and signature method of authorization, there should be a meaningful increase in competition among issuers. By choosing the lower-cost option, merchants could force issuers and card networks to reduce their interchange and network fees—perhaps making the regulation of fees no longer necessary, once competition were firmly in place.

[25] *See,* Federal Reserve Board Notice, *ibid.,* pp. 88722 and 88735. I realize that the Board is undertaking a separate rulemaking regarding an adjustment for issuer-specific fraud prevention costs using the statutory considerations for such an adjustment, but that is beyond the scope of my report.

EXHIBIT 1

James C. Miller III

Curriculum Vitae
January 2011

Education and Professional Activities

Degrees:	Ph.D. (Economics), University of Virginia, 1969
	B.B.A. (Economics), University of Georgia, 1964
Current Positions:	Senior Advisor, Husch Blackwell Sanders, LLC, since June, 2006
	Senior Fellow (by courtesy), Hoover Institution (Stanford University), since December 1988
	Distinguished Fellow, Center for Study of Public Choice, George Mason University, since October 1988
	Member, Board of Governors, U.S. Postal Service, since April 2003 (elected chairman 2005, 2006, and 2007))
	Member, Board of Directors, Washington Mutual Investors Fund, since October 1992 (Member of Advisory Board, November 1989 – October 1992)
	Member, Board Directors, The Tax Exempt Fund of Maryland, since April 2000
	Member, Board of Directors, The Tax Exempt Fund of Virginia, since April 2000
	Member, Board of Directors, The J.P. Morgan Value Opportunities Fund, since December 2001
	Member, Board of Directors, Clean Energy Fuels, Corp., since May 2006
	Member, Board of Directors, Americans for Prosperity, since February 2004

Member, Board of Directors-Emeritus (previously Co-Chairman or Counselor), The Tax Foundation, since October 1989

Chairman of the Executive Committee, International Tax and Investment Center, since September 2009

Previous Positions: 2010

Member, Board of Directors -Emeritus (previously Member of Board), Progress & Freedom Foundation, April 1994 – March

Chairman of an Independent Commission to address the fiscal challenges of Cayman Island Government; established by Cayman Islands Government; October 2009 – February 2010

Chairman (or Chairman Emeritus), The CapAnalysis Group (of Howrey, L.L.P.), April 2002 – January 2006

Chairman (or Chiarman Emeritus), The CapAnalysis Group)of Howrey, L.L.P.), April 2002 – January 2006

Member, Board of Directors, Independence Air (formerly Atlantic Coast Airlines d.b.a. "United Express" and "Delta Connection"), March 1995 – January 2006

Member, Board of Visitors, George Mason University, June 1998 – June 2002

Distinguished Fellow, Mercatus Center, George Mason University, August 1997 – April 2003

Director, LECG – Economics-Finance, November 2002 – April 2003

Senior Advisor, Hagler Bailly, January 2000 – November 2002.

Member, Board of Directors and/or Counselor), Citizens for a Sound Economy, January 1989 – April 2003

Member, Board of Directors, The Tax Foundation, October 1989 – April 2003

Member, Board of Visitors, U.S. Air Force Academy, November 1988 – November 1990.

Director, U.S. Office of Management and Budget, Member of President's Cabinet, and Member of National Security Council, October 1985 – October 1988

Vice Chairman, Administrative Conference of the United States, December 1987 – October 1988 (Member of Council, November 1981 – December 1987)

Chairman, U.S. Federal Trade Commission, September 1981 – October 1985

Administrator, Office of Information and Regulatory Affairs, U.S. Office of Management and Budget; and Executive Director, Presidential Task Force on Regulatory Relief, January 1981 – September 1981

Resident Scholar, Center for the Study of Government Regulation, The American Enterprise Institute for Public Policy Research, January 1977 – January 1988; Co-Director of the Center, March 1977 – January 1981; Member, Board of Editors, Regulation, July 1977 – January 1981; and Member, Board of Editorial Advisors, The AEI Economist, September 1977 – January 1981

Consultant, National Science Foundation, July 1977 – January 1981

Lecturer (in Economics), George Washington University, September 1971 – May 1972, September 1975 – May 1976, and September 1978 – December 1980

Assistant Director (for Government Operations and Research), U.S. Council on Wage and Price Stability, October 1975 – January 1977

Adjunct Scholar, The American Enterprise Institute for Public Policy Research, May 1975 – January 1977

Senior Staff Economist, U.S. Council of Economic Advisers, July 1974 – October 1975

Associate Professor of Economics, Texas A&M University, August 1972 – May 1974

Consultant, U.S. Department of Transportation, March 1972 – July 1974

Consultant, National Bureau of Standards, January 1974 – June 1974

Research Associate, The American Enterprise Institute for Public Policy Research, May 1972 – July 1972

Associate Staff, The Brookings Institution, August 1972 – May 1974

Senior Staff Economist, U.S. Department of Transportation, December 1969 – February 1972

Assistant Professor of Economics, Georgia State University, September 1968 – December 1969

Affiliations: American Economic Association

Public Choice Society

Southern Economic Association (Vice President, 1990 – 1991; Member of Executive Committee, 1980 – 1982)

Selected Publications and Presentations

Books: Monopoly Politics (Stanford: Hoover Institution Press, 1999)

Fix the U.S. Budget!: Urgings of an "Abominable No-Man" (Stanford: Hoover Institution Press, 1994)

The Economist as Reformer: Revamping the FTC, 1981-1985 (Washington: American Enterprise Institute, 1989)

The Federal Trade Commission: The Political Economy of Regulation (co-editor and contributor, with Robert J. Mackay and Bruce Yandle; Stanford: Hoover Institution Press, 1987)

Reforming Regulation (co-editor and contributor, with Timothy B. Clark and Marvin H. Kosters; Washington: American Enterprise Institute, 1980)

Benefit-Cost Analyses of Social Regulation: Case Studies from the Council on Wage and Price Stability (co-editor with Bruce Yandle; Washington: American Enterprise Institute, 1979)

Perspectives on Federal Transportation Policy (editor and contributor; Washington: American Enterprise Institute, 1975)

Economic Regulation of Domestic Air Transport: Theory and Policy (with George W. Douglas; Washington: Brookings Institution, 1974)

Why the Draft?: The Case for a Volunteer Army (editor and contributor; Baltimore: Penguin Books, 1968)

Monographs:

The Economics of the Military Draft (with Ryan C. Amacher et al.; Morristown: General Learning Press, 1973)

Transportation Legislation (published anonymously; Washington: American Enterprise Institute, 1972)

Articles:

"Public Choice Theory and Antitrust Policy: Comment," Public Choice (March 2010).

"Economics and the All-Volunteer Military Force" (and with Beth J. Asch and John T. Warner), in John Siegfried, ed., Better Living Through Economics (Cambridge: Harvard University Press, 2010)

"An Event Analysis Study of the Economic Implications of the FCC's UNE Decision: Backdrop for Current Network Sharing Proposals" (with Jeffrey A. Eisenach and Paul S. Lowengrub), 17 Commonlaw Conspectus 33 (2008)

"Monopoly Politics and Its Unsurprising Effects," in Roger Koppl, ed., Money and Markets : Essays in Honor of Leland B. Yeager (London : Routledge, 2006)

"The Tyranny of Budget Forecasts" (with J.D. Foster), Journal of Economic Perspectives (Summer 2000)

"Incumbents' Advantage," George Mason University, Working Papers in Economics (December, 1997)

"Suggestions for a Leaner, Meaner Budget," Jobs & Capital (Spring 1995)

"Budget Process and Spending Growth" (with Mark Crain), William and Mary Law Review (Spring 1990)

"Independent Agencies -- Independent from Whom?," Administrative Law Review (Fall 1989)

"A Reflection on the Independence of Independent Agencies," Duke Law Journal (1988)

"It's Time to Free the Mails," Cato Journal (Spring/Summer 1988)

"Spending and Deficits" (with an introduction by Robert D. Tollison), G. Warren Nutter Lecture in Political Economy, The American Enterprise Institute for Public Policy Research, 1987; reprinted in Thomas Jefferson Center Foundation, Ideas, Their Origins, and Their Consequences (Washington: American Enterprise Institute, 1988)

"Predation: The Changing View in Economics and the Law" (with Paul Pautler), Journal of Law and Economics (May 1985)

"Comments on Baumol and Ordover," Journal of Law and Economics (May 1985)

"Industrial Policy: Reindustrialization through Competition or Coordinated Action?" (with Thomas F. Walton, William E. Kovacic, and Jeremy A. Rabkin), Yale Journal on Regulation (1984)

"The Case Against Industrial Policy," Cato Journal (Fall 1984)

"Report from Official Washington," Antitrust Law Journal (1984)

"Reindustrialization Policy: Atari Mercantilism?," in Richard B. McKenzie (ed.), Plant Closings: Public or Private Choice? (revised edition; Washington: CATO Institute, 1984)

"Resale Price Maintenance: An Analytical Framework," Regulation (January/February 1984)

"Is Organized Labor Rational in Supporting OSHA?," Southern Economic Journal (January 1984)

"A Note on Centralized Regulatory Review" (with William F. Shughart II and Robert D. Tollison), Public Choice (January 1984)

"Comparative Data on Life-Threatening Risks," Toxic Substances Journal (Summer 1983)

"Report from Official Washington," Antitrust Law Journal (1983)

"Occupational Exposure to Acrylonitrile: A Benefit/Cost Analysis," Toxic Substances Journal (Winter, 1982/1983)

"Report from Official Washington," Antitrust Law Journal (1982)

"Regulatory Relief under President Reagan," Jurimetric Journal (Summer 1982)

"The (Nader-) Green-Waitzman Report," Toxic Substances Journal (Winter 1980/1981)

"Has the 1970 Act Been Fair to Mailers?" (with Roger Sherman), in Roger Sherman (ed.), Perspectives on Postal Service Issues (Washington: American Enterprise Institute, 1980)

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Other testimony before the Department of Energy, the Civil Aeronautics Board, the Interstate Commerce Commission, the

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Presentations before Committees of the	U.S. Senate Committee on Appropriations; U.S. Senate Committee on the Budget; U.S. Senate Committee on Commerce, Science, and Transportation; U.S. Senate Subcommittee on the Constitution, Committee on the Judiciary; U.S. Senate Committee

U.S. Senate:	on Governmental Affairs; U.S. Senate Committee on the Judiciary; U.S. Senate Committee on Small Business; U.S. Senate Subcommittee on Administrative Practice and Procedure, Committee on the Judiciary; U.S. Senate Subcommittee on Antitrust and Monopoly, Committee on the Judiciary; U.S. Senate Subcommittee on Alcoholism and Drug Abuse, Committee on Labor and Human Resources; U.S. Senate Subcommittee on Aviation, Committee on Commerce, Science and Transportation; U.S. Senate Subcommittee on Commerce, Justice, State and Judiciary, Committee on Appropriations; U.S. Senate Subcommittee on Consumer, Committee on Commerce, Science and Transportation; U.S. Senate Subcommittee on Federal Expenditures, Research and Rules, Committee on Government Affairs; U.S. Senate Subcommittee on Intergovernmental Relations, Committee on Governmental Affairs; U.S. Senate Subcommittee on Productivity and Competition, Committee on Small Business; U.S. Senate Subcommittee on Regulatory Reform, Committee on the Judiciary; U.S. Senate Subcommittee on Treasury, Postal Service, and General Government Appropriations; and U.S. Senate Special Committee on Aging
Presentations before Joint Congressional Committees:	U.S. Joint Economic Comm. Subcommittee on Economic Goals and Intergovernmental Policy, U.S. Joint Economic Committee; Subcommittee on Trade, Productivity and Economic Growth, U.S. Joint Economic Committee; Congressional Grace Caucus; and Motor Carrier Ratemaking Study Commission
Expert Reports:	Various